

Business For Sale

Like Selling a House, There are Some Things That can be Done to Increase the Value of a Business Being Put Up For Sale

During the rosy mid-and late 1980s, a For Sale sign on a business would attract a lineup of frenzied purchasers anxious to bid up the price. Demand for good businesses and even not-so-good businesses outstripped supply, and it was not unusual for the vendor to realize a windfall value - much higher than anticipated, and in many cases, much higher than the business was worth. Not now; sanity has returned to the mergers and acquisition marketplace. A backlash from the failure rate of leveraged situations, compounded by disastrous current economic conditions, has created a buyer's market. Shriveling bottom line performance of businesses is driving down values even further as buyers worry about continuing weakness caused by free trade, the threat of Quebec's separating, the record high of the dollar, the refusal of consumers to open their pocket books and the absence of the deep-pocketed financial buyers.

What can a vendor do to sell for top value against that backdrop of harsh reality? If the business was a house, you could fix the screen door, renovate the bathroom and apply a fresh coat of paint. In a somewhat similar way, it is possible to prepare a business for sale, whether the seller is a corporation choosing to divest itself of the business or an individual deciding to realize on an investment, a career shift or engage in estate planning.

An Orderly Approach Will Help to Increase Value

Advance planning and an orderly, disciplined approach to preparing the business for sale, as opposed to leave-it-to-the-last-minute crisis mode, makes it possible to avoid the traps and realize maximum value, even in this tough buyer's market. Here are some steps to ensure maximum value is received for your business when you sell.

1. *Optimize Cash Flow* - Most knowledgeable buyers and their advisers favor a discounted cash flow approach to valuation, based on a detailed knowledge of historical events and the future cash likely to be generated by the business. Once the sale decision is taken, the owner should evaluate every decision on how it affects cash flow. Obviously, discretionary capital expenditures should be scrutinized according to their impact upon margin and payback. Similarly, investments in new products may not be fully valued by the prospective purchaser if there is a current negative cash impact.

Reduced overheads can cause a significant positive cash flow; if overhead reductions are required, make them. One-time implementation costs get normalized in the financial statements, and the purchaser puts the greatest emphasis upon the ongoing performance of the business.

If the company is holding excess or obsolete inventories, get rid of them. It is false economy to preserve them on the balance sheet, as the prudent purchaser will certainly uncover the true asset value, leaving the current owner with all the pain and no gain. Similarly, make every effort to collect accounts receivable and keep them as current as possible. The lower the working

capital requirements, the more the buyer can afford to pay for shares or other assets of the business.

In a recent divestiture, the vendor, a medium size food processor, had started the –phase-out of non-core, unprofitable businesses. The overheads related to these businesses were not eliminated prior to offering the business for sale. Even though the vendor presented a detailed plan, supported with strong rationale, the purchaser refused to fully value the projected savings because they were not “real” yet. Completing the rationalization of the unprofitable businesses and related overheads prior to the divestiture might have yielded a higher selling price.

2. *Complete the Normalization Process* – The normalization process requires adding back extraordinary one-time costs such as for severance pay, labor strikes, discontinued product lines and restructuring costs, to reflect the performance of the business under normal circumstances. Any to avoid a debate with the prospective purchaser about their legitimacy and the perception that you are trying to artificially improve the portrayal of the business’ performance. Also, to convince the prospective purchaser of the legitimacy of the add-backs, document the trail from the audited figures to the adjusted, normalized figures.

The vendor, a Southern Ontario light manufacturer, completed a detailed normalization of its financial statements, but its historical records were not well kept. Therefore, while adjustments were probably accurate, they were based on the judgment of the vendor's management team, some of whom were no longer with the company. A big leap of faith was required to reconcile the audited financials with the normalized figures, as a clearly identified trail of documentation did not exist. Eventually, the prospective purchaser lost confidence in the validity of the normalized figures, and retreated to the non-normalized numbers and a lower resultant value. The vendor was forced to accept a value significantly below his expectations.

3. *Purge Redundant Assets* - Many owners have unrelated businesses owned by the divestiture candidate. It is important to show a purchaser the business that is for sale net of anything that is to be left with the owner. The most obvious redundant asset is cash. Since the purchaser is responsible for his or her own financing, it does not make any sense to sell cash.

Although less obvious, the business may contain excess assets in the form of land or buildings, the values of which are too high to justify their continued employment in the business, or at minimum too high to be fully valued by a purchaser. The owner may be wise to relocate the business to other premises, or to keep and lease the land and buildings to the new owner for a reasonable transition period, thus preserving the opportunity to sell them for fair market value at some point in the future.

In another might-have-been transaction, a buyer evaluated a private business being offered for sale by an owner wishing to retire. The seller’s financial statements included accounts of unrelated businesses that were not for sale. It appeared, however, that a substantial portion of the debt on the balance sheet - which the vendor wanted the buyer to assume - was incurred for the benefit of those businesses remaining with the present owner. This caused major disagreements and ultimately killed the deal.

4. *Plan for Management Continuity* – Most buyers value a solid experienced management team. While it is true that some buyers may want to replace one or more key people, the vendor should not count on that. Continue to build the future capability of the firm and replace weakness promptly. Severance costs are one-time costs and will be taken out in the normalization process. Furthermore, future severance pay is usually an issue at the time of sale if marginal employees are still on board.

5. *Do Not Launch Gold-Plated Incentive or Benefit Plans* - If a buyer perceives that the owner is rewarding employees at a level beyond market realities, the excess cost of those compensation programs will most likely be offset by an appropriate reduction in the purchaser's offer for the business. The prudent buyer will allow ample time to bring the programs into line or replace the people.

A few months prior to closing, the vendor approved a 6½% wage increase for its hourly workforce when the norm for these types of companies had recently been around 3%. Unable to roll back the wage increase, the purchaser was prompted to reduce the purchase price by a compensating amount.

6. *Treasure and Maintain Information Systems Excellence* - Do whatever is necessary to ensure that the business can produce information to make prospective purchasers comfortable that they know on paper, and counter the fear that there are skeletons in the closet. All too often owners have key information in their heads and not in writing.

Being able to produce timely, accurate and relevant information often creates a halo effect, improving the prospective purchaser's perception of the overall business. The need to produce this information increases as the divestiture process progresses, particularly during the due diligence phase.

Many cases are on record where the prospective purchaser reduced the offering price by a significant amount simply because he or she could not attest to the historical numbers during the due diligence process.

7. *Consider Leases and Contracts Very Carefully*- Once you decide a sale is on the horizon, avoid making commitments that bind the future owner unless you are absolutely certain that such obligations will be deemed to be a benefit, not a drawback.

The president, knowing that the business would be sold, yet faced with the expiry of a major facility lease, negotiated a short term lease with a renewal option. Shortly thereafter, the president's head office offered the business for sale. The terms of the lease were not viewed negatively by any of the prospective purchasers, as those who did not need the facility would require the better part of the 18 months remaining on the lease to relocate the business, and prospective buyers who did want to remain in the same location could exercise the renewal option.

8. *Minimize Legal Contingencies – Anxieties Will Cost You Money* - Be prepared to settle up all outstanding matters that impinge upon the business unless they can be severed from the business and left with the seller. In most cases, this is not readily achievable and, therefore, an owner is well advised to resolve real or threatened lawsuits where possible.

It is equally important that matters of title, trademarks and licenses be buttoned down well in advance of the due diligence process. You would not be the first owner to find out that you could not deliver what was being offered for sale.

A multi-division Canadian vendor received numerous attractive offers for one of its businesses. After the preferred prospective purchaser was selected and the due diligence process initiated, a lawsuit was served by another company claiming it had rights to the formulations and trademarks included as a key part of the divestiture. The suing company was able to obtain an injunction, involving the vendor company in lengthy and costly legal proceedings, taking over two years to settle.

9. *Clean Everything* - A clean bill of environmental health is becoming as important as market share and customer relations. Horror stories abound about contingent environmental liabilities coming back to bite the new owner. For that reason, purchasers are reviewing any environmental questions with a fine tooth comb and trying to leave all contingencies with the vendor or seek indemnification.

Although less complex, the concept of clean also applies literally to the plant and all workplaces. Unfortunately, when something appears to be down at the heels physically, a prospective purchaser will be concerned even if the income statement and balance sheet tell a different story.

A company that was divesting a business that had changed ownership three times in the preceding 15 years encountered significant difficulty over the level of environmental warranty that would be provided to the prospective purchaser. Few environmental records from the previous owners were available, and the vendor company had not completed an environmental audit. As a result, to save the deal the vendor was forced to provide an onerous environmental warranty.

10. *Sell the Monkey* - What you do not sell may be as important as what is sold. Contingent liabilities involving environmental matters, claims relating to products or services, employees, contracts and, of course, taxes will be the subject of intense negotiations. Which, if any, are to be left with the vendor and which are to be assumed by the purchaser? Any one of these decisions can be a show stopper since, in certain circumstances, the amount of money involved can exceed the purchase price. As a vendor, do not underestimate the importance of eliminating risk, even if it means foregoing a portion of immediate proceeds.

11. *Gain Tax Advantage, But in a Win-Win Way* - Get expert tax advice. Making decisions that will affect sale proceeds due to tax implications is not a job for laymen. Often, even the most subtle difference can result in totally different treatment -either positive or negative.

A first taxation question concerns the choice of selling assets or shares. It is impossible to generalize on this subject, but the vendor is well advised to understand the differences to their own account, which can be substantial. There is usually a way to compromise to create a win-win for both buyer and seller.

Implement only those things that are clearly to the vendor's advantage and would not negatively preempt negotiations with a prospective purchaser. The question of whether or not to strip net worth and its underlying asset value is even more critical in this buyer's market environment. For all tax matters, have a plan, including your first preferences, and present it to prospective purchasers as part of the deal.

12. *Do Not Neglect The Minute Book and Other Administrivia* - Neglecting the little matters can cause a last minute panic at closing, but more importantly, can provide a purchaser a technical excuse not to close the deal if he or she is looking for an out.

13. *Be Finicky About Buyer Fit, Capability and Reputation* - Early in the process, the vendor needs to decide if the maximum value is likely to be obtained from one buyer purchasing the whole business, or whether the business is divisible into separate parts or product lines that would be attractive to separate purchasers and, if sold separately, would fetch a higher total price.

Once having made the decision to sell, most vendors demand top dollar, which is most likely to come from the purchaser for whom the acquisition can create the most synergy. When faced with evaluating multiple offers, the seller will find that the price offered is obviously important, but there are many other factors that must be considered. Perhaps the most critical is the buyer's financial capability to consummate the transaction.

GETTING MAXIMUM VALUE FOR YOUR BUSINESS

1. Optimize cash flow
2. Add back extraordinary one-time costs
3. Purge redundant assets
4. Plan for management continuity
5. Avoid gold-plated incentive or benefit plans
6. Maintain information systems excellence
7. Be careful with long term commitments such as leases
8. Minimize legal contingencies
9. Clean everything
10. Get rid of nuisance items
11. Get expert tax advice
12. Look after details
13. Check buyer out carefully
14. Keep earnouts simple
15. Identify special requirements up front
16. If you have decided to sell, sell

Although it is an extremely delicate matter, verifying the buyer's financial strength is absolutely essential. Some buyers make high initial offers, only to negotiate the price down severely as the negotiations proceed. Other buyers are known for making unreasonable demands for representations and warranties.

A multinational company divesting a misfit division was faced with comparable excellent non-binding bids from four quality purchasers. The company selected the bidder whose strategic need appeared greatest. Assurances were received from the bidder's representative that they had ample funds to close the deal. Months later, after numerous stalls, it became all too apparent that the bidder's assurances were misleading and that they were unable to raise the necessary funds. More rigid scrutiny at the outset, even at the risk of offending the –prospective buyer, would have avoided a great deal of frustration and wasted time for all concerned. The business was sold to another buyer.

14. *Contemplate Earnouts - As a Last Resort* - It is not surprising that a prospective purchaser may well be less optimistic than the current owner about future prospects for the business. In such circumstances, the only way to bridge the gap between what the vendor wants to receive and what the purchaser wants to pay is to make part of the purchase price conditional upon the business achieving certain performance targets. While it sounds superb in

theory and can be made to work, there are perils. When there is a performance shortfall, the

previous owner - the vendor – may well believe that the new owner - the purchaser has mismanaged the situation due to ineptitude, or even consciously to avoid making further payments under the earnout provisions. In either instance, a legal harangue becomes probable. If you, the owner, are forced to accept an earnout to realize what you consider to be acceptable value, try to specify and simplify the performance target. Usually the way to do this is to focus on the sales or the gross margin line, staying out of the mire of bottom line profitability, which is so subject to discretion and manipulation.

15. *Identify Special Requests or Requirements Up Front* - If you, as owner, intend to impose certain conditions upon a purchaser, be clear about them up front. For example, if there are some employees that just have to be protected, make their protection a condition of the offer. Similarly, if you need to be able to leave immediately upon the sale, or if you want to remain as chairman or on a consulting basis, make that known. Finally, be prepared to negotiate certain perquisites that contribute toward your realizing a satisfactory value for the business.

16. *Beware Vendoritis and False Hope* - The sale of any business, but particularly an owner-operated business, can be an emotionally-charged experience. The vendor must come to grips with this matter before the divestiture process begins. Are the vendor's motivations based on sound logic or on emotions? Are price expectations realistic given the performance record, the conditions of the assets, revenue and profit prospects, and equally important, the mergers and acquisitions market at the time? Is the vendor aware of the implications of the sale of the business on his or her personal lifestyle, family members and employees? If the sale process is started and the vendor changes his or her mind prior to the consummation of the transaction, or if the market values the business dramatically below the vendor's expectations, the organization will have been subjected to an unnecessary upheaval, with ongoing organizational anxiety costs if employees believe that the future for the company and, therefore, their futures, are uncertain.

Stakes for Both Buyer and Seller Usually High

There are practical steps that can be taken to prepare a business for sale and to manage the process of sale to ensure the vendor receives full value. Because the stakes are usually extremely high for both buyer and seller, the undertaking is bound to be fraught with risk - an I win - you lose mentality - and emotion. Having a plan, a checklist and a ruthlessly honest appraisal of what does exist in your business through the eyes of a potential buyer will allow you as owner or responsible executive to prepare the business for sale, make necessary changes and corrections and thereby avoid squandering business value.