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Insights

Maximizing Value on the Sale of a Privately Held Company

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Maximizing Value on the Sale of a Privately Held Company

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Business owners should obtain sound, objective, professional advice to assist them in preparing their company for sale, including legal, tax and financial advisors, as well as experienced transaction intermediaries. The right advisors enhance value by performing due diligence, preparing your company for sale, preparing a valuation, identifying potential buyers, marketing and presenting your company, negotiating, and closing a transaction with the best possible price and most favorable terms.

Whether a business owner is contemplating a transition of the business to family members, employees, or a third-party buyer, adequate planning and preparation is essential to ensuring that your personal and financial objectives are met.

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Motivation for a Sale

As a seller you should carefully consider your motivations for selling and how you will position your reasons during discussions with potential buyers. They will want to have a clear understanding of your motivations. Your desire to sell may be driven by:

- Liquidity needs (the business may represent an owner's largest single asset)
- Succession considerations (subsequent generations in the family may not want to participate in the business)
- Business environment change (e.g. increase in capital needs, new competitive pressures, new risks, etc.)
- Age or health considerations
- Personal desire to retire
- Optimal market conditions to sell

Whatever your reasons for selling the company, you will need to be prepared to explain them to potential buyers and place yourself in the best possible position for negotiations.

Timing of the Sale

It is best to begin preparing to sell a company years before you actually plan to exit the business. Working with an advisor well in advance to help prepare and position your company for sale can significantly increase the value and negotiating position.

The ideal timing for the sale is important to consider and can be difficult to determine. The right time to sell from a personal perspective may not align with the market. Owners must balance personal objectives with existing market conditions. Having flexibility of timing can significantly increase negotiating power.

Important factors to consider include the owner's personal and financial situation, the company's recent and future operating performance, risks to the business and industry, and other economic and industry conditions. Companies command higher transaction prices and better deal terms when they have demonstrated a recent history of revenue and earnings growth, combined with realistic expectations that growth will continue or at least that earnings are stable and predictable.

Improving the Sale Price

The price paid for a private company is largely dependent on its recent financial results, such as its EBITDA. Therefore, business owners benefit if they can increase the EBITDA of their company in the years prior to a sale. By focusing on optimizing operational processes, performance improvement initiatives can improve revenue, cost, margins, as well as products and service. For example:

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- Improving cycle time to reduce the amount of material, labor, and expenses tied up in inventory
- Disciplined demand management to minimize the accumulation of unnecessary inventory
- Shortening the order to cash cycle
- Improving capacity utilization
- Reducing business risk in a manner that improves revenue quality and predictability

Seller Due Diligence

Potential buyers are going to perform their own due diligence on your business before they can prepare an offer. They need to have a complete understanding of what they are buying including all of the associated risks before considering a transaction. Typically, the buyer will have the assistance of a professional to perform this due diligence.

You, as a seller, want to be prepared for what the buyer's due diligence efforts might turn up. There could be perceived risks that will impact the buyer's offer.

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Seller due diligence provides the opportunity to gain early knowledge and control of issues that could potentially derail a deal. A balanced due diligence report by an outside party that fairly reflects the business can help make you aware of issues and have the opportunity to address them proactively, improving your negotiating position.

For example, a buyer might claim that your supplier base is not large and diverse enough. Perhaps this is true and the best approach might be to simply admit that it is indeed a risk. Or, perhaps you always knew this was an issue but it never caused enough problems for you to seek out other vendors. The seller due diligence process should flag this before the buyer identifies it giving you a chance to proactively mitigate it and improve your negotiating position. You could make a small time investment to identify additional suppliers and start building relationships in a short period of time to demonstrate to the buyer that this is not a significant risk for the business.

Valuation

Privately held firms can be more challenging to value than public companies. Often private companies do not operate by the stringent accounting and reporting standards that govern public firms so their financial statements may be inconsistent and not standardized, making interpretation more difficult.

A private company valuation is primarily constructed from assumptions and estimations. Some of the more common valuation methods are Comparable Company Analysis (CCA), EBITDA multiples, and discounted cash flow (DCF) analysis. A valuation report will apply various methods to derive an approximate company value.

While there are many ways to calculate value, ultimately your business is only worth what a buyer is willing to pay. You can influence the value the buyer perceives by being prepared and presenting your company in the best possible light. This can be accomplished by preparing a strong company presentation and Confidential Information Memorandum (CIM) which are your primary marketing tools.

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Quality of Earnings

Revenue quality is an area of focus for buyers and private equity investors. Two companies with the same revenue and margins can be valued very differently if their quality of earnings is significantly different. Companies with high revenue quality have revenue predictability, continuity, and diversity.

In evaluating the quality of earnings, we consider whether past performance is a good indicator of future success. We perform an objective analysis of your earnings by asking key questions about revenue and assigning a quality rating to them. For example: *what percentage of your revenue is recurring? are your products and services mission critical and are they embedded in your customers' businesses? are switching costs high?*

The importance and relevance of each question to your business, industry, and the current economic environment is used to create a weighted average quality of earnings score. When formulating the questions that are relevant to your business we will consider such factors as revenue diversity from a customer, product, and geographic perspective, contracts, relationships, the sales cycle, and the 5 competitive forces.

Identifying Potential Buyers

Many sellers who have not been involved in an M&A transaction make the false assumption that the only potential buyers are their larger competitors. In fact, buyers come in many forms besides direct competitors (horizontal merger), there are customers or vendors in the supply chain (vertical merger), conglomerates, private investors, venture capital and private equity firms, and new entrants to name a few. It is important to consider other types of buyers who might place a higher value on your company.

For example, a small direct competitor wishing to expand geographically and to grow their top line might not value your company the same way a large strategic buyer in the supply chain who sees your company as key to optimizing their corporate portfolio and strategic position in the market.

It is important to work with advisors who can identify potential buyers from various sources to ensure your company is properly marketed to those who place the highest value on it.

Negotiating

The keys to putting yourself in a strong negotiating position are knowledge, preparation, positioning, and professional assistance.

- Knowing your business well through proper seller due diligence and being prepared to address potential buyer concerns
- Preparing your business months or years ahead of a potential sale to increase valuation and give you flexibility of timing
- Positioning your motivations for selling and post-sale involvement
- Engaging advisors who have negotiated M&A transactions before

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Post Sale Involvement

Some owners wish to remain involved with their businesses post-close. Entrepreneurs who built their business from start-up to going concern sometimes want a legacy to survive. Other owners might be satisfied with a liquidity event and clean break.

The interests of the buyer will have some impact on the level of involvement they wish from previous owners. The continuing efforts of previous management or owners might be of significant concern to a buyer, enough to have an impact on perceived value and even whether to make an offer.

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For example, in an industry where business is driven by personal relationships, a new owner should be concerned with how well customer relationships will transfer and will place value on post-close involvement of the owner. In an industry that has a high level of technical complexity, there could be significant value in the previous owner staying on in some capacity for an agreed-upon length of time for training purposes.

In preparing for a company sale, don't forget succession planning and ongoing management post-closing. If you're looking to sell and retire, who will run the company if you're no longer active? Have you developed and mentored a management team to drive future growth if you're not there? There should be a clear plan for management succession in advance of a potential transaction.

Some owners will also feel the need to address other parties such as employees, customers, or suppliers who have helped the owner create a successful business.

Conversely, a buyer might want to dismantle or move a company which would work well only if the seller wants a clean break. Either way, it is important to understand before negotiating a transaction what the interests of the buyer and seller are regarding the post-close involvement of the previous owner and/or management team. ❖

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