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

You're interested in selling your business and you have a prospective purchaser. What happens next?

at a glance

- ❑ The purchaser wants everything his way and you want everything your way; outline and know your key issues ahead of time.
- ❑ Knowing the process and the place you want to end up will help you maintain the proper focus on both running your business and the steps in the transaction.
- ❑ When you know what the purchaser is looking for (return on investment, growth, level of profitability) you can determine how to position and present your business.

You've had a couple of lunch meetings with a prospective purchaser. You have thought through what you would like your role to be in the business going forward if you do sell, and you are curious about whether you and the prospective purchaser can reach agreement on valuation. What happens next?

You essentially have two options. You can let the prospective purchaser (or purchasers) determine the next move. Or, you can put together a strategy on how the process should proceed in order to retain a certain amount of control over the process. As presented in the first article in this series (see the June/July issue of ***SBC Magazine***), the second option is the preferred method, especially if you are able to simultaneously manage the operation of your business during this stressful period of distractions.

The Confidentiality Agreement

As a seller, you will want an enforceable confidentiality agreement in place to make sure that the information you provide the prospective purchaser is held in the strictest confidence—this is paramount if the prospective purchaser is a competitor. While it is quite easy to just accept a standard confidentiality agreement, sign it and move forward, my recommendation is that at this stage you begin to set the tone of the process. With ample preparation, you can use the confidentiality agreement to address each of the following:

Your authorized representatives. Who are the persons authorized to speak on your behalf? Do you want to limit contact by the prospective purchaser to specified individuals inside your company (i.e., the controller, the operations manager, etc.)?

Employee disclosure. Which employees should be informed of the pending transaction and when is the right time to tell them? More importantly, do you want the majority of your employees to remain unaware about the possibility of a transaction until right around the time of closing?

Amount of information. In order for the prospective purchaser to make an offer, they need to have conducted at least a preliminary review of your financial information. How much information is enough? You don't want to spend too much time and effort producing the first round of information only to find that you are not even close on valuation.

Solicitation. You may want to consider a restriction against soliciting any of your employees for employment elsewhere. This is especially true if you are concerned about the possibility of allowing a prospective purchaser identifying your key employees and rather than purchasing your company they simply choose to hire your key employees.

Contacts with outsiders. At some point a purchaser may want to meet with your key customers and suppliers. Clearly the timing of any disclosure to outsiders, the form of the disclosure, and the substance of the discussions are important to define in the confidentiality agreement.

There are no right or wrong answers in formulating the confidentiality agreement; each manufacturer will make these decisions based on its own unique set of circumstances.

Status of Your Information & Documents

On several occasions, seller(s) have told me that they learned more about the nuances and details of their business than ever before by going through the details required in preparing for a sales transaction. Going through the detailed assembly of information, records and documents can be quite tedious. The most important thing to keep in mind when preparing this paperwork is to identify any questionable or unique areas before they are uncovered by the purchaser. Doing at least a quick investigation of the following areas can be quite beneficial in the long run.

How ready is your information? Are all your key agreements with vendors and customers preserved in written paper or electronic format and up to date? Are all the various licenses and approvals required to operate your business up to date? Do your written policies and procedures reflect actual practices?

Customer relationships. Often current customers relationships are not reflected in the original contracts or arrangements that may be several years old. Preparing a synopsis of the relationships with key customers can avoid disruptions to the "due diligence" process that the purchaser will undertake. The same can be said for key suppliers.

Financial statements. Even if you have current financial statements, they usually reflect the accounting philosophy to structure your business affairs in such a way as to reduce your taxes to the minimum legally possible. You will want to spend time understanding what your business would look like if recast to reflect what the business's performance would be when the purchaser's accounting principles are applied. Such items include:

- **Salaries and benefits.** You may have been paying bonuses to you and your family members well in excess of what a purchaser will pay to operate the business. How would things look if salaries and bonuses were adjusted to prevailing market levels?
- **Extra perks.** Country club dues, fancy dinners, car leases, first-class travel and other "perks" may be items that could be depicted as items that could be reduced or eliminated.
- **Inventory numbers.** A lower ending inventory level increases the cost of goods sold, which in turn reduces net income. Accurately counting inventory will bring profits to more actual levels and, at the same time, increase the book value of the business.
- **Affiliated transactions.** If you have been personally leasing or licensing real estate or equipment to the business (or vice versa), the rental rates may be changing the true results of earnings. If they are above market for example, this will reflect lower earnings. These leases should be reviewed for their relationship to market rates and recast if appropriate.
- **Expensed capital items.** You may have expensed capital items instead of depreciating them in order to accelerate expenses for tax purposes. A review of items that will be capitalized is appropriate.
- **Depreciated capital items.** You may have depreciated capital items on an accelerated depreciation method. If you had used a straight-line method of depreciation, your net income would have been increased.

Negotiations

Know the process and your issues and keep your focus. As you begin the negotiation process it is very important that you have a good idea of how you would like the sales agreement terms and conditions to read. Every purchaser will want a one-sided agreement with terms and conditions that are quite broad from the seller's standpoint. For example, the purchaser most likely will want you to make very broad representations and warranties while you might want to narrow these and make the buyer undertake a more thorough review or due diligence of the business so that he can learn what pitfalls might exist. Determine early on how you would like these conditions to read. By understanding a) the process, b) your important issues, and c) keeping your focus on what is important to you, you have the optimal chance to make sure all the conditions are addressed the way you want them addressed as you structure the transaction. You may not achieve everything you want, but you will at least know that everything you wanted to have addressed has actually been addressed and didn't get lost in the process.

Experienced Advisors. Having seasoned advisors with experience in tax, business valuation, accounting and legal

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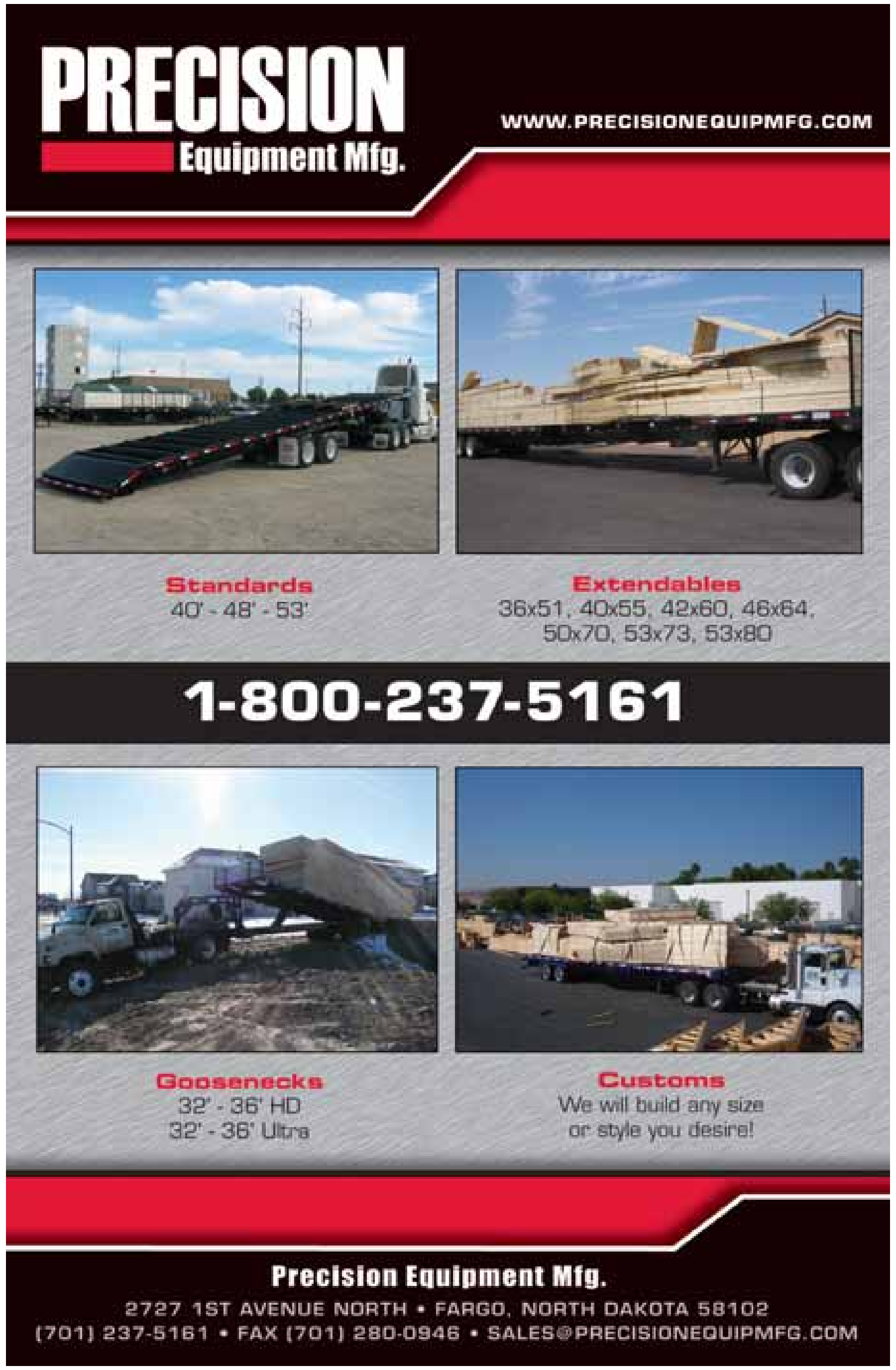

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Mergers & Acquisitions

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issues can help you keep your focus on both running your business during the process and the conditions of the transaction that are key to you. While another article in this series will address this in more detail, suffice it to say that enlisting the help of advisors who can help you determine, early on, the conditions that are key to you and keep the focus on those conditions are well worth the cost.

Your Purchaser's Conditions. Purchasers buy businesses ultimately to receive a return on their investment. The way in which they intend to achieve that return can provide you with insight into their motivations. Is the purchaser buying other similar businesses to attempt to gain economies of scale? Does the purchaser already own complementary businesses and does he view your business as having the potential to form synergies with existing operations? Knowing these conditions can help you understand how to present your business to the prospective purchaser and to align your conditions—or, to determine that maybe not everything can be matched up.

Price is not everything. The sale of your business is very seldom strictly about price. There are a host of terms and conditions that are to be determined in the ultimate structure of the sales transaction. These include the form(s) of payment (e.g., whether you receive cash, stock or promissory notes or a combination of these forms of consideration) you will receive, special consideration to be allocated to your key employees, the incentive plans to be put into place going forward, the handling of relationships with key consultants, customers and vendors and industry transition/development realities.

Probably the best advice you as the seller of your business can keep in mind is that you need to know where you want to get in the negotiations. You can then compare this with where the purchaser wants to go in the negotiations and work to establish common ground. For instance, you know that the purchaser wants to optimize the earnings stream when it owns the business. In what ways can you help the business continue to migrate in order to optimize the earnings?

Distractions. It is common during the buyer's investigation that facts or realities are brought to light that he wants to have further explained. Always be aware of whether these are valid investigations or "red herrings" where the buyer (or more likely, some representative of the buyer) is exploring one or more aspects of your business in depth, as if to create a distraction or a big deal out of a minor point. Often these distractions can be avoided by pointing them out at the beginning of the process. Some examples that should be disclosed early to avoid being brought up as material concerns during the investigation include: a large portion of your revenues and profits being generated by a few customers; significant portions of your revenues being generated under written agreements which are terminable at will or are generated without any written agreements in place; the turnover of your customer base over the past several years or your reliance on certain key personnel or supplier/vendor relationships. If these are, and always have been, elements of your business, don't let a buyer make a mountain out of them.

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Bridging the Gap on Valuation

When the purchaser says he wants your business but says it isn't worth what you think it is and you still want to work out a transaction, how do you bridge the gap? A common way to bridge the gap is called the "earn-out," where you are paid additional consideration for producing specified targeted results over a defined period of time after the closing.

With an earn-out arrangement, there are a host of structuring issues used to determine the formula to be applied when measuring the amount of additional consideration:

- What performance level determines the pay-out: gross profit, operating profit or net profit?
- What expenses are applied in determining the profit level: cost of capital, corporate administrative expenses, and other overheard expenses?
- Are there minimum performance levels (such as an additional dollar of consideration for every two dollars of gross profit in excess of $250,000)?
- Are there minimum margin requirements that must be maintained?

As you can see, the amount of time and effort that can be spent on determining the earn-out formula can be extensive. When you and the buyer agree on the earn-out concept, you will find that it usually requires pages and pages of documentation to capture how the earn-out will be calculated and paid out. Be very careful here for the language of the earn-out to be clearly understood as earn-outs are often the subject of a dispute later on as to whether the earn-out goals were achieved or not. The purchaser has a strong incentive to argue the earn-out goals were not achieved—and if successful in this argument a portion or all of the additional pay-out will not have to be paid to you as seller.

Regardless of the ultimate earn-out formula, there are a few structural points to be recognized that will determine whether the earn-out arrangement is even possible. As the seller looking to make additional money through an earn-out, you want the commitment from the buyer to provide you with the capital necessary to grow the business, pursue opportunities and achieve the profits required. This is directly at odds with the buyer's view that he owns the business and determines how to deploy its capital. Keep in mind that the nature of your business may restrict whether an earn-out is feasible. If the buyer has operations in the same geographic region your business operates, it is difficult to operate an earn-out. This is because you want to maximize profits for your particular location, while the buyer wants the businesses to operate together and do what is best for the entire corporation.

Earn-outs can be a way to bridge the gap on valuation. Just be aware of all of the nuances that can restrict the feasibility of applying an earn-out formula.

Conclusion

Properly structuring the confidentiality agreement, preparing the information on your business, outlining and following a process that is orderly for you and your employees and successfully concluding the sale can be accomplished by preparing ahead of time. An important part of the preparation includes drawing upon experienced advisors that know how to work with you in helping you achieve your goals—the topic of the next article in this series. SBC

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