Sell-side considerations for middle-market companies

Starting and growing a business is tough; exiting it can be even tougher. An owner of a private, mid-market company who is contemplating its sale should execute the process with forethought and precision; the owner should sell for the right reason, have an understanding of value, and be prepared to address a host of financial, operational, technology, and human resource issues during the transaction. The process can be daunting, especially because achieving goals in running a company — whether it is a longtime family business or an up-and-coming entrepreneurial firm — doesn't necessarily translate into achieving those goals when selling it.

When is it time to sell?

Owners of mid-market companies face numerous issues and challenges leading up to and during the sale process. One big question: When is the preferred time to pursue a transaction? Oftentimes, the decision involves three considerations: company-specific variables, existing market conditions, and synergy opportunities with potentially interested parties.

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Company-specific variables

Many owners of entrepreneurial firms typically are good at starting businesses but may not be as adept at handling the myriad challenges typically encountered throughout a "normal" company lifecycle; at a certain point in the company's growth, an owner may realize: "I'm great at marketing but need additional human and financial capital to take this business to the next level." Another trigger might arise from a life event or from a desire to pursue other interests. Alternatively, a second-generation owner may feel that their passion for the business is waning or that their children aren't interested in or capable of taking over the business.

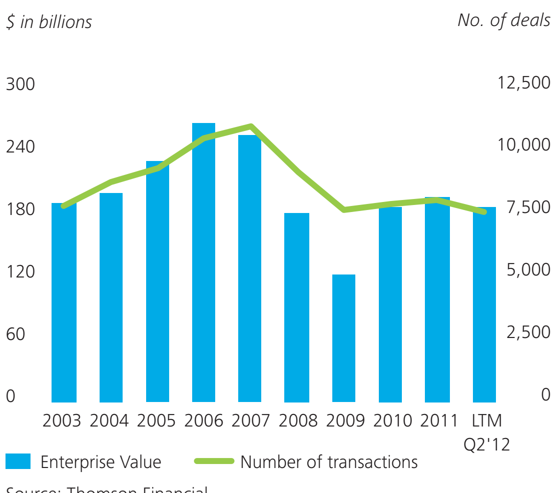
Existing market conditions

Many people think their baby is the most beautiful in the world; however, pride of ownership can make it difficult for owners to determine the appropriate price for their company. An entrepreneur who has devoted years to building a business or an owner who considers a family company to be their legacy may find it difficult to take an objective view of the company, resulting in an inflated perception of value, and become frustrated in their attempts to consummate a transaction. Conversely, if an owner is looking for a quick exit and suggests a willingness to accept a price that is below the market's perception of value, the owner not only risks forfeiting the financial rewards to which they are entitled (especially if estate and gift taxes are part of the sales equation) but also invites potential buyers to negotiate the price down even further.

It also can be challenging for owners to identify the "windows of opportunity" in which to sell the business at the desired price. Important questions to ask include: Is the overall market for selling companies favorable? Will my company's recent performance garner an attractive price? Am I emotionally ready and financially prepared to exit my company? While conditions rarely align perfectly, the answers to these questions should be acceptable or the owner/entrepreneur may be better served to delay the possible transaction.

Fortunately for sellers, recent mid-market deal activity has been quite favorable (Figure 1). U.S. corporations today have more cash on hand than any time in history; concerted efforts to shore-up balance sheets during the recession has positioned companies with reduced debt levels and strong cash balances, which could be used to pursue Merger & Acquisition (M&A) activity as a vehicle for growth[1].

Figure1: U.S. mid-market deal value & volume[2]
(Less than $500 MM enterprise value)



Source: Thomson Financial

Additionally, private equity (PE) firms have considerable available cash to invest in private businesses. At the end of second quarter 2012, PE funds had $423 billion worth of capital that they need to put to use,[3] potentially via mid-market M&A. Another positive that may boost short-term, mid-market divestiture activity: Capital gains rates will likely remain at 15 percent until the end of 2012[4], along with more favorable Bush-era tax rates for individuals and a temporary estate tax regime[1]. The prospect that Congress may fail to extend these cuts or adopt a more permanent tax structure, as well as the potential for Congress to act on broad tax reform in 2013 or 2014, raises new tax planning concerns and could spur numerous transactions in late-2012 and early 2013, as owners who are desiring liquidity seek to attain material tax savings.

[1] "Sellers, conditions are ripe: Time to take a bite at the apple" Deloitte Corporate Finance LLC, June 2012

[2] "Middle Market M&A News, September 2012," Deloitte Corporate Finance LLC

[3] Ibid

[4] http://www.forbes.com/sites/beltway/2012/01/24/capital-gains-taxes-are-going-up/

While ample capital is available and tax conditions are favorable, many of today's buyers are more disciplined than they were five years ago and will be fairly rigorous with respect to acquisition prices. They may be willing to pay for quality assets, but a company seeking to be purchased needs to demonstrate that it has, among other characteristics, a defensible position, a proprietary product, and positive client relationships, in order to attract the most favorable valuation. Not all cash flow is created equal; current owners should demonstrate that when their company is in the hands of someone else, the new owners should be able to not only maintain but, in fact, significantly expand upon its historical achievement.

Synergy opportunities

Standalone mid-market companies may offer considerable synergy opportunities for potential purchasers; among them, access to new products, technologies, customer segments or geographic markets, accelerated time to market, and increased management depth and experience. It is important that the seller promote any potential synergies early in the sales cycle to increase market interest and improve valuation. Also, when a mid-market business is an important contributor (vendor, service provider) to a larger company, it may be easier for the mid-market owner to leverage that relationship and be acquired by the larger company. However, it is likely that the owner will need external assistance to determine if the entity is worth more as part of a bigger company or as a standalone, and when the time is right to approach potential buyers.

Sales transaction challenges

Once a business owner has decided to sell, navigating the transaction process can bring numerous other challenges. Among them: identifying and vetting interested buyers. There may be a lot of pretty candidates, but only a few really good matches. For example, is a strategic competitor or a PE firm a more practical option? What about a foreign versus domestic buyer? Also, how can the seller confirm bidders' credit-worthiness, their access to capital, and governance practices?

The next hurdle is the sale itself. If a business owner wishes to manage price, can a high price be achieved through a one-to-one negotiation? Or, must the owner pursue a broad auction process and risk possible confidentiality leaks and/or the reputational risk of having a wide sale process that ultimately may not be consummated? Either option can become a complex, nerve-wracking game between seller and bidder that weighs the optimism of the owner against marketplace realities: Buyers want to get a deal done at the lowest-possible price, while sellers are looking to leverage their after-tax proceeds from the transaction. The current financial and economic environment adds another wrinkle and can create additional pricing pressure[5].

Even when a deal has been reached, the transaction is far from complete: the current and new owners have much to accomplish in the period between signing and closing, including developing an employee retention program, reconciling disparate compensation strategies, and creating and implementing an effective employee communications plan. For some, the process can seem never-ending.

Human resource issues can loom large in a company sale

Situation: a large Asian manufacturer is currently entering the U.S. market via the purchase of its third-largest U.S. competitor. As the manufacturer is entering a new geographic market, one factor to the achievement of goals in the acquisition is the retention of the management team.

Issue: The company is currently owned by a PE firm, and the management equity incentive plan will pay out multi-million dollar amounts on the change in control, providing executives with significant "walk-away" money.

Result: A detailed retention plan was developed with three facets. First, it was determined that the roles, responsibilities, and titles that the executives would have after the acquisition were critical to their continued satisfaction. A detailed organization structure, reporting responsibilities, and governance structure was developed to address this. Also, the senior U.S. executives were named to various Board positions in the global parent company, giving comfort to the management team. Second, a long-term incentive plan was redesigned, allowing executives to reinvest a portion of their existing equity. The rollover was matched by the company, providing enhanced opportunity for future wealth accumulation. Third, the business rationale and leadership team vision of the new organization was developed in detail and communicated by the leadership jointly with the target, helping to secure the buy-in of the extended executive team.

[5] "M&A Seller Services: Preparation drives value," Deloitte Corporate Finance LLC, 2012

Experience counts

Because mid-market company owners often lack experience in M&A — and the financial implications of selling their business can be considerable, especially when the proceeds are needed to provide future financial security for an owner and their family[6] — owners should consider enlisting a team of independent, experienced advisors to provide support before, during, and after the sale. These individuals and their typical roles to assist the seller are as follows:

Investment bankers	Attorneys	M&A accounting/ forensics professionals	Tax professionals	Human resources professionals	Asset managers/ estate planners
Establish a range of values and advise on the spectrum of possible outcomes; identify challenges early in the sales cycle; develop the selling story and marketing strategy;[7] "shop" the company to numerous potential buyers (so the seller has multiple parties with which to negotiate); assist owners with valuation and negotiation strategy.	Assist with negotiation of transaction terms; draft legal documents to effectuate the transaction; focus on those aspects that might create exposure for the seller post-transaction; understand and assist with regulatory approvals.	Conduct pre-sale financial due diligence with a focus on earnings quality, normalized working capital, and financial commitments (net debt). Such seller due diligence can help to reduce surprises during the transaction as well as the possibility of price chipping in the latter stages of the process. These professionals also review the consistency and accuracy of the data room documents. Upon assessing the value drivers, their focus often shifts to provide comments on the transaction agreements; prepare funds flow statements, conduct closing date balance sheet or working capital analyses; and assist in identifying purchase price adjustments.	Provide advice on the structure of the sale (e.g., receive a lump sum, stretch out the sale payments over several years, remain on the company payroll for a while as a consultant or advisor[8]); determine the preferred domicile and type of legal/tax entity; obtain desired tax treatment of transaction (taxable or tax-free, where available).	Develop the organization's talent strategy so that it is most favorable to the seller's employees, including organizational design and integration under the new leadership; terms and conditions for retention of senior executives; separation agreements; rewards strategy and compensation packages; and employee communications plan.	Help seller assess whether the level of anticipated proceeds can achieve the owner's hoped-for post-sale lifestyle and aspirations, given his or her appetite for investment risk.

It is important that external advisors work collaboratively, both with the owner/other company contacts and with each other — if they are from different firms, the advisors may have competing agendas and be more complex to manage. There should be no duplication of services but each major area should be addressed; a single issue could have tax, accounting, and HR impacts and thereby affect the valuation and negotiation of the transaction documents. As a result, these issues should be examined through different lenses.

Preparation can drive value

The goal when selling a business is often to capture the highest value possible. While a number of factors drive deal valuation — company prospects, competitive landscape, economic conditions, deal structure and tax considerations, among them — well-prepared sellers are generally better positioned to meet the challenges posed by potential buyers during the process. Among leading practices that can help a seller prepare for and execute a transaction that achieves their goals for deal value are the following:

[6] Andrew Menachem, Andrew. "What to know when you are selling your business," The Miami Herald, July 13, 2012. (c) Copyright 2012, The Miami Herald. All Rights Reserved. http://www.miamiherald.com/2012/07/13/2894767/what-to-know-when-youre-selling.html. Accessed July 24, 2012

[7] "Using Investment Bankers to Sell a Business," Gaebler.com Resources for Entrepreneurs, http://www.gaebler.com/Role-of-Investment-Banker-Selling-Your-Business.htm. Accessed July 24, 2012

[8] Andrew Menachem, Andrew. "What to know when you are selling your business," The Miami Herald, July 13, 2012. (c) Copyright 2012, The Miami Herald. All Rights Reserved. http://www.miamiherald.com/2012/07/13/2894767/what-to-know-when-youre-selling.html. Accessed July 24, 2012

Accurately value the company

Remember that the true worth of a business is the current and potential income it will generate for the new owner[9]. To manage the risk of overvaluation, company owners should work with an investment banker/financial advisor with experience valuing businesses in their sector; provide the broker with all the necessary financial information to facilitate the valuation process; and listen to the broker (who is more objective about the company's worth).

Enlist seller services support

In collaboration with the legal and financial advisors described above, M&A seller services professionals can provide a broad spectrum of customized services and solutions to help mid-market company owners complete a divestiture across the sale lifecycle (Figure 2). Typical services include:

- Deal planning and preparation: Define what will and will not be included in the transaction; identify potential tax, accounting, labor, operational and system issues before going to market; determine whether the transaction structure is in line with company strategy; quantify the strategic value of risks and opportunities; address issues associated with the Confidential Information Memorandum, including the appropriateness and comparability of financial information presented.
- Due diligence/seller diligence: Identify financial and regulatory matters; examine compensation-related agreements; assess the quality of the information that will be made available to potential bidders; preparation of a Seller Diligence Report (see sidebar article), when applicable.
- Deal structure: Assess alternatives and structure the deal to meet seller's financial objectives; estimate gains; analyze the allocation and preservation of tax attributes; identify potential perceived risks of prior tax positions.
- Transaction execution: Identify deal issues and develop negotiating positions; assess proposed purchase price adjustments and earn-outs; comment on representations and warranties to be included in the purchase agreement; develop a workable purchase price mechanism to reduce the potential for disputes over judgmental accounting areas and resolve tax and accounting issues.
- Transaction closing and post-closing support: Apply accounting principles and prepare historical financial statements; after deal has closed, help calculate the gain on the sale and assist in determining purchase price adjustments; assist in drafting transition service agreements and preparing the divested business for day-one readiness, including cutover of IT systems and the establishment of HR and financial functions.

Figure 2: Seller services across the sale lifecycle

Employing a structured approach to sales/divestitures can unlock and drive value at each step of the process

Phase I 4–5 weeks	**Phase II** 10–12 weeks	**Phase III** 3–4 weeks	**Phase IV** 6–8 weeks
• Preparing the business for the sale and pre-sale due diligence	**• Marketing the business**	**• Buyer selection and due diligence**	**• Closing the transaction**
• Discuss goals and objectives of management • Develop understanding of the company's business model, competitive position and corporate functions' allocations • Identify potential obstacles to sale and deal with them directly and upfront • Analyze strategic rationale for various buyer/investor groups • Develop understanding of union agreements • Assist management in developing and diligence finances (historical and projected) • Compile and review data room information • Prepare detailed valuation analysis to assist buyer/investor evaluations • Create executive summary and prepare the confidential information memorandum	• Finalize list of potential buyers/investors and analysis of buyers/investors and analysis of buyer-specific synergies' opportunities labor considerations • Direct calling on potential buyers at C-suite level • Distribute information memoranda to approved parties • Develop management presentation • Field injuries from interested parties to minimize disruption to the company	• Assist in evaluating letters of interest and qualifying buyers/investors • Arrange value with management for qualified parties • Facilitate flow of information to prospective buyers/investors • Assist the company in soliciting and evaluating bids • Evaluate price, structure, non-cash consideration, potential synergies and conditions set by buyers/investors • Evaluate buyers/investors' financial capability to close transaction • Assist where applicable in drafting labor business case and related documentation and begin negotiations	• Manage final due diligence process • Assist in negotiation of definitive purchase and sale and other ancillary agreements • Assist in structuring and closing the transaction • Continue to assist in preparing information to be utilized in labor negotiations • Ensure timely follow through and settlement of any post-closing obligations

[9] Bannister, Adam. "Business valuation: the danger of overvaluation," http://www.businessesforsale.com/sell-a-business/articles/Selling-a-business-the-danger-of-overvaluation. Accessed July 24, 2012

Tailor the story

While the strategic advantages and core competencies of the business do not change depending on the potentially interested buyer, how that third-party might utilize the seller's specific attributes and thereby manage value within the acquiring company can change from buyer to buyer and can evolve over time. To this end, having intimate familiarity with the strategic visions of potential buyers and knowing how to position the selling company such that the opportunity hits home with the C-suite of possible buyers can be a main determinant in achieving the seller's objectives. A financial advisor with deep sector experience and a track record of achievement may generate the type of buzz within an organization that yields the highest price.

Conclusion

A confluence of market events that include tax law changes, a pent-up supply of corporate cash and uninvested private equity capital, and favorable financing conditions are providing a window of opportunity for mid-market company owners who are seeking to sell their business. Yet optimism should be tempered by realism when determining company value, and owners should consider turning to financial, legal, and M&A seller services professionals for solutions to help them navigate the transaction, manage sales price, and enjoy the fruits of their labors.

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Sell-side due diligence can boost credibility, deal value

The credibility of a seller can have a dramatic impact on deal value. Incomplete or inaccurate information, particularly financial data, may have a direct, negative impact on sale price. Conversely, reducing uncertainties about the accuracy and reliability of information being provided — company description, sales, cost, and profit figures — may make a potential buyer more willing to pay full consideration — or even a premium.[10]

Sellers can expect that potential buyers will conduct due diligence on the data they provide; sellers, therefore, have a compelling reason to be thorough in their own analysis. Conducting sell-side due diligence before the sales process starts can help a seller anticipate issues that a buyer may raise and develop responses that can help to reduce uncertainty and enhance credibility during the buyer's examination of the company. Among main focus areas in sell-side due diligence:

- Understand intra-company transactions, allocated costs, shared services, and plans for providing support post-acquisition and during transition.
- Evaluate the quality of earnings and identify "non-recurring" items for which management may want to consider adjusting the financial information.
- Understand the assumptions in company forecasts and the bridge of detailed data from actual results to forecast information.
- Evaluate the cost structure for fixed versus variable costs, capital expenditure requirements, and the relevance of certain general and administrative activities to the business being sold.[11]

10 "Sell-Side Due Diligence: Can you pave the way to a higher-value carve-out?" Deloitte Corporate Finance LLC, 2008
11 Ibid

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