The Issue

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Looking to Sell Your Company?

Gain from the recent perspective of experienced professionals

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Our M & A practice group has managed the financial aspects of numerous transactions during the first nine months of 2014 both from a buy side and a sell side, two transactions for sellers closed last month alone. In addition, we have been supporting the seller in $1.4B transaction with a public company in Europe over the past six months that closed in October.

The corporate world is in the midst of a grand shopping spree however how does this activity relate to the decision to sell your company. I spoke to more than a dozen advisory, part- and full-time CFOs who generously shared their collective wisdom and personal experience regarding the process of preparing for and selling their businesses. Here are their and my thoughts.

This is likely the most important question to ask: "when should I sell?" There is no one answer for everyone however reasons tend to fall into three broad categories: personal situation, market situation and business situation.

<u>Personal Situation</u> (the needs of ownership and management).
"For the health and wealth diversification of the primary shareholder, I knew that it was time" said one CFO who recently negotiated the sale of the company to a private equity firm. "I feel fortunate that the rest of management and I contemplated the event three years before we actually sold. We were well prepared from an accounting, legal and management team perspective."

Lessons:

- Anticipate that with age comes a declining capability (perhaps interest too) to execute at competitive levels.
- Keep your options to sell open by understanding and performing at the market standards for accounting and legal.   Build an effective management team.

In another instance, age and diversification were the factors.   "I knew it was time for the shareholders to sell as all their eggs were in a single basket (the business) and at their ages (late 50s/early 60s) they should not risk going through another recession," said another CFO whose company recently sold to a strategic buyer.

Lessons:

- Understand how the business fits in the overall personal portfolio of the shareholders.   This means understanding how and when retirement will be funded.

Market Situation (externalities including market economics, customers and competition)
One CFO recalled, "Most of the shareholders felt that it was too soon to sell.   It was 2006. We had just turned the business around, we had momentum in our favor - sales growth was stronger than ever".   The CFO continued, "I remember a meeting when I said that it will take us five years of near perfect execution to get close to the offer price.   There is too much risk in not taking the deal.   We all know now that the Great Recession of 2007/2008 would have made even that impossible".

Lessons:

- Understanding valuation and the ability to model/evaluate potential business outcomes is essential to the decision to sell.

Of course, everyone wants to sell when they are hitting all-time profit and sales records.   However one CFO pointed out that "buyers are looking for additional forward momentum in the business and in the economic cycle. Therefore, smart sellers realize that they need to leave a little bit of the upside for the seller."   "This means that to get potential buyers excited about the business at the valuation, they will need to see that with additional time and effort on their part, they will maximize their investment. Therefore, put in the effort to show that you are leaving plenty of upside on the table for the buyer; doing so is often a wise move and a little counterintuitive."

Lessons:

- Understanding both the market timing and the execution performance risks of the business is critical to the decision to sell.

Business Situation (internalities including growth, profitability and technology)
A former CFO of a fast growing franchisor said, "Our situation was really a strategic decision to focus our business more narrowly geographically.   We recognized that our southeastern franchisees were the most difficult (and expensive) to manage.   While selling those operations to a regional competitor achieved at an above average valuation, it was a game changer for us as it returned valuable growth capital to the company which narrowed our focus and got us back to profitability".

Lessons:

- Understanding revenue and costs by products, distribution channels and regions opens up the possibility of effective business strategy.

Another CFO described a situation in which the talent required to grow the company to the next level was not present in the current management team. "Basically, we were an engineering and content production company that had produced an exceptional SaaS platform," stated the former CFO. He added, "In order to optimize the business opportunity, we needed to invest in product marketing and sales including the talent to lead those departments. Headcount goals in marketing and sales that formed the underpinnings of our revenue assumptions in our operating plan went unmet for 5 months – sales bookings were flattening. I (the CFO) said look, let's be honest with each other – we have a very valuable company that is more than sufficient to take care of each of our personal financial requirements. We are no longer willing to take the risks necessary to take advantage of the business opportunity, let's look to merge or sell." The CFO prepared the company information and presented the company to four strategic buyers. The company was sold within three months.

Lessons:

- Know the value of your business today and the steps that must be taken to optimize value over the next 3 to 5 years. Are you able and willing to take them?

One CFO of a research and development company I spoke to suggested that an appropriate time to sell is when the capabilities and the finances of the company have reached their limit and the failure to grow or complete a project will eventually lead to losing out to the competition and maybe even losing the company. "In the area of research and development", the CFO explained, "if a company with limited resources is racing to develop a product that other companies with significantly larger resources are also working on, it may be time to bundle up the IP and sell to someone who has the scale to complete the project".

Lessons:

- Know your limitations and structure your milestone path so that at any critical points your company could "plug into" one or more of the larger companies in the same field.

I have spent a fair amount of space in this article on knowing when to sell a business. Now I want to address the expertise, the process of evaluating the buyer and the terms & conditions to successfully maximize your sales price.

Advisors

Being able to rely on strategic advice through this process is critical. The fact is that most often, the buyer is going to be more experienced than the seller. So do yourself a favor and get the best M&A attorney that you can find. It helps if they have industry experience however transaction experience is a must. Also, be sure to seek out a personal business tax advisor to help you structure the most tax efficient deal and help you understand what your net after tax proceeds will be. Investment bankers are also very important to most sellers in advising on valuation. They will help you put all the key information of the business together in an organized and easy to read fashion. They also play an important role in finding buyers, negotiating and communicating to the buyer universe and helping to get the deal closed. The right banker for you will have knowledge of the subject matter, the industry and the acquisition activity in your industry. They are also in the position to attract multiple buyers and be the effective conduit between those buyers and the seller in a way that would be very difficult for the Seller to manage.

One CEO stated that he could not have selected the advisors without the help of his CFO let alone manage them effectively during the transaction.

It's very difficult and important to negotiate a fair deal when emotions are running high during the negotiations. One CFO said, "Our bankers did an exceptional job in keeping us informed, our emotions in check and guiding us along the way."

The CFO's role in this process is to anticipate information needs and prepare for them well in advance so that once the process starts there will be no delays in answering the questions that will always get asked – what does the financial history look like, is it reliable, is the propriety information adequately protected, what are the costs and where are the pressure points on profitability, what is the per-unit profitability, who are the key human resources and what are their credentials, what are the barriers to entry, etc.
Someone needs to build the "data room," "bible," or "brick" and it typically is the CFO - with the help of the advisors (lawyers, bankers, brokers, tax advisors, and outside accountants).
Not having an advisor to smooth the way can be disastrous. One CEO who was able to hold the role of his company's CFO during normal times said, "I wish that I had hired a consulting CFO to provide the accounting and tax advice from the outset to help me understand the after tax net of all fees and post close amounts. We completely misunderstood some of the terms in the Letter of Intent that derailed the sale at the close date after spending over a hundred thousand dollars of due diligence dollars and divulging trade secrets to our strategic buyers. I was stunned to learn that the total net proceeds would not meet the shareholders' financial goals. It was a frustrating, emotional and embarrassing time."

Determining the Best Buyer

This process can be a difficult one. The right buyer can make the process easier. But there is no right or wrong answer when it comes to what would be the best buyer for your organization. It boils down to the combination of valuation, deal structure, vision for the business, cultural match and timing for both the buyer and seller.

Many considering a sale wonder if it is better to sell to a strategic or a financial buyer, public or private entity. The answer varies depending on the situation. One CFO said that "we found it all with a private equity firm as they had just purchased a competitor and wanted more scale into our customer segment. We were the perfect match for each other and the pricing reflected that."

Another CFO stated, “We were happy to sell to a competitor. They understood better than anyone the value of the business that we had built and they wanted our technology as well. They were able to maximize our technology across an international platform and potentially multiple customer groups.”

It took an offer from a competitor for one company to consider selling however they opted to sell to their employees after their CFO produced an exhibit for management that showed how an ESOP might accomplish more of the family owned business’ objectives. Said the CFO, “The employees were more like family than employees and they wanted to know how they fit into the company’s future. While the family owners represented over half of the management team, they were 3-5 years from retirement. Selling the business was more about management succession, funding their retirement and estate planning.”

Another consideration when selling is cultural fit. One CFO whose company sold to a financial partner said, “I wish that we could have found a buyer who had knowledge of our business operations sufficient to scale the business. The buyer (a private equity firm) did not understand our business. This created its own set of problems, such as constantly explaining the business to them, he explains. It would have made a world of difference to have a buyer that understood the business.”

Another CFO has no regrets. “Our buyer (a private equity firm) has taken great care of our former colleagues and they have done a good job in growing the business,” says one CFO. “Their management team and our management team look at the marketplace similarly and for that reason I feel that the transition went well for everyone involved, our shareholders, former employees and the buyers.”

Yet another CEO acting as the company’s CFO has many regrets. In one situation, the prospective buyer was a competitor who seemingly had a strategic fit for the products being developed by the seller. However, as he later learned, the buyer wasn’t interested in buying at all. They were just interested in distracting management long enough for them to run out of money, thus eliminate a competitor.

In another situation, this same CEO acting as the company’s CFO experienced the tactic of a strategic buyer pretending to want to buy so that otherwise secret information can be more fully understood by them in the due diligence phase. While a Non-Disclosure Agreement sounds like protection, it oftentimes is not. It is impossible to “un-ring the bell” once proprietary information is disclosed. It is forever known. Also, key employees become known to the competitor and thus become “poaching” candidates.

This CEO advises, “Be very careful when a strategic buyer or competitor comes knocking or when a banker or broker suggests one as a suitable buyer. The story does not always end well.”
Protection against mischievous motivations may be a significant escrowed disclosure fee creditable against the purchase price or forfeited if no deal is consummated.

Valuation and Earn-Out
The best transactions are a “win-win” for all parties concerned, it is important to determine what that valuation will be.

This is very tricky, as is weighing one offer against another. This is one of the reasons having tax, legal and investment banking advisors is so important. They can help sellers understand and properly structure transactions. The advisors also serve to keep emotions in check during a highly stressful time. Valuation ranges will vary widely by size, growth rates, EBITDA margins and verticals. Investment bankers can advise you on what to expect up front before the process begins.

Consideration given in exchange for the sale of a company, can come in the form of cash, shares of the acquiring company's stock, or some combination thereof. If accepting stock as part or all of the consideration, one must consider the viability and future potential of the acquiring company, and whether the acquirer is a public or private company. By accepting stock, the sellers are inexorably tying the value received to the future success of the acquirer. Whereas public company shares are highly marketable, private company shares are less so. This doesn't mean never to accept private company shares, just be more cautious. According to Facebook's Mergers and Acquisition executive, more than half the company's acquired by Facebook before it was public, chose Facebook stock over cash, when given the choice.

It's rare in today's private company market that anyone receives a 100 percent cash deal structure without an earn-out (the promise of a future payment based upon achieving future financial targets post-close). But an earn-out is not without its risks for the sellers. One CFO reported that, "While I am sure that the timing to sell was right, the earn-out was outside of our control and was left in the hands of the buyer to perform. Our buyer had to file for bankruptcy protection in 2009 which ultimately cost us our earn-out."

Another CFO had to deal with different issues that also hurt his earn-out. "Unfortunately, (the buyer) made key changes from day one that hurt the business' performance before they completely understood our company. Our earn-out was based on net profits that were completely out of my control and the new company weighted us down with overhead burden. I will be smarter the next time around."

A lesson learned may be to base subsequent performance metrics that affect price on units delivered, customers obtained, gross revenue, or something that is easily verifiable and not susceptible to adjustment or "judgment."
While rare, strategic buyers will sometimes buy 100 percent of the company. Most private equity buyers will ask management to roll 20 percent or more of their equity forward for a minimum of three to seven years. Add in the likelihood of an earn-out and it's easy to see why picking the right buyer is so critical.

Ready to Sell or Not, Get Ready

The best advice that the CFOs and I have is to get ready now and keep yourself ready so that when the opportunity comes you can respond quickly. You often can't plan exactly when that moment will be. You should run your business using sound business judgment and fundamentals, and keep one eye on the future for what, for most owners, will be an inevitable event.

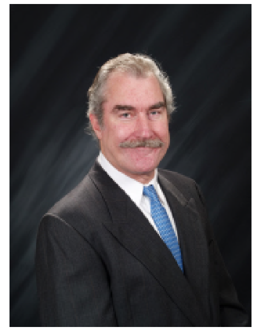
And if there is something that is likely to be inescapable in business, understanding the process is smart. One CEO/business owner wished that he had comprehended the M&A process better as he did not distinguish between what a business broker was capable of performing compared to an investment banker. "When we sold to a strategic buyer, management was not prepared for the time away from its core business and the energy it took meeting with multiple buyers over several months. We might have kept the company longer had we understood the process," he says.

These sentiments are shared by many CEO/business owners. One of the CFOs interviewed had a saying to explain this sentiment – "All my wealthy friends sold too early!" The CFO (who had completed at least a half dozen transactions) explains, "Without exception, everyone I spoke with felt that as the sale of the business drew nearer, they felt that they were likely selling too early and there was just a little more value they could have squeezed out of the deal or the business. Trying to squeeze the last ounce of value out may well kill a deal.

In a future issue of our newsletter, I will address the subject from the buyer's side; when do you want to buy a business and what due diligence is necessary.

Summary

Our M&A practice group helps companies navigate complex buy-side or sell-side transactions with speed and agility anywhere in the U.S. by providing "as needed" CFO support whether in an advisory, part- or full-time capacity. In addition, we are able customize "arm and leg" support talent for the transaction including in evaluation, diligence and integration. Gain from our professional experience.



Bob Weis is the founder and CEO of CFOs2GO and CIOs2GO. He leads both the M&A and the International Practice groups that mesh traditional tax, accounting, IT and human resource consulting with innovative recruiting services that are designed to produce unmatched value for our client companies by taking care of their unique concerns.

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