

# PRIVATELY HELD

C O M P A N Y

the report on transaction issues

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### FIRST BUSINESS RESOURCES, INC.

is a full service business advisory firm providing professional acquisition, divestiture and consulting services to private middle market corporations. We competently counsel our clients in the areas of disposition, acquisition, and exit strategy development.

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### Preparing the Business for Sale

For sellers to receive top dollar for their businesses, planning is critical! It is not something to put off just prior to the decision to sell. Following are some factors to consider, both long-term and short-term.

#### Long-Term Considerations

Ideally, the seller will start planning a full year in advance of a sale, because numerous elements will take considerable time and expense to execute. Most small private companies, for example, have their financial documents "reviewed" or "compiled" but rarely audited. Auditing statements involves conducting an actual physical inventory, with each accounts receivable and all other financial details verified in the process. While audited statements are mandatory for public companies, many private companies opt not to pay the extra cost of auditing, which can range from \$10,000 to \$40,000. However, an audited statement, which is a verification of the reported numbers in the financials, may result in a higher offer by the buyer.

Other items to address in preparation for selling a company include cleaning up the balance sheet of old debts and writing off uncollectable accounts receivable and old inventory. This ensures that the buyer is not deterred by a less than pristine financial statement.

Settle outstanding lawsuits and engage top management in non-competitive and stay agreements.

Further, make sure the plant is in excellent physical shape; spruce it up if need be. If the facility does not show well, it will very quickly turn off buyers.

#### Short-Term Considerations

In addition to the long-term issues discussed above, certain elements need to be considered in the short term. Prior to going to market with the sale of a company, sellers need to allocate about two to four months for organization purposes. A critical element in organizing a business sale is to assemble a team of advisors, including a mergers and acquisition (M&A) intermediary. This representative will partner with the seller during the entire selling process and will probably be in contact with the seller almost daily for the next six to twelve months. The intermediary will also orchestrate the process and act as "quarterback" for the team of advisors. A transaction attorney, an accountant, and most likely a tax attorney who will be knowledgeable about the company's personal affairs should also be by the seller's side.

Next, it is advisable to have a valuation of the business that not only determines the "anchor" price but also supports the seller's reasoning in the negotiating process. Along with the business appraisal, sellers should consider obtaining a machinery/equipment appraisal and a real estate appraisal. The buyer will need these separate appraisals to know what will be required in order to finance some of the hard assets.

Finally, the preparation of the selling memorandum by the intermediary is the major selling tool in the entire process. This document describes in detail the industry, the company, the financials, and investment considerations.

Along with this document, a seller should have a "war room" of various documents pertaining to the business: lease agreements, bank agreements, a sales representative agreement, and corporate minutes. The war room would be the single place where all of the necessary secured files are kept. These files contain all the pertinent facts of the company, which buyers will want to review as part of their due diligence process.

There is an old saying that the right time to prepare to sell your company is the day you start or purchase it.

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Putting a price on privately-held companies is more complicated than placing a value or price on a publicly held one. For one thing, many privately-held businesses do not have audited financial statements; these statements are very expensive and not required. Public companies also have to reveal a lot more about their financial issues and other information than the privately-held ones.

This makes digging out information for a privately-held company difficult for a prospective purchaser. So, a seller should gather as much information as possible, and have their accountant put the numbers in a usable format if they are not already.

Another expert has said that when the seller of a privately held company decides to sell, there are four estimates of price or value:

1. A value placed on the company by an outside appraiser or expert. This can be either formal or informal.
2. The seller's "wish price." This is the price the seller would really like to receive - best case scenario.
3. The "go-to-market price" or the actual asking price.
4. And, last but not least, the "won't accept less than this price" set by the seller.

The selling price is usually somewhere between the asking price and the bottom-dollar price set by the seller. However, sometimes it is less than all four estimates mentioned above. The ultimate selling price is set by the marketplace, which is usually governed by how badly the seller wants to sell and how badly the buyer wants to buy. What can a buyer review in assessing the price he or she is willing to pay? The seller should have answers available for all of the pertinent items on the following checklist.

The more favorable each item is, the higher the price.

- Stability of Market
- Stability of Historical Earnings
- Cost Savings Post-Purchase
- Minimal Capital Expenditures Required
- Minimal Competitive Threats
- Minimal Alternative Technologies
- Reasonable Market
- Large Market Potential
- Reasonable Existing Market Position
- Solid Distribution Network
- Buyer/Seller Synergy
- Owner or Top Management Willing to Remain
- Product Diversity
- Broad Customer Base
- Non-dependency on Few Suppliers

There may be some additional factors to consider, but this is the type of analysis a buyer should perform. The better the answers to the above benchmarks, the more likely it is that a seller will receive a price between the market value and the "wish" price.

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## What Are Buyers Looking for in a Company?

It has often been said that valuing companies is an art, not a science. When a buyer considers the purchase of a company, three main things are almost always considered when arriving at an offering price.

### Quality of the Earnings

Some accountants and intermediaries are very aggressive when adding back, for example, what might be considered one-time or non-recurring expenses. A non-recurring expense could be: meeting some new governmental guidelines, paying for a major lawsuit, or even adding a new roof on the factory. The argument is made that a non-recurring expense is a one-time drain on the "real" earnings of the company. Unfortunately, a non-recurring expense is almost an oxymoron. Almost every business has a non-recurring expense every year. By adding back these one-time expenses, the accountant or business appraiser is not allowing for the extraordinary expense (or expenses) that come up almost every year. These add-backs can inflate the earnings, resulting in a failure to reflect the real earning power of the business.

### Sustainability of Earnings

The new owner is concerned that the business will sustain the earnings after the acquisition. In other words, the acquirer doesn't want to buy the business if it is at the height of its earning power; or if the last few years of earnings have reflected a one-time contract, etc. Will the business continue to grow at the same rate it has in the past?

### Verification of Information

Is the information provided by the selling company accurate, timely, and is all of it being made available? A buyer wants to make sure that there are no skeletons in the closet. How about potential litigation, environmental issues, product returns or uncollectible receivables?

The above areas, if handled professionally and communicated accurately, can greatly assist in creating a favorable impression. In addition, they may also lead to a higher price and a quicker closing.

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Basically, there are three major negotiation methods.

1. Take it or leave it. A buyer makes an offer or a seller makes a counter-offer - both sides can let the "chips fall where they may."
2. Split the difference. The buyer and seller, one or the other, or both, decide to split the difference between what the buyer is willing to offer and what the seller is willing to accept. A real oversimplification, but often done.
3. This for that. Both buyer and seller have to find out what is important to each. So many of these important areas are non-monetary and involve personal things such as allowing the owner's son to continue employment with the firm. The buyer may want to move the business to a new location.

There is an old adage: "Never negotiate your own deal!" The first thing both sides have to decide on is who will represent them. Will they have their attorney, their intermediary or will they go-it-alone. Intermediaries are a good choice for a seller. They have done it before, are good advocates for their side and they understand the company and the seller.

How do the parties get together in a win-win negotiation? The first step is for both sides to work with their advisors to settle on the price and deal structure positions. Both sides should be able to present their side of these issues. Which is more important price or terms, or non-monetary items?

Information is vital to a buyer. Buyers should keep in mind that the seller knows more about the business than he or she does. Both buyer and seller need to anticipate what is important to the other and keep that in mind when discussing the deal. Buyer and seller should do due diligence on each other. Both buyer and seller must be able to walk away from a deal that just is not going to work.

Bob Woolf, the famous sports agent said in his book, Friendly Persuasion: My Life as a Negotiator, "I never think of negotiating against anyone. I work with people to come to an agreement. Deals are put together."

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### Top Ten Mistakes Made by Sellers

- Neglecting the day-to-day running of their business since it will sell tomorrow.
- Starting off with too high a price since the price can always be reduced.
- Assuming that confidentiality is a given.
- Failing to plan ahead to sell/deciding to sell impulsively.
- Expecting that the buyers will only want to see last year's P&L.
- Negotiating with only one buyer at a time and letting any other potential buyers wait their turn.
- Having to reduce the price because the sellers want to retire and are not willing to stay with the acquirer for any length of time.
- Not accepting that the structure of the deal is as important as the price.
- Trying to win every point of contention.
- Dragging out the deal and not accepting that time is of the essence.

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