Family Business

THE GUIDE FOR FAMILY COMPANIES

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Hello Mother... Hello Father...

Successors' challenges at family-owned summer camps

- How family vacations build shareholder unity
- When to walk away from a prospective buyer
- Succeeding in a consolidating industry

From left, Candy, Rodger, Lauren and (seated) Jason Popkin of Blue Star Camps in North Carolina.

When it's time to walk away

Someone wants to buy your company.
But the deal that's on the table may not be the right one for you.
How can you tell?

BY DAVID N. DEUTSCH

For many owners of closely held enterprises, selling the business is the right decision. But it's sometimes smarter to walk away from a deal than to complete the wrong transaction. The savvy seller is able to distinguish between the right and wrong reasons to defer a sale.

Corporate sales are advisable in many situations: When an owner wishes to exit and to liquefy his or her family's equity in an enterprise. When a sale can facilitate intergenerational transition. When the owner is fatigued and running the business is no longer fun. When growth requires a degree of investment that the family is unwilling to make. Or when the best option may be to complete a sale at an assured value rather than risk the family fortune on the business talents of the next generation.

Whatever the reason for sale, such transactions, once commenced, often develop lives of their own. Therefore, it's important to know when to call "time out" or to walk away from the transaction.

There are three basic reasons for sellers to walk away. These reasons involve issues of *timing, valuation* and *ego*. In each instance, there are valid reasons to walk as well as "red herring" issues that should not deter sellers from completing otherwise advantageous transactions.

Issues of timing

Corporate sales begin with the *personal motives and objectives* of individual shareholders. Many shareholders simply aren't ready to sell (or can't focus on a transaction at the moment). A seller's personal timing is affected by stage of life, health, willingness to invest, need for liquidity and many other factors. If you're not ready to sell, don't. Soul searching is an important prerequisite to any corporate sale.

There are also issues of *corporate* timing. If a company is not performing well *vis-à-vis* projections, it risks losing the confidence of prospective acquirers. It's generally best to address the causes of earnings surprises and to adjust projections before approaching potential buyers. Sale transactions take months to complete, and current-year projections will be validated (or not) before closing. It's vital to meet or exceed these numbers.

Some companies and their owners are simply unprepared to proceed with a transaction. For them, it's well worth the delay to make a few corporate repairs (much like fixing the kitchen or bathroom before selling your home).

Sale transactions take long enough for seller and buyer to learn each other's styles. If one party loses trust in the other, it may be time to walk away.

Red herrings

Unfortunately, many sellers defer transactions for the wrong reasons.

• *The company is expecting a near-term windfall* (cash collection, major new order, etc.) or, its corollary, *the company is still growing; it'll be worth more in a year or two.* Waiting to cash in on an immediate windfall is smart, but waiting to realize the last bit of corporate growth is foolish. Acquirers pay greater multiples for companies with good growth prospects. Conversely, they ascribe lower valuations to companies whose best years are behind them. Near-term, and even longer-term, corporate growth can be addressed with well-defined "earnouts" and other seller incentives.

• *The company's business/industry environment is expected to improve in the future.* Is it expected—or just hoped—to improve? Unfortunately, company financial results deteriorate as often as they improve. Some industries experience multiyear slumps or structural declines. Some never recover.

• *We can't sell quite yet.* If you're not ready, try to determine this before commencing the sale. On the other hand, if you and your family have resolved to sell, then do all you can to combat "seller's remorse," the inability to complete a sale for fear of regret.

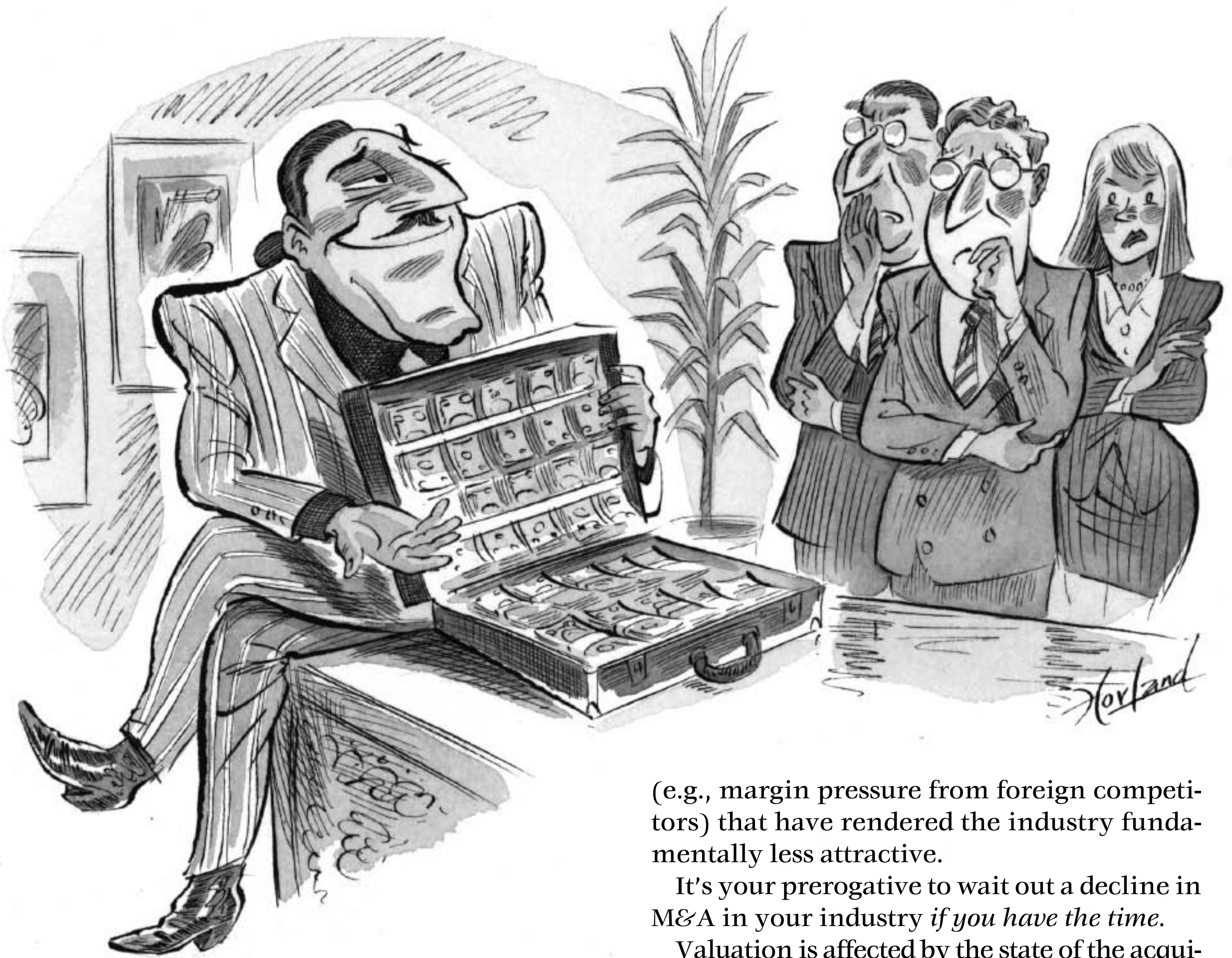
More than anything, corporate sales should be motivated by timing. Once shareholders have resolved to sell, the main consideration should be getting the best price and terms possible in the market at that time.

Issues of valuation and terms

Is valuation, speed of closure or confidentiality most important? Sellers invariably say "all three." All of these are important, but the quest for top-dollar valuation may require compromise on the other two. If shareholders want super-premium valuation, they must be prepared for a broader discussion (with many prospective acquirers, possibly resulting in more market "chatter") and a more extended process. Alternatively, if quick closing and utter confidentiality are most important, then a narrower, shorter process is called for, and lower valuation could possibly result.

One of the most common—and valid—reasons for walking away from a sale is failure of a proposed transaction to satisfy shareholder valuation objectives.

In any corporate sale, there is a short list of "likely suspects" (prospective buyers who are most likely to pay a premium) and a longer list of other possible acquirers. These prospects, logical as they may be, might be distracted by the integration of a recent acquisition, by management transition issues, etc. If too many "likely suspects" are out of the market at the time of your transaction, valuation could be affected negatively, and it might be wise to postpone a sale.



Among other factors, valuation is affected by the state of public equity markets. Ultimately, acquirers aren't buying broad market averages; they're buying your company in your industry. If publicly traded "comparables" are trading at full multiples, then those potential buyers can pay more for your company. (The acquisition might still be accretive to earnings.) On the other hand, if the public "comps" are trading at less-than-full multiples, there's a limit to the multiple that they can pay for any acquisition.

Likewise, the state and *pace* of M&A activity in your industry are more relevant to your company than the overall M&A environment.

Wait for a better valuation if there has been acute negative publicity regarding your industry or if, for example, the most active acquirer in your field has been temporarily sidelined. But you may not want to wait if your industry has already largely consolidated or if there have been structural changes in your industry (e.g., margin pressure from foreign competitors) that have rendered the industry fundamentally less attractive.

It's your prerogative to wait out a decline in M&A in your industry *if you have the time.*

Valuation is affected by the state of the acquisition financing marketplace. Today's acquisition marketplace, for example, is characterized by a robust debt financing environment. If the credit cycle is at its nadir, you might wait for more accommodating times. On the other hand, if banks are lending and mezzanine and other acquisition financing sources are providing capital, then acquisition values—whether you like them or not—are probably reasonably "full."

Of course, valuation is a function of both price and terms. Aggregate pre-tax valuation of the proposed transaction may seem acceptable, but net after-tax proceeds might not be. "Structure," including choice of transaction format (e.g., asset sale, stock sale, merger, recapitalization) is as important as total pre-tax value. Too little cash at closing, too much "seller paper," too uncertain an "earnout" and too much equity reinvestment are all good reasons to consider rejecting an otherwise attractive transaction.

Needless to say, tax considerations figure

ILLUSTRATION: GARY HOVLAND

heavily into valuation and any decision to accept or reject a transaction. Sellers of C corporations generally wish to sell stock or engage in merger transactions to avoid taxation on both corporate and individual levels. But acquirers typically prefer to buy assets and assume only certain liabilities. Overly unfavorable tax treatment to the seller may be good reason to reject a transaction.

Thankfully, transaction structure can be altered to address or ameliorate many tax issues. For example, a transaction might be treated as a stock sale with a "338(h)10 election," allowing the seller to avoid double taxation while enabling the buyer to write up assets for future depreciation purposes, although it's not quite that simple.

The valuation that matters most is the valuation at closing. In due diligence, the acquirer and its team of businesspeople, accountants, attorneys and others will scour your company for issues that might affect value. Detailed due diligence is standard operating procedure in M&A, and it should be welcomed. However, if a buyer appears to have engaged in "bait and switch" (i.e., it promised premium valuation only to claw much of it back upon "discovery" of numerous issues in due diligence), it might be time to walk away.

We have seen too many clients reject highly favorable transactions because there was simply too much hubris in their decision making.

Red herrings

"Not enough" isn't always a good reason to reject a transaction.

• *The M&A market—or M&A in our industry—is sure to improve. Someone will surely pay us more in the future.* Markets are notoriously difficult to predict. Waiting entails risk: business risk, market risk, regulatory risk, etc. Ornithologically speaking, a bird in the hand really is worth two in the bush.

• *We're not getting what we want.* Unfortunately, corporate valuation is not about what you "want," "need" or "deserve." It's also not about a magic number that you and your family might have in mind. It's about value as calculated by prospective acquirers based on company prospects and prevailing market conditions.

• *We're not getting six times EBITDA.* Somehow, six times EBITDA is considered the yardstick by which all private corporate sales are judged. In reality, it's not. Valuation is a function of quality of earnings, sales and earnings growth rates, future investment required by the acquirer, working capital issues, availability and cost of acquisition financing, required rates of return, etc. Ten times EBITDA may be cheap for a company whose earnings are growing rapidly. Five times may be high for a small company with customer concentration and flat earnings.

• *Our family can't agree on a sale price.* This shouldn't stand in the way of completing sensible transactions, but it often does. Before a sale is considered, a company's shareholders should have frank discussions about value with the input of an independent financial adviser.

• *At the end of the day, we're trading a business asset for a financial asset, and investment income won't yield as much as our business did.* This is virtually always true. The sale of a business should be based on issues like liquidity, certainty of value, relief from business risk (as well as management responsibility, personal guarantees, etc.) and the need to take the company to the next level.

• *Due diligence is tough, and we're afraid the acquirer is going to change the deal.* Due diligence is always intrusive. And, yes, that new tax that affects your bottom line, that lost customer and that key management departure all affect company value. If the prospective buyer raises these issues in a tactful and reasonable way, you may have found yourself a good partner.

Issues of ego, legacy and trust

Successful corporate sales are characterized by seller feelings of satisfaction, pride, respect, etc. as much as "hard" issues like valuation.

Initially, sellers often favor "strategic buyers" because of the prospect of premium valuation, only to learn that strategic-buyer synergies might involve consolidation of oper-

ations, layoffs or the discontinuation of your family's century-old brand in favor of the acquirer's. Such "mistreatment" of companies and their employees, and acquirer "disrespect" of other legacy issues, sometimes prompts sellers to reconsider their choice of buyer or their sale decision entirely.

Likewise, "financial buyers" can seem callous and high-handed in their somewhat clinical approach to acquisitions. Tough negotiating is one thing; lack of respect for you and your family is another.

Sale transactions of closely held and family companies take time (typically six to 12 months from start to finish). There's enough time for seller and buyer to become familiar with each other and their respective styles of operating, negotiating, etc. If the seller or buyer loses trust in the other party, then it may be time to walk away.

Red herrings

Mutual respect between buyer and seller is important. But emotion and ego can get in the way of otherwise winning transactions. There are a number of emotional "red herrings" that should be guarded against.

• *I'm not getting what my buddy got.* First, your buddy might be stretching the truth a bit. Second, he may have omitted a few important details. Third, your company and your buddy's aren't identical. Fourth, his transaction occurred at a different time, in a different market. Fifth …

• *Our company is "special," and any transaction must occur at a super-premium to be acceptable.* Yes, but even the most special companies can't defy the laws of finance and corporate valuation. A winning transaction, from the seller's point of view, is one that achieves the highest end of a "fair" range of values. Unfortunately, we have seen too many clients reject highly favorable transactions because there was simply too much hubris in their decision making.

• *If we can't keep the painting of Uncle Lou, the deal is off.* Is the dispute really over the painting of Uncle Lou, or are you looking for an excuse to reject the transaction? If the painting is of purely sentimental (and non-economic) value, your request to keep it is reasonable. But if the company's brand is built around the story of Uncle Lou, then such company memorabilia might be key assets to the acquirer. Keep your eyes on the big picture and try not to fight over who gets to keep the TV set.

• *Family members won't be treated equally in the transaction, and Cousin Joey is insulted.* Equitable treatment of family members is important; however, Cousin Joey may not be a member of the continuing management team (with the new acquirer). Some family members might have an opportunity to earn more cash, equity, etc. into the future than others. A different family issue: There are some family members who won't sell at any price. Perhaps they enjoy their regular paycheck, or they're terrified at the prospect of life/work outside the family business. In either case, the good of the group must be placed above the more-personal-than-economic thinking of certain family members.

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• *We don't have to sell (we won't be forced to sell).* You're right. You don't *have* to sell; the decision is yours alone. You're young. You're healthy. In fact, you *never* have to sell. Unfortunately, many sellers wait until there *is* a problem (with them, their company or the market). Regrettably, corporate values don't always grow. It's almost always better to sell too early than too late.

There are many good reasons to walk away from a corporate sale … or to stay the course. Any family (or other corporate shareholder) considering a sale should carefully weigh the pros and cons of, and alternatives to, any contemplated transaction and enlist the services of experienced legal, accounting and investment banking advisers. FB

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