Mergers & Acquisitions Part 1

M&A how to prepare for sale

by Doug Cerny of Pagel, Davis & Hill

First in a series of four articles on the preparation and steps involved in the sale of your business.

A prospective buyer is interested in talking to you about your component manufacturing business. Are you ready to entertain discussions?

at a glance

- Think ahead so you are prepared before you get a phone call or visitor interested in purchasing your business.
- Thinking about your role after the business is sold is one of the first decisions you should consider.
- Because the buyer will want to understand the operations and financial aspects of your business, be prepared for a lengthy timeline and some disruption.
- Consider a confidentiality agreement in order to keep the control of the process in your court.

You started your manufacturing business because you wanted to be in control of your destiny. You saw needs in the marketplace and had a vision of how you could build a company that would meet those needs. You continue to build your business. Tomorrow morning your phone rings and the caller identifies himself as a representative for a private equity firm that is interested in meeting with you to discuss "exploring purchase" options. Are you ready to go down this path?

Virtually every entrepreneur that has started, built and sold a business will tell you that the next time they sell their business there are certain things that they will do differently. Whether it involves how they have structured ownership, organized their management team or positioned their business in the marketplace, or how they disclosed information to the ultimate purchaser, they all have a story about how they will do it differently the next time. The lessons they have learned in this process present valuable insight to those who have not sold a business before.

This is the first in a series of articles that will touch upon various things that should be considered when going through the sales process. Future articles in this series will address:

- Keeping all relevant conditions (or terms) in the negotiations while pursuing agreement on **valuation** and bridging the gap when agreement cannot be reached on valuation.
- Engaging advisors: why, who, when and at what price?
- Protection features sought by the buyer in the signed agreement: **escrow, representations and warranties, indemnification** and **right of offset**.

To view the definitions of the terms highlighted in this article, visit **Support Docs** at www.sbcmag.info.

In this article, we will examine the questions you ought to consider while beginning the process of selling your business. Knowing what you want and to assess, as best you can, what the prospective buyer wants is the most critical first step. A good starting point is to spend some time thinking about your current role and what, if any, future involvement you want in the business. Is the role you have been playing the one you want to continue to play? If you have been active and now want to spend time on other things (perhaps enjoying the money you received), do you have management in place to take over your responsibilities? Will the purchaser view your current management team to be capable of operating the business on their behalf? Walking into the negotiation phase with the answers to these questions will not only lay the foundation for a smooth and successful negotiation process, but it will also prepare you for big changes on the horizon.

Next, anticipate the factors that will be presented throughout the valuation process. For instance, do you have realistic expectations as to how a prospective buyer will view the value of your business? Just as the economy goes through ups and downs, the **valuation multiples,** which dictate the price at which companies may sell, will also go up and down, often as a result of factors completely outside your business itself. For example, if a **private equity group** or a series of financial groups have become interested in the component manufacturing industry, this type of external factor can be a reason for a higher valuation multiple because there are buyers chasing sellers. The same thing can hold true if there are one or more large companies in the same or similar industry that are looking to grow through acquisition to get the benefits of scale.

Time Is Not Always on Your Side

It is also important to recognize that discussions with any prospective buyer do not always happen on your timeline. Just as selling a house involves timing issues, so does selling your business—only to a magnified degree. Therefore, as you run your business and would be interested in holding discussions with a viable prospective buyer or buyers, you need to be prepared for those kinds of discussions to happen any time.

Keep in mind that the process of holding discussions and working toward closing can be quite disruptive. Before the closing, the buyer will want to conduct "due diligence" and understand intimately the operations and financial aspects of your business. You, on the other hand, will want to know if their valuation views are anywhere in line with your views. You also will want to give them enough background information they need to structure an offer—but you don't want them to spend so much time on the analysis process that the disruption to you (and possibly others in your company) becomes a detriment to the business.

Think Ahead

So, before you get that phone call or visitor interested in your business, think about the following:

- Is your ownership structure in line with where you are and where you are going? For example, have you made commitments to employees or others that need to be documented?
- Do you want to have a portion of your business owned by a trust or family partnership for the estate planning benefits that can be derived from these entities?
- Are you comfortable enough with your skills to "go it alone" in the negotiation process? For which areas should you seek the advice of a professional (tax advisor, valuation expert, business transaction lawyer, etc.)?
- It is normally preferable for you to sell stock rather than assets (assuming you are incorporated). Is this possible and what are the tax effects?

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- What type of consideration will you want or can you live with (cash, notes, stock or a combination of two or more of these)?
- Are there certain employees that you want to assure are properly taken care of?
- Do you have the various assets (operating assets, real property assets, etc.) in the proper entity or entities?
- Are there certain assets (such as real property) that you want to retain rather than sell?
- Are you prepared for the time and attention the negotiation and sales process will take away from your business?
- Are there aspects of your business that you do not want to disclose until you are sure that the buyer is serious?
- Are your records in order for assembly and delivery to aid the buyer's due diligence? (I often advise clients that are getting ready to sell a business for the first time that they will get to know their business in more detail than they ever have before.)
- Do you know what your business will look like to the prospective buyer? For example, is he going to view your salary as too high and could you consider the excess portion as earnings? Or, is he going to take the position that your salary does not reflect what it will cost him to get the same management in place and he will want to lower the earnings stream because he will be paying a higher salary to the next leader?

The analysis of, and answers to, each of these questions will guide you in determining the key drivers in your discussions and negotiations. You will likely complete the analysis of some of these questions with help from the advisors you engage; after their input, you will have to weigh the various paths you could take and determine the importance of each path.

Take Control!

As a prospective seller that is serious about assuring that the process will be as efficient as possible, you will want to do as much as you can to control the process. This means you should have a confidentiality agreement in place before you disclose anything to any prospect. You may also want to structure the process in stages: after the confidentiality agreement is signed, you deliver a set of financial statements to the prospect. To the extent possible, you will want to normalize your financial statements with adjustments that demonstrate what the results would have been had the buyer been running the business. Items such as personal autos, excess salaries and other payments that you have run through the company will no longer be paid by the company—these are added back into the earnings for valuation purposes.

To determine whether the buyer is serious and you and he are within range on valuation, you may want to deliver these financial statements (and possibly include certain additional information on the company such as number of employees, profile of customer base, and key milestones in the company's history) and ask for a valuation range before you disclose any further information. This can help prevent you from spending too much time preparing information before you find out whether the valuation is acceptable to you.

During the process you also want to do the best you can to assure that the business is not disrupted. This begins with assessing who in the company is going to be involved in the process and which details will be disclosed to them. It also involves getting assurances from the buyer that they will only contact the persons that you have identified as "in the know" regarding the possible transaction.

The process of selling your business can be quite rewarding, both emotionally and financially. Knowing what you want or can live with ahead of time and knowing what to expect in the process can make what will likely be a stressful process manageable through good preparation. SBC

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