'An ounce of prevention is worth a pound of cure'

Proper planning will facilitate the transaction process and help ease emotional issues related to the sale of your business.

By David N. Deutsch and Thomas M. Cagnina

THOUGH IT MAY BE A CLICHÉ, when it comes to the sale of a business, the old adage about the benefits of proper planning rings true. The right pre-sale preparation helps position a business for a better future, facilitates the transaction process, eases the transition for owners and employees, reduces impediments to a successful deal and can yield substantial increases in transaction value.

Transitioning the ownership of a business—whether to other family members, the management team, a strategic acquirer or financial investor or some combination thereof—is a pivotal and challenging event in a company's evolution. With effective preparation, the transition can position the business—and members of the family and management team who are continuing their involvement—for ongoing success or an improved future.

Successful business owners often field unsolicited offers from would-be suitors. In such cases one might think, "Our business is performing well and is clearly in demand, and we know how to tell its story—why bother with pre-sale preparation?" On the other hand, owners of a business facing performance issues might perceive that it is not the right time to engage in pre-sale preparation—and sometimes it seems as if the right time will never arrive.

Whether your company is a top performer or faces growing pains or worse, there are many reasons to prepare. A focused preparation process enables selling shareholders to present the business in the best possible light, organize a company for smoother acquirer due diligence and anticipate and address issues of potential concern. Just as you would spruce up a home before listing it for sale, you should also take steps to enhance the "curb appeal" of your business.

Ultimately, good preparation will result in more confident responses to prospective acquirers' queries, fewer surprises, reduced risk of a late-stage renegotiation of the purchase price and/or transaction structure, and increased odds of a successful outcome.

Advantages of a preparatory process

The typical sale process features certain basic elements: investment banker due diligence, drafting of a descriptive memorandum, identification and solicitation of prospective acquirers, execution of confidentiality agreements, distribution of information to prospects, management presentations and the negotiation and structuring of "the deal" (typically articulated in a letter of intent). Finally, there is buyer due diligence and transaction documentation. While these form the basic recipe for a corporate sale, none of these steps *prepares* your company.

In our view, the best corporate sale processes are *preparatory* and not merely procedural. For example, while an information memorandum can clinically describe facts ("the company operates 100 stores"), a good memorandum becomes a platform to articulate company strategy ("the company operates 100 stores but plans to expand to 225 stores by pursuing....").

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The objective

Preparation for a sale has three fundamental goals:

1. Positioning the company for the transition and beyond.
2. Presenting the company in the best possible light.
3. Anticipating and addressing risks inherent in the business and likely concerns of prospective acquirers.

The ultimate objective is that the company be perceived to be of "institutional" quality. Good companies are established and well organized. They have compelling business plans and credible growth plans. Their marketing, sales, manufacturing/operations and administrative practices are well codified. They have multiple sources of revenue and well-developed supply chains. Moreover, they typically have deep management teams. As Jim Collins would describe them, they're "built to last."

If your company is profitable and growing, that's great, but it's not enough. In a transaction process you will face intense scrutiny. You'll have to address questions about the company's market positioning, business strategy and direction, market share and likelihood of sustainable growth, among many others.

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A proper sale process will demonstrate the company's key strengths and selling points. It will address likely concerns; in many cases, those concerns can be transformed into perceived opportunities if management has a plan to address them.

Operational, financial and transactional issues

There are three categories of issues to address before a transaction: operational issues, financial issues and transactional issues.

Operational issues include those related to strategy, marketing and sales, manufacturing/operational efficiency, supply chain management, customer and vendor concentrations and management capabilities. You should identify what the business can do as well as opportunities to improve it further.

Financial elements include accounting policies, financial controls and reporting, working capital management and cost containment. Most substantive businesses have audited financial statements. For those that don't, getting them makes a world of difference in how the company is perceived and valued. This is not a place to cut corners.

Transactional issues include legal risks and exposure, due diligence review, third-party issues including those related to consents (such as from landlords, suppliers or licensors), risk management and environmental issues. Another area that must be addressed involves which employees should be included in the process and the timing and extent of all communication with respect to the planned transaction.

Valuation considerations

Operating income is a key value driver, and EBITDA (earnings before interest, taxes, depreciation and amortization) is a typical metric. To properly demonstrate the earning power of a business, a fundamental element of financial preparation is the identification of unusual or non-recurring expenses adjustments or "add-backs" to EBITDA and the restatement of financials. While public companies are typically managed to maximize earnings, private companies are often managed to minimize taxable income. When possible, they may defer revenue and overstate expenses; hence the need to restate to properly represent earnings.

The most common add-backs are (1) certain "owner expenses" (e.g., personal vehicle expenses, insurance expenses, and travel and entertainment expenses that were incurred by the company primarily for the benefit of its owners); (2) all or part of the owners' compensation on the theory that the owners will be leaving the company upon sale and/or that they were overly compensated; (3) payroll and other expenses associated with other family members on the payroll; and (4) overly aggressive reserves against (and/or write-downs of) inventory.

There are other creative-yet-legitimate add-backs to consider, too. For example, a company might have routinely expensed certain payments that could be capitalized. Or it might engage in what some refer to as "vanity advertising." The shareholders of many closely held companies are pillars of their communities, and as such sponsor Little League teams, put their names on park benches and the like. Much of this kind of advertising is not essential to the company's business; it's a "vanity" or charitable expense and can be added back to earnings.

In some cases, the re-articulation of a company's income statement to bring its format into conformity with industry practices and buyer's expectations can also enhance a company's sale prospects.

Timing your preparation

Just as many smart investors evaluate their exit alternatives as a normal part of their investment evaluation, so should family business owners start preparing well in

advance of an anticipated sale.

For a well-managed business with strong performance, pre-sale preparation can be concluded quickly in parallel with the initiation of the sale process. But for most businesses, a formal preparation process is advisable.

Often the steps necessary to portray a company in the best possible light may take months or years to accomplish. Moreover, depending on the transition process and the desires of both seller and buyer, the seller may be continuing with the business for a while after the transaction. Anticipate the time needed for the preparatory process, the transaction itself and the period you will likely stay on—and allow some extra time for the vagaries of the transaction markets and the economy.

While the process can vary, typically there are three phases: (1) assessing the business's strengths and weaknesses, (2) making recommendations to address them, and (3) implementing the recommendations and monitoring the progress of the implementation. Generally the first two elements can be accomplished in 60 to 90 days, but execution of the recommended plans may take three to six months or more.

Preparing for a sale not only positions the company for a better transaction but also prepares the management team to make presentations to buyers and for the due diligence process. It can also speed the banker's process and shorten the transaction timeline.

Preparing for the next phase of your life

You should also prepare personally. Personal preparation includes personal financial planning, trust and estates work and discussions with your children and the management team. This is the beginning of the rest of your life—and it could be a time of dramatic change for family members in the business as well, particularly if it's unclear if they will continue with the new owner.

So you need to determine what you wish to do next. Whether the activity is civic or philanthropic or involves a new venture, travel, teaching/writing, mentoring, corporate directorships or otherwise, it's often best to begin to assess these options before a sale.

Common mistakes

Formal pre-sale planning can enable a seller to avoid some very common pitfalls. Those include:

• Lack of a coherent strategic plan: A prospective acquirer is buying the future, and a company's strategic plan is essential to the articulation and realization of that future.

• A disorganized process that opens a Pandora's box: While there's a certain value to frank and open discussion, the "go ahead, ask me anything you want" approach can subject the seller to surprise questions that can't be readily or easily answered.

• Over-reliance on talents and/or relationships of the selling shareholder(s): The business must have enough talent to execute its plan without the sellers or executives who intend to depart.

Frequently asked questions

Should you make (or delay) certain capital expenditures on the eve of a sale? In general, you should operate the business as if it's *not* being sold. Making decisions that are the best for the business, independent of a transaction, gives suitors comfort and minimizes risks should the business not be sold.

Regarding capital expenditures ("capex"), there's a distinction between maintenance capital expenditures and other types. Maintenance capex—for example, replacing

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a worn-out but necessary piece of equipment—is essential. The necessity for other capital expenditures may be debatable. In general, acquirers seek modern, well-maintained operations and a certain amount of excess capacity. Deferring capex to the point at which a company has little capacity for growth and large future capex requirements will give an acquirer good reason to argue that the cost of capex to meet the plan should be deducted from the company's value.

Should you hire new senior managers prior to a sale? If the manager is a key part of the ongoing team and is involved in the plan to sell the company, the addition can be beneficial. We've seen many successful situations in which new senior management's compensation is directly tied to the achievement of a certain sale values. If you need to augment your management team, do so.

Good reasons to prepare

Neither you nor your banker can predict or control the M&A, credit, currency or other markets. However sellers can control the look and feel of their company. You can enhance your company's "curb appeal" and make it one of the more attractive companies to a prospective buyer. Particularly in a difficult market environment, that may make all the difference.

In our view, preparation for a sale is essential. Good preparation limits surprises and makes for smooth and value-maximizing transactions. FB