

# MARKET PERSPECTIVE

*Serving Main Street and Middle Market Business Owners and Buyers*

## ***Using Process to Maximize Value: A Guide to Selling a Company in Today's M&A Market***

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Often an emotional undertaking, the sale of a privately held business is sure to cause disruptions in any enterprise. The process impacts customers, suppliers, shareholders, and employees. Done poorly, it can erode value and adversely affect future operations even if the sale never happens. A well-coordinated process, on the other hand, can enhance the value of a business.

Sales are initiated for a variety of reasons, including an asset transfer between family generations or purely strategic reasons. Often an unsolicited offer from a competitor or a private equity group triggers the sale. Whatever the driving force, a sale often is an inevitable event for a private company—when the business' value is ultimately realized and shareholders receive liquidity for their interests. It is when the financial rewards for years of hard work and risks are determined.

Given its importance, one would think that a company's sale always would be carefully managed. Unfortunately, it is often a chaotic free-for-all characterized by emotional decision-making and lack of focus. To maximize the business' value, the sale process should be well-planned, well-executed, and given the attention that any crucial business event deserves. Planning the process, sometimes years before it is initiated, and executing the plan professionally are the shareholders' best guarantee that the business will be sold to the right buyer at an attractive price under the most favorable terms and conditions.

### THE CAST OF PLAYERS

The mergers and acquisitions world is a surprisingly small universe involving immense sums of money controlled by buyers, lenders, and investors. Understanding the key players and their roles in the process is critical for a seller.

*The Buyers.* Buyers typically fall into two categories: strategic and financial. Strategic buyers can be public or private companies that want the acquisition because it can benefit their current operations by gaining market share, managing production inputs, or gaining distribution channels. Other strategic objectives may include diversification of business lines or cost reduction.

A strategic buyer desires to build value by integrating an acquisition with existing operations, executing a joint strategy, growing revenues and reducing costs. From a seller's perspective, the importance of strategic buyers lies in their ability to pay higher values than buyers focused on stand-alone acquisitions. Strategic buyers typically have a unique value proposition that provides a rationale that other acquirers may lack. Furthermore, they may often have greater access to capital at a lower cost. These factors

usually translate into a higher value on the potential acquisitions.

Financial buyers also strive to build value but do so by creating a capital structure with a cost less than the expected returns from the acquisition. Private equity groups constitute the vast majority of financial buyers. Their objective is to generate returns for their investors, which include pension funds, university endowments, wealthy individuals, banks, and investment firms, in addition to the fund's operating partners.

Financial buyers acquire companies using a combination of funds raised from their investors and loans from banks and other capital sources. A positive return on the acquisition investment is earned as long as profits exceed the cost of capital. The financial buyer usually wants to achieve a rate of return that at least meets their targeted return on equity – typically in the mid-twenties.

Given the right price and the right capital structure, financial buyers employ a host of strategies to build value. Such strategies include the restructuring of the company's cost structure, expanding sales, or building economies of scale through additional acquisitions in an industry segment.

A financial buyer's objective is to buy at as low a price as possible, grow earnings, and sell at the highest price once the investment has been held for an optimal time, typically three to seven years. When financial buyers exit their investments, they usually focus on selling to a strategic buyer, or if the stock market is healthy, taking a company public. However, smaller private equity groups increasingly are selling their portfolio companies to private equity groups that focus on larger transactions (an interesting development for those investors who have an investment in both the buyer and the seller!)

Often, financial buyers become strategic acquirers through one of their portfolio companies—sometimes referred to as hybrid buyers. A portfolio company owned by a financial buyer may grow to such an extent that it accumulates resources that enable it to outbid other potential buyers in the industry because it now has financial resources and opportunities for synergies.

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The following summarizes the characteristics of buyers. The differences go beyond the buyers' willingness and ability to pay top dollar for acquisitions. When marketing a firm in an M&A transaction it is important to know your potential market and communicate accordingly. A strategic buyer and a financial buyer look differently at the same acquisition. Their "hot buttons" can be measured through financial analysis, for example, by studying the potential dilution aspects of a deal for a strategic buyer or by identifying the key elements affecting the returns of a financial buyer.

*The Advisors.* A typical M&A team assembled by the seller includes key members of management, attorneys, outside accountants, and investment bankers. The smooth functioning and interaction within this team is a critical element in the success or failure of the sale process.

The seller never should fully delegate control of the deal team. The team requires executive management the same as any other functional area within a firm. Unfortunately, managing the advisory team is no easy task. A strong hand is often needed to keep everyone marching in the right direction. This is often difficult for entrepreneurs who are successful in their own right but may be overwhelmed venturing into the unfamiliar M&A world. Sellers who manage the process well retain executive control and daily involvement, while relying on the team members to manage their respective responsibilities and coordinate with the rest of the team.

Most companies contemplating a divestiture or a sale already have an outside attorney. However, an attorney who deals with the business' day-to-day aspects may not have the specialized knowledge required for M&A transactions. An experienced deal attorney is essential in any sale to ensure that the deal is structured and documented properly. The best deal attorneys know where pitfalls can occur and how to protect their clients well after the deal is closed. Most law firms have this expertise in-house or know other firms that can assist.

The accounting firm's role continues to expand as the M&A world grows in sophistication. Buyers need to have confidence in the accuracy of the financial statements. Furthermore, the seller's accountant is pivotal in due diligence when buyers are investigating the business. Companies should plan early and establish reliable and accurate procedures and reporting systems. An audit is a good investment for any company contemplating a transaction. Trying to reduce costs by avoiding an audit or choosing an accounting firm without regard to reputation will cost more in the long run. "Clean" companies command greater value and provide the seller with clout in deal negotiations.

The third leg of the typical M&A team is the investment banker, who acts as process manager, financial analyst, and lead marketer. The investment banker must understand the company, its industry, and all of the elements that determine the value of the business. Duties of the banker include the preparation of marketing documents, building financial models, developing a target list of potential buyers, distributing marketing materials, and conducting the auction that ultimately helps to maximize the value of the deal for the seller. Good bankers excel at developing the strategy and adapting the marketing process as the sale evolves.

Choosing the right deal team is an art form in itself. More often than not, the deal team is chosen based on those who have attained a position of trust with the client or have been selected by the client through a "beauty contest." Compatibility with other team members is an important trait for any potential team member. Other criteria include competence (do they know what they're doing?); market credibility (do they have a good reputation?); and a proven track record for getting things done. Many potential sellers weigh industry knowledge heavily. However, this can be a double-edged sword—make sure your team's loyalty is to the seller and not the industry.

Any seller recruiting a team should pay as much attention to assembling the team as it has put into growing the business. It is astounding that entrepreneurs will devote decades of hard work and attention to detail to grow their businesses but do not even take the time to check out the references of an investment banker responsible for selling the business. The sales process is so disruptive and time-consuming that a seller ideally has one shot at getting it done right. Changing the team in the midst of a deal is difficult and will be perceived poorly by the market-place.

### THE PROCESS

A common progression of stages characterizes most M&A sell-side processes. Each deal is different, as are the players, but most well-run deals progress from one stage to the next in similar fashion. A typical deal process is described below.

*Planning.* The process kicks off once the deal team is assembled. Objectives and expectations of the seller should be clearly defined at the very beginning. Value expectations, indemnification risks, and expectations for management's post-divestiture roles should be clearly defined. Misunderstandings over what the seller is willing to accept in a final deal can be avoided in the planning stage. Defining potential deal structures (asset versus stock sale and full sale versus partial or leveraged recapitalization) should also be done early. Detailed planning is important and helps ensure confidentiality by eliminating the risk of careless mistakes.

*Analysis.* The development of the strategy is a theme that cuts across the entire process. The most important question that must be answered is: Why would someone be interested in buying the company? Other questions include: What messages should be conveyed that will entice different categories of buyers? Is the company a good stand-alone investment? Is it a growth play? Does the company's value depend on a competitor's willingness to gain market share through the purchase?

Once a thesis, or multiple variations of the thesis, is developed, carry that theme throughout the process. In political terms, it's called staying on message.

*Document preparation.* The next stage of the process is to develop the materials used to communicate information to potential buyers. An information memorandum describes the company, its products, markets, customers, competitors, and industry, in addition to historical financial information and projections.

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The memorandum, also known as “the book,” should communicate the marketing theme for the company at every chance.

The first few pages of the memorandum, the executive summary and the key investment considerations, allow prospective buyers to see what is special about the company and why it would make a great acquisition. Potential buyers also must sign a confidentiality agreement before reviewing the memorandum.

Finally, the work of constructing a data room begins. A data room is a collection of documents that contains more detailed information available only to a final group of bidders. Data room documents include audit reports, employee information, contracts, and environmental studies. Honest and accurate disclosure should be the guiding rule in assembling the data room—holding back negative information can result in lower values before closing and potential lawsuits afterwards.

*Marketing and evaluation.* Prior to distribution of the memorandum, a significant amount of research is applied to developing the list of potential buyers. Who are the logical buyers? Who has been making acquisitions in the industry? Which private equity groups are looking for deals of this size and in this industry? Investment bankers maintain and subscribe to comprehensive databases that ensure the deal is shown to the right buyers and no stone is left unturned.

Once the documents and the target list are complete and accurate, the actual external marketing begins. It starts with a phone call to each potential buyer (usually followed by multiple voice mail messages). After the confidentiality agreement is negotiated and signed, the memorandum is distributed, usually in an electronic format such as a PDF document. A tracking list, organized by buyer type (financial versus strategic), is used to communicate information on the marketing process to other team members. This report contains contact information, details actions taken (such as the date the book was sent to each potential acquirer), and includes notes on discussions requiring communication to the client or other team members.

As the process of book distribution continues, the tracking list grows as the investment banker uses his or her network to expand the target list of acquirers. A skilled banker adds value by finding potential acquirers that might not have been intuitive or by pitching the deal to other potential buyers as an idea that they might not have considered.

Once the memorandum is distributed to the list of potential buyers, the deal makes its way through the evaluation process by the potential buyers. Follow-up questions and discussions between the banker and the buyers lead up to a target date when potential buyers are asked to submit a letter called an indication of interest, a non-binding document that identifies a value, or range of values, that the buyer proposes for the company. Other elements of the letter include a proposed deal structure and an opportunity to explain why the buyer is interested in pursuing the acquisition.

The client and the M&A team sift through these letters to determine which potential buyers can advance to the next stage. This is when the market value of the company begins to crystallize. Clues as to how the market assigns values to different aspects of the deal and where weaknesses are in the company's value thesis become apparent at this stage.

The process of marketing a company is analogous to a funnel. If the target list begins with 100 potential buyers, perhaps 60 receive a book. If 10 submit indications of interest, perhaps only five are chosen to meet management and conduct additional due diligence in the data room.

The objective of this phase is to continue communicating the marketing themes while allowing buyers to firm up their bids for the company. A management presentation provides buyers with the opportunity to assess the management team and discuss strategic issues. Often the buyers bring their bankers. If the presentations and discussions go well and the data room tests to their satisfaction, potential buyers will have comfort with the deal and enough confidence to push their valuations to the top of their original indications. The goal at this stage is to move the buyers' range of valuations higher than their original submission.

The investment banker hopes that the primary fear of each bidder is losing the deal to one of the other bidders.

However, there are things that can move buyers' perceptions of value in the opposite direction. Common pitfalls that might result in negative perceptions include inaccurate information, unfavorable information that was not properly disclosed, or a stale management presentation. Once the presentations are finished and the data room has been digested, the task is to identify that one right buyer. Potential acquirers are given a couple weeks to refine their value calculations and line up their financing sources. The investment banker then asks the bidders to submit their final offers. These offers are typically structured as a letter of intent that addresses how much they will pay, the structure of the payment (cash versus notes), conditions of closing, and timing. The letters, although non-binding for the most part, provide the basis for choosing the final bidder. Often the bidders are provided with a draft purchase agreement that they are asked to “mark up.” This often provides the deal team's attorney with a sense for the key legal issues identified by the buyer. Choosing the final buyer based solely on value without considering legal structures is a common mistake that many sellers come to regret.

If all has gone well and there is a sense of excitement among the bidders, this is when the clout of the seller is at its maximum level—when that last morsel of value can be extracted through the competitive auction process and bidders are asked: “OK—who wants to buy this company the most?”

*Negotiations and closing.* Once the buyer is chosen, the seller's clout obviously declines and the push and pull of the final negotiations begin. The letter of intent is signed and final negotiations commence. This is when the investment banker moves to the background (not disappearing) by passing the lead role of process manager to the deal attorney. Following execution of the final purchase agreement, ownership changes hands and funds are transferred.

*Fulfillment.* The M&A process does not necessarily end with the transfer of funds. To truly realize the company's value, funds should be coordinated with the seller's financial plan. There may be deal covenants or performance goals that need to be managed as well.

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### PROCESS MAXIMIZES VALUE

In conclusion, a carefully managed and organized sales process designed to reap the benefits of the competitive auction can help to maximize the value that shareholders realize. You may have a great company with tremendous perceived value, but if the sales process is botched, that value will not be realized. Worse yet, you may inflict damage on the business if, for example, trade secrets make their way to competitors or if employees, frightened by the prospects of a sale, choose to seek employment elsewhere.

Selling a company using a hit-and-miss approach without a road map and a professional deal team rarely results in the realization of the company's full potential value in the marketplace. A well-executed process unlocks a company's value. It should be comprehensive such that once the deal is completed, the client can rest comfortably knowing that all potential buyers were involved. Equally important, the process should be competitive to ensure that all the bidders stepped forward with their best deal. Careful execution of these elements remains the best way to find the appropriate buyer and cultivate the right deal.

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6/3/11	Pawn Shops

# COMPANY PROFILE: SUNBELT

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