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Virtually every private business must deal with the matter of ownership transition at some point. For many owners, their business represents a lifetime's worth of hard work and a significant proportion of their personal net worth.

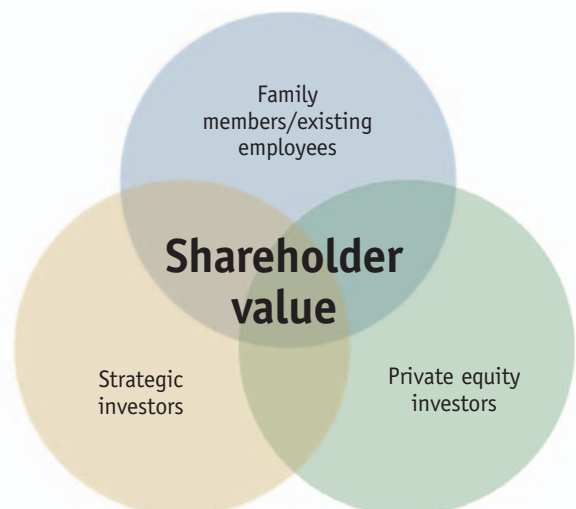
many private middle market business owners considering the sale of their company are concerned that they will spend substantial time, energy, and money on the process, only to reach an unsatisfactory conclusion. While the outcome of any sale process is ultimately impossible to foresee, the likelihood of closing a deal on acceptable terms can be significantly increased through an awareness of some of the most common procedural mistakes. The following includes ten habits that can significantly jeopardize the success of private merger and acquisition (M&A) deals and provides advice on how to avoid these pitfalls.

1) Limiting competition for the business

Many business owners tell their advisors that they already know the most likely buyer for their business. However, in almost every sell-side process, the most likely buyer identified at the onset is not the party that ultimately acquires the business. An owner's willingness to simultaneously explore a diverse range of options is often

essential for maximizing shareholder value and increasing the probability of close. Broadly speaking, purchasers will fall into one of three categories, and each presents their own unique opportunities and challenges.

Family members or current employees are often a natural



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By Chris Polson, CMA

successor to the current ownership. Companies which currently operate in related lines of business (e.g. strategic investors) often have a strong interest in combining the business with their own. Finally, private equity (PE) groups invest in private businesses with the intention of selling at some future date and realizing a return on the investment. These groups are typically funded by institutional investors (e.g. endowments and pension funds), and seek returns which are superior to those realized in public equity markets. In most cases, PE groups use debt to finance a significant portion of the purchase price (e.g. a leveraged buyout, or LBO), thereby increasing the prospective return on the group's equity investment.

While most business owners know the other players within their industry, they are often unfamiliar with the universe of PE groups. For many business owners, particularly those who have a management team in place that is capable of taking over the business, a PE group may provide an attractive alternative to a sale to a strategic competitor. The past decade has seen a tremendous increase in the number of private equity groups, creating a much greater list of options for business owners.

One common rationale which owners cite for limiting the number of parties contacted in a sale process is they do not want their employees or customers to know that the business is being shopped. Although these concerns are valid, a well run sale process can help minimize the exposure and the benefits of a competitive auction far outweigh the risks. Competition creates a fear of loss in the minds of potential buyers and is instrumental in keeping interested parties on track and focused.

2) Unrealistic value expectations

Most private business owners will add a significant emotional premium to the market value of their business. Similarly, some owners approach value by first estimating the amount of money they need to retire and then backing into a value for the business. While retirement and estate planning are very important considerations in the decision to sell or not to sell, market values may not align with an owner's long-term financial needs or wants.

Another common phenomenon is for business owners to look exclusively to valuation multiples from other companies

or transactions within their industry without objectively analyzing whether the multiples are applicable to their company. Even within the same industry, different companies can trade at dramatically different multiples for a variety of reasons including, but not limited to, size, growth expectations, proprietary products or services, debt capacity, revenue stability, capital reinvestment requirements, and investment liquidity.

Generally speaking, a high growth, publicly-traded company with \$50 million of earnings before interest taxes and depreciation (EBITDA) will always trade at a higher multiple than a lower growth, private company with \$5 million of EBITDA.

Factors influencing valuation multiples

Company size	Revenue stability and concentration	Proprietary product or service	Growth expectations	Debt capacity	Capital expenditure requirement	Buyer synergy expectations	Terms of the transaction	Comparable transactions
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A second common risk is the adoption of a “country club” multiple as a valuation benchmark. Retired business owners will often proclaim to friends at the club that he or she “got 8.0x EBITDA for the business.” Owners frequently neglect to mention that the 8.0x multiple was based upon an unadjusted EBITDA number, which included significant personal expenses (e.g. travel, meals, automobile leases, insurance premiums, or pension funding payments), which might bring the multiple effectively paid for the business down to 7.0x. Furthermore, the owner may not mention that 1.0x EBITDA was in the form of a contingent “earn-out” payment based on a forecast that the business has a very low probability of hitting, resulting in what is effectively a 6.0x multiple paid for the business. That is not to say that business owners need to be in the dark regarding value before approaching the market. Trusted advisors can provide helpful insight into the likely value for a business, usually expressed in terms of a range of potential value (e.g. \$60 to \$70 million, or 6.0x to 7.0x times adjusted EBITDA). However, the only way to ultimately know the market value of a business is to approach potential buyers in a controlled, competitive auction process.

3) Failure to engage qualified advisors

Acknowledging the self-serving nature of this statement, it is almost undoubtedly true that a business owner will be well served by engaging an experienced team of advisors to manage the sale process. Qualified advisors, including corporate finance professionals, lawyers, accountants, and wealth managers, are usually instrumental in the planning and successful execution of a transaction.

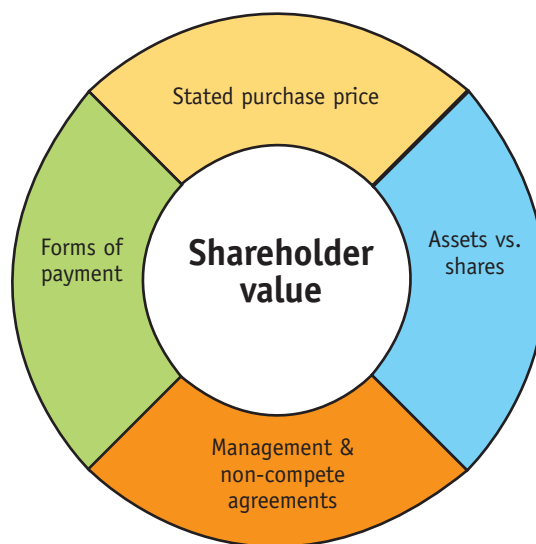
One excellent reason for the use of outside advisors is that many owners find it difficult to objectively evaluate their

business. Outside advisors can tell business owners what they need to hear and not necessarily what they want to hear. Furthermore, managing a sale process can be extremely time consuming and it will often last between six to 12 months. Most owners who are actively involved in their business already have tremendous demands on their time. Trying to run a comprehensive auction process without a qualified advisor often causes the business to suffer as the owner becomes overwhelmed trying to manage the business and the process at the same time. Finally, selling a business is often a very emotional experience and it is beneficial to have a third-party serve as a buffer between the business owner and prospective investors.

4) Lack of negotiating flexibility

Negotiation is an art, not a science. Aside from the stated purchase price, the form(s) of payment (e.g. cash, shares, earn out, etc.), the deal structure (e.g. a sale of the underlying assets or outstanding shares), and any future consulting or non-compete compensation received will all have an impact on the business owner’s net after-tax proceeds. Sellers or buyers that take an inflexible negotiating position on every possible element of a transaction are rarely successful.

From the seller’s perspective, a better approach is to identify and prioritize the elements of a transaction which



are most important and then leverage the attributes of a competitive auction process to reach a resolution on as many of these points as possible before moving forward with one party on an exclusive basis.

Even once the seller enters into a period of exclusive discussions with a buyer in order to finalize the deal terms it is unrealistic to expect that the owner will get everything that they want. For instance, compromises relating to the specific language used within the transaction documents are often necessary. Competent legal counsel and corporate finance professionals will help business owners to identify those points where it makes sense to take a firm stance and those points where a compromise may be more appropriate.

Transaction participants sometimes like to draw similarities between negotiations and Texas Hold ‘em poker. However, unlike a poker tournament, when the negotiating parties go “all-in” they are not required to show their cards and will take their money (or their business) with them when they leave the negotiating table. Ultimatums and hardball negotiating tactics often create a counter-productive environment.

5) Poor financial performance

Financial performance is an obvious driver of value for any business and will be of critical importance throughout a sale process. There is no quicker way for a seller to lose credibility with buyers than to miss their internal financial forecasts. It’s recommended to prepare forecasts that are both reasonable and achievable, especially for the time period during which the sale process takes place. In many ways “hockey stick” growth projections, if not based on sound assumptions, can do more harm than good.

Some private business owners are disadvantaged by the fact that they do not typically prepare a formal annual budget and have never prepared three to five year financial projections. While this type of forecasting is not a requirement to sell a business, it is typically very difficult to monetize the potential of a company when the owner cannot provide buyers with a vision of the future from a financial perspective. Detailed forecasts generated pursuant to a comprehensive, rational planning process will receive the greatest credibility from buyers. If circumstances permit, it is beneficial for business owners to implement a formal budgeting process a few years prior to selling their business, not only from a best practices perspective, but also from the standpoint of refining the budgeting and forecast process.

Qualified advisors can be very helpful to companies preparing forecasts for the first time. Advisors should insist that management take ownership of its forecasts even though this might add a level of anxiety to the forecasting process. A classic warning sign for buyers occurs when a management team responds to questions about their financial forecast by saying, “We don’t know — ask our advisors.”

While the seller’s financial performance is more commonly the focus in a sale process, deals also can fall apart due to a buyer’s poor financial performance or (in the case of a publicly traded company) a declining stock price. Obviously, one of the primary concerns that must be vetted is a buyer’s ability to finance the transaction. A buyer’s poor financial performance can prevent the buyer from securing the financing necessary to fund the transaction or could distract the buyer’s management team to the point that they can no longer focus on the deal. Where a public company’s stock forms part of the consideration paid to the seller, a significant decline in its value may reduce the effective purchase price to the point where the seller is unwilling to complete the transaction. Qualified advisors can assist business owners in the screening and evaluation of potential purchasers to minimize these execution risks.

6) Inadequate financial reporting

Despite common references to valuation “multiples,” and other indications of value as a function of historical performance, buyers are really buying future cash flows. If the historical financial information which a buyer relies upon (to produce estimates of future cash flow) turns out to be misleading, the buyer will need to revisit their valuation model. This will often result in a significant discount to the value of the business. Similarly, any proposed earnings adjustments (often referred to as “normalization adjustments,” or “add-backs”) on account of owner-related and non-recurring items must be based on sound assumptions in order to hold up under a buyer’s due diligence.

While most business owners know the other players within their industry, they are often unfamiliar with the universe of PE groups.

Any owner contemplating the sale of their business should be sure to hire an experienced, professionally trained controller or a chief financial officer who is capable of establishing the appropriate accounting and financial reporting infrastructure. Where practical, it is also strongly recommended that business owners have annual financial statements verified by a qualified third-party accounting firm in accordance with Generally Accepted Accounting Principles (GAAP). Ideally, an accounting firm will prepare an audit, or at least a review. Compiled statements, which are essentially a restatement of the company’s internal statements, typically add little value in a sale process.

While an audit can be time-consuming and an added

expense, it is well worth the cost and is an ideal exercise to prepare private business owners for the rigors of buyer due diligence. It also has the added benefit of improving the quality of financial information that will be used to manage the business. However, business owners should avoid the trap of relying on their year-end audit to clean up any financial reporting deficiencies which occur throughout the year. Transactions rarely close conveniently at year-end and interim financial statements are often just as important as year-end statements.

7) Providing insufficient information to potential purchasers

Private business owners are understandably hesitant to share details about their business with third-parties. During a sale process, however, this reluctance can be problematic as it denies participants the information necessary to gauge their level of interest in the business and, importantly, develop a refined view as to value. One year's worth of externally prepared (either audited or reviewed) financial statements is generally not sufficient for a buyer to develop a credible estimate of value for any business.

In a typical auction process the seller, in collaboration with their advisor, prepares an information memorandum which contains detailed financial and operational information about the business while being careful not to disclose highly sensitive information. This confidential information memorandum (or CIM) is distributed only to promising pre-selected parties who are willing to sign a

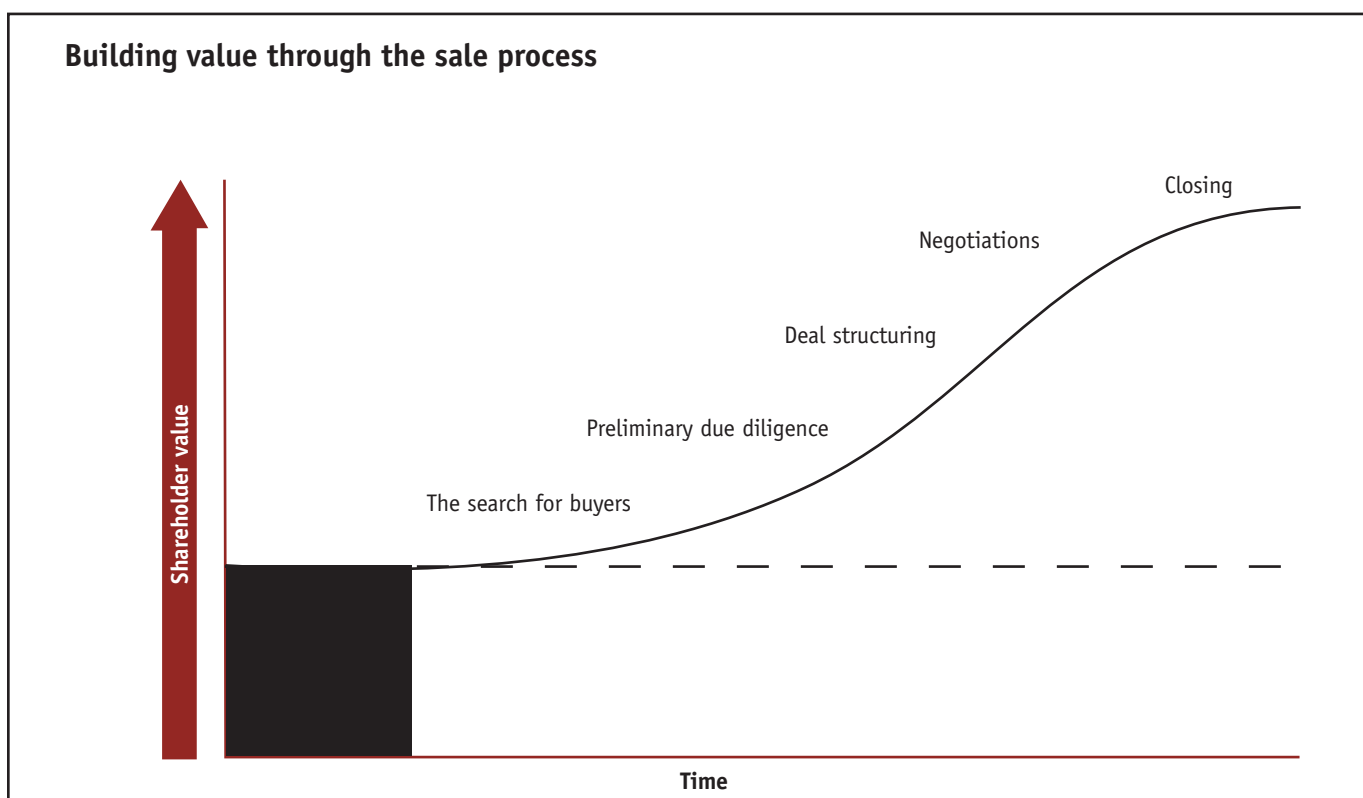
confidentiality agreement.

An efficient auction process will release sensitive information about the business in stages as select buyers move forward with their due diligence and others are eliminated. Even when releasing information in stages, however, buyers will need a certain amount of financial and operational information up front. This information

Negotiation is an art, not a science.

should be sufficient for prospective buyers to produce an informed initial view regarding value for the business, which in turn allows the seller to decide which parties to invite into the next round of the process.

Even in a well run auction process there is no way to completely eliminate the risk of a competitor gaining access to sensitive information, or of employees and outside parties learning that the company may be for sale. This is particularly true in the later stages of the process where due diligence inquiries reach their maximum breadth and depth. The best way to minimize this risk is to approach the market in an organized manner and run a disciplined auction process. A well-managed process will keep the participants focused and moving forward within a relatively short timeframe.



8) Concealing negative issues from purchasers

At the beginning of a sale process, owners are best advised to disclose “the good, the bad, and the ugly” about their business. Hiding bad news from a prospective buyer in the hopes that, the buyer either will not discover the issue or will choose to ignore it because they are already committed to the transaction, is rarely an effective approach. The best opportunity to disclose troublesome issues is early in the auction process when competition amongst buyers is at its peak.

A proactive approach to the disclosure of bad news allows a seller to properly characterize the situation and, to the extent that there are still multiple bidders within the process, convince potential buyers that they will not be competitive if they unduly penalize the company on account of the issue. Even relatively late in the process, when the seller is under a period of exclusivity with one buyer, the knowledge that there were other bidders for the business can help to mitigate potential issues.

9) Personality conflicts

Private business owners are often highly motivated, results-oriented individuals. While these attributes are an asset from an operation’s perspective, they can become a liability in a transaction where a business owner lets his/her ego or emotions get in the way of the deal. Preventing this is easier said than done of course, as most owners are very emotionally attached to their business. Owners will find that it is not easy to listen to a prospective buyer critique various aspects of their business, even where the buyer makes valid points. The natural response is to become defensive, which can alienate the buyer and impair their objectivity.

In many cases, an owner who is active in the business will need to work for the buyer for some period of time after the transaction closes, either in a transitional role or as senior executive going forward. The loss of control is an extremely difficult adjustment for some business owners and speaks to the underlying question asked throughout the process — are you really ready to sell your business?

It is important that both sides work hard to keep the negotiations from becoming too personal and impairing what hopefully will be a very profitable relationship after close. A qualified team of advisors can serve as an important buffer between buyers and sellers, but at some point a buyer will need to interact directly with the seller.

10) Lack of process momentum

Deals are often in jeopardy where the process lacks any sense of urgency and becomes excessively lengthy. Any number of bad things can happen when a sale process stagnates. Although “deal fatigue” is a common phenomenon that happens at some point in almost every

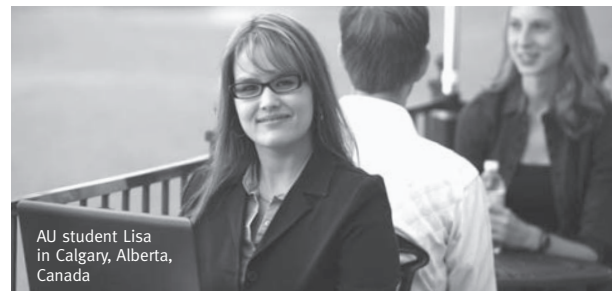
transaction, it is particularly problematic for deals that linger inconclusively. There is a relatively short psychological step from “when is this deal ever going to close” to “maybe I don’t want to do this deal anymore.” As time passes, there is also a greater risk that the deal will fall victim to unfavorable industry or macroeconomic events (e.g. a recession or global credit crisis) or that the buyer will choose to abandon the transaction in favour of a newer opportunity that recently surfaced.

One of most important benefits of an auction process is the sense of urgency it creates for buyers and the seller. To fully capitalize on the value of the business, enthusiasm and momentum should be generated and leveraged throughout the various stages of the sale process. ■

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