SELLING A BUSINESS: STRATEGIC AND FINANCIAL CONSIDERATIONS

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CHAPTER 6

TODD ANDERS is a partner with GuideCap and brings significant transactions experience with an expertise in structuring, negotiation, and international strategies. Prior to GuideCap, Mr. Anders was the Executive Director of International Investment Strategies for the Carlson Companies, a $30 billion company with holdings in hotels, restaurants, travel and cruise lines. During his tenure with Carlson, Mr. Anders was charged with international expansion, which was accomplished through direct foreign investment, strategic partnerships, licensing, and acquisitions in over 70 countries. Prior to Carlson, Mr. Anders was a principal with SBC International, a strategic consulting firm focused on the telecommunications sector, whose notable clients included Alcatel and GTE. Previously, Mr. Anders practiced law, focusing on mergers and acquisitions and general business representation. Mr. Anders has also served as adjunct professor of Business Law at Southern Methodist University. He received his B.S. in Business and B.A. in Economics from Centenary College of Louisiana, his J.D. from Baylor University Law School, and his M.B.A. and L.L.M. from Southern Methodist University. Mr. Anders is a frequent speaker on exit strategies and M&A-related topics.

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Brad Whitlock is a partner with Scheef & Stone, L.L.P. His practice focuses on business transactions, including mergers and acquisitions (including stock and asset purchases and tender offers), securities matters (including representation of issuers, underwriters, venture capitalists, and private equity and hedge funds in connection with public and private offerings of debt and equity securities), and lending transactions (including the representation of lenders and borrowers in connection with loan documentation). He also has considerable experience representing companies in connection with their general legal needs, including labor and employment, contracts, and real estate. He was a partner in the corporate section of a large Dallas-based law firm for many years and has served as the general counsel for a large Dallas-based manufacturing company, where he was responsible for all of the legal aspects of the company.

Mr. Whitlock was named as one of the best lawyers in Dallas in the May 2003 issue of *D Magazine* and as a Texas Super Lawyer by *Texas Monthly* magazine from 2003-2009. He is also included in the 2005 and 2006 editions of *The Best Lawyers In America*.

MEMBERSHIPS

In addition to his law practice, Mr. Whitlock is involved in many bar and professional activities. He is a past Chair of the Business Law Section of the State Bar of Texas. From 2002-2003 he served as Chair of the Corporation Laws Committee of the Business Law Section and he has helped draft sections of the Texas Business Organizations Code. Mr. Whitlock has served as chairman of the Securities Law Section of the Dallas Bar Association, as Chairman of the Texas Business Law Foundation, and on the Council of the Business Law Section.

Mr. Whitlock has served on the board of several civic organizations, including the Greater Dallas Youth Orchestra and the Arts District Friends. He is a 2001 graduate of the Leadership Dallas program sponsored by the Greater Dallas Chamber of Commerce and served as chair of the Chamber's Leadership Advisory Council.

PUBLICATIONS/SPEAKING ENGAGEMENTS

Mr. Whitlock is the co-author of the four volume *Texas Practice Guide—Business Transactio*ns published by Thompson Reuters/West. This treatise analyzes a number of Texas contracts, including employment agreements, technology agreements and service agreements. Mr. Whitlock is also a frequent speaker on a variety of transactional topics.

EDUCATION

Mr. Whitlock received his J.D. degree from the Southern Methodist University School of Law where he was a member of the *Journal of Air Law & Commerce* and a Hatton W. Sumners Scholar. He received his B. A. degree from Westminster College in Fulton, Missouri.

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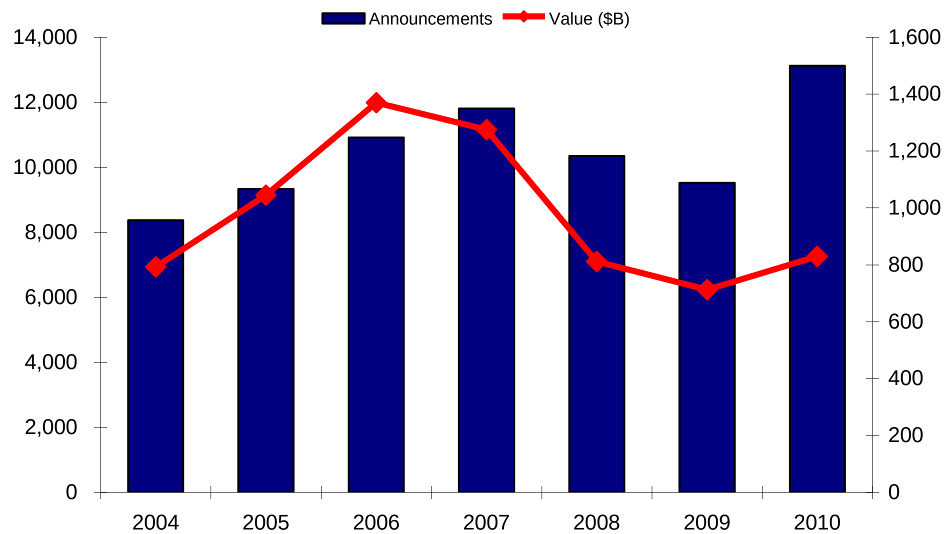
I. State of the Market

While the majority of this paper deals with principals that are not dependent upon the current economic conditions, it would be imprudent to ignore the current state of the mergers and acquisitions (M&A) market.

Mergers and acquisitions activity has rebound in the second half of 2010. While some economic uncertainty still persists, the economy has expanded and the lending environment has improved. In addition, strategic buyers have returned to the market and private equity firms need to deploy uninvested capital.

M&A activity increased throughout the first ten years of 2000, reaching a peak in value of $1,369 billion (2006). Aggregate value declined each subsequent year until 2010 which showed a slight uptick to $829 billion in value, which was 60% of the 2006 high (See Figure 1). The decline from 2006 to 2010 resulted from the credit crisis, declining home values, lack of confidence in the financial sectors, the war on terrorism.

Figure 1: Deal Activity vs. Deal Value



Due to the changing dynamics of the current M&A market, it is critical that sellers carefully evaluate the strategic and financial factors in determining the best time to sell their business.

II. Strategic Considerations

Is it the right time to sell?

Many business owners begin the process of trying to find a buyer without asking if now is the right time to try to sell. They do not consider how timing affects the final selling price. The purpose of this section is to examine several general factors that impact a business's marketability and price. This includes factors that the business owner can influence, and factors that they cannot. The way a business is run, with a view toward an exit, differs from the way it is run if the owner is planning to keep it indefinitely. Therefore, the process of planning an exit should begin well in advance of the actual sale process. Owners should begin planning several years in advance of a sale to maximize the value of the business. As sellers think about exiting, they should engineer performance to put the best light possible on the business. Some of the factors under an owner's influence that will impact the value of the business include:

- Grooming a good leadership team;
- Maintaining a clean balance sheet;
- Maintaining a clean capital structure;
- Deferring "truly" discretionary expenses for the nine months before the sale;
- Creating a track record of consistent versus sporadic sales;
- Building a good sales pipeline;
- Properly capitalizing the business;
- Preparing the business for the scrutiny of Sarbanes Oxly and rule 401 compliance; and
- Avoiding extraordinary changes in the business for nine months before the sale.

Conversely, there are a number of factors that cannot be influenced by an owner, but should be considered in evaluating the right time to sell the business. They include:

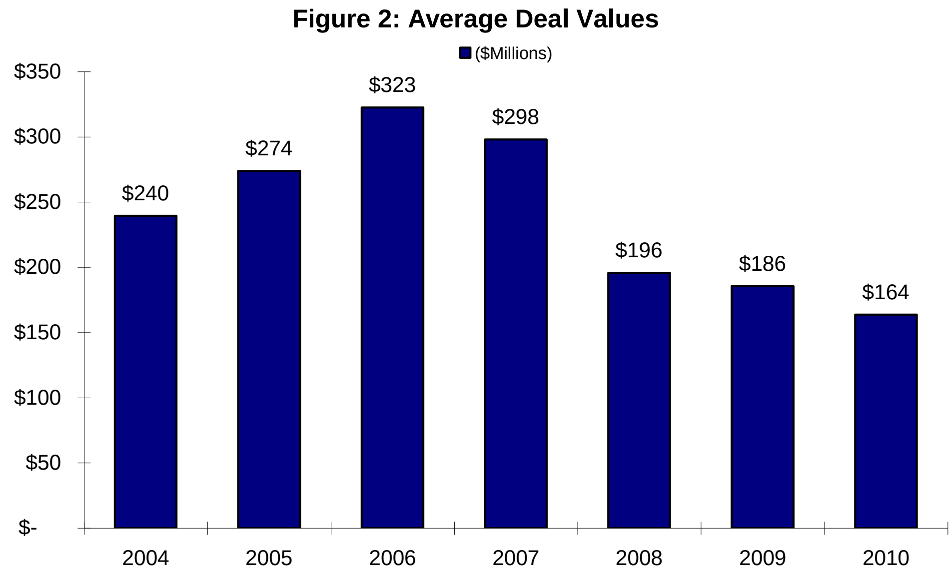
- General economic conditions;
- Industry consolidation;
- Business life-cycle, and
- Unsolicited offers.

Below we will discuss a number of these factors and how they affect the timing of a sale.

General Economic Conditions

In evaluating when to sell a business, general economic conditions and their impact on maximizing cannot be ignored. Changes in the general economy affect the overall demand for businesses, the price buyers are willing to pay, and the structure of the deals getting done. In down economic markets, the value of public and private businesses decline. In addition, if the credit markets are tight, buyers may not have access to the capital required to fund acquisitions . Figure 1 (above) shows the affect of the down economic cycle on M&A from 2007 to 2009.

When the economy is in a slowdown, many buyers are on the sidelines, demand is decreased, and deals are not getting done and average values have decreased (Figure 2 below)



While this general principle holds true for most businesses, some industries or businesses are actually counter-cyclical. When general economic conditions are not favorable for most, these contrarians are actually in higher demand. As a result, when most sectors are depressed, companies in these industries are demanding higher-than-average multiples. In the downturn of 2008-2010, there was a flight to quality in the public and private markets. As a result, businesses that showed higher-than-average economic returns could still find prospective buyers.

Industry Conditions

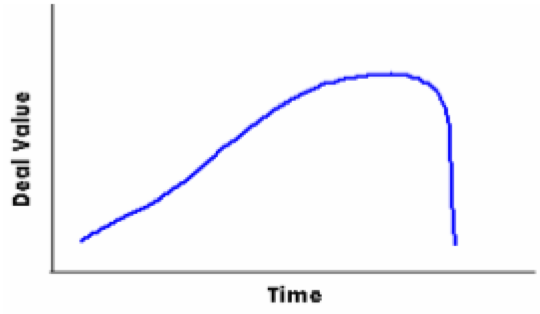
Industry specific conditions are a good indicator of the right time to consider a sale. Factors such as:

- the strength of the industry;
- its position along the sectors growth curve;
- whether the industry is in vogue; and
- whether the industry is experiencing consolidation

influence prices paid for a business. When industry insiders see growth on the horizon, prices paid swing upwards and buyers will pay premiums. Likewise, if the industry is undergoing consolidation, multiple buyers vying for a limited number of businesses can push prices upward.

This effect of consolidation causes some sellers to believe the longer they wait, the higher the price they can demand. The seller must be cautious, however. Consolidation cycles and prices may build slowly, but once the consolidation cycle hits its apex, values and the potential of doing a deal fall sharply (see Figure 3).

Figure 3: Consolidation Cycle



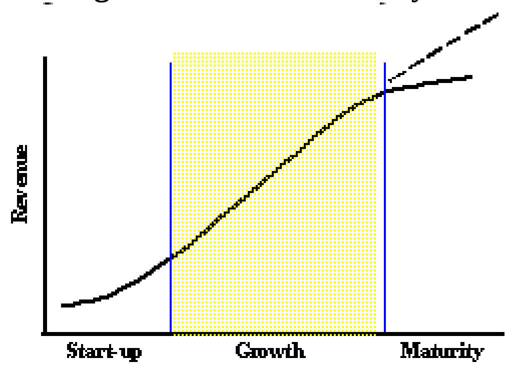
Source: GuideCap Partners LLC

This reality makes it necessary to carefully watch consolidation cycles. The process of exiting should be initiated with plenty of time to conclude a transaction before the seller is whipsawed in the collapse in value that follows the end of a cycle. As with the not-so-distant dot com and telecom bubbles, consolidation fervor can inflate values in any industry. The end of the cycle often means no alternatives for those who wait too long. While not every cycle is as extreme as the dot com craze, the pattern is repeated over and over, in varying degrees, in every industry. The unfortunate reality is that too many sellers wait too long to take advantage of consolidation cycles, or are not even aware of their effect on the value of their business.

Business Life Cycle Considerations

Fundamentally, prices are driven by a company's performance. One gauge of performance is a company's position in the business lifecycle. While most business owners consider overall performance in evaluating the right time to sell, they are far less likely to evaluate how the company's movement along the fairly predictable business lifecycle affects value. Many sellers want to sell either too early or too late in their business' lifecycle. When a business is still young and has not yet begun its growth phase, overzealous owners seek investors to assist with the financial demands of the new enterprise. In so doing, they are in effect selling a portion of the business or giving up equity while valuations are low (e.g. before they have sales, profits, a product, etc.). When the business is growing, with sales accelerating and profits flowing, many owners have no interest in selling. They become enamored with prospects and ride the business lifecycle until growth flattens, sales slow, and profits level out. Figure 6 depicts the lifecycle. The yellow shaded area represents the period when it is easiest to obtain a premium for future growth prospects. Of course, in the ideal world, a seller would sell just before the apex of the curve. However, in the real world, timing an exit is as much art as science. It is preferable to sell a little early when healthy growth is continuing, rather than once growth begins to flatten.

Figure 4: Business Life Cycle



Source: GuideCap Partners LLC

As Figure 6 illustrates, a seller interested in maximizing the price for his business should sell late enough to get credit for developing a robust business with a history of sales, products, and profits, but not so late that there is no "potential for future growth." As a general rule, once growth begins to flatten out, a buyer will extrapolate the trend and be less willing to pay for future growth. Buyers will value a low growth business as some multiple of past cash flows, rather than some multiple of future prospects. Prices begin to fall because the future prospects of the business, while favorable, do not exhibit the kind of upside that justifies significant premiums for future growth.

Other Considerations

In a number of cases, sellers are forced to consider selling because of circumstances beyond their control. In such cases, the seller must develop a strategy that takes into account the realities of the situation and creates reasonable expectations for the sale. When a seller cannot plan the timing of the sale to maximize value, they may need to be content with selling the business at a fair price without the expectation of maximizing returns. The reasons people choose to sell a business vary as widely as the personalities of business owners. Some owners just grow tired of managing the business. Economic pressures force others into a sale. Still others make lifestyle or life-stage decisions. Whatever the reason, an axiom of selling a business applies: the faster the need to sell, the lower the seller's ability to negotiate to maximize economic value. Conversely, a seller who is patient and flexible has a better chance for the maximum economic value from a sale. Table 1 illustrates a few key places where a seller's flexibility can favorably affect the price.

Table 1

Areas for Flexibility	Potential Effect
Continued involvement in the business	When a seller is willing to continue with the business and provide a smooth transition, buyers are more optimistic for continued financial success. They are thus willing to consummate a transaction and/or pay a premium for having that business risk reduced. A founder who is heavily involved in the business should expect to remain with the business for 2-4 years after the sale is consummated.
Timing of compensation	When sellers demand to be cashed out of a business on day

	one, buyers often have concerns about potential undisclosed risks. Buyers may feel more comfortable if a seller is willing to participate in the business for some period of time. While earn-outs have their own set of difficulties, well-structured earn-outs provide a way for the seller to participate in future upside that they might otherwise be forced to leave on the table.
Forms of compensation	Often qualified buyers have legitimate reasons for preferring to use stock, earn-outs, seller financing, employment contracts, or other forms of compensation to pay for an acquisition. Buyers may be able to afford more if the seller demonstrates flexibility in the form of consideration paid. Additionally, when structured properly, alternative forms of compensation may provide tax or other advantages to the seller.
Structure of the transaction	Often sellers have heard that stock deals are preferable to asset transactions. From a tax perspective this is generally the case, but there are legitimate reasons to consider structuring a transaction differently. A savvy seller can negotiate a financially neutral or even advantageous deal while accommodating structural concerns of the buyer. Additionally, understanding the intricacies of a given industry and its accounting, tax and other financial characteristics can provide creative structure that addresses both the buyer's and seller's legal and financial concerns.
Future direction of the business	Sellers often make decisions about potential buyers based upon the strategic direction the buyer wants to take the business. Evaluating buyers based upon personality, vision for the business, and other "soft" factors deserves consideration. But in the process, the seller may be trading away the maximum sales price. In many cases, the real issue is that the owner is selling their "baby" and may be having difficulty letting go.

When advising a client about the possibility of selling his business, an advisor (i.e. lawyer or financial advisor) must consider the client's various goals and work with the seller to find creative solutions that balance each of the competing needs of buyers and sellers. Only when this is accomplished can an advisor help its client get the most favorable deal.

Who would be interested?

For every business there are a number of potential purchasers, both inside and outside the business. Would management be interested in owning the business? If so, can they afford it? Are there potential buyers with strategic reasons for acquiring the company? What about financial buyers? What should they be willing to pay? These questions and a myriad of others should be examined when identifying the right group of potential acquirers. Each potential acquirer has different reasons for being interested, different abilities to pay, and different values that they place on the business. Financial buyers (such as private equity firms) may evaluate the company from a strictly financial perspective (balance sheet, income statement, and projected cash flows). They are less likely to pay the premiums that strategic buyers often pay. Management should be the group that best sees the company's potential or warts. But do they have the ability to pay for the company? Strategic buyers are companies that have a strategic interest in the seller's business. But how does a seller identify these buyers and how does it know the reasons behind their interest? The following are some simple rules to consider when identifying a prospective purchaser.

Management/Employees

A number of techniques are available to help management buy a company. Management buyouts (MBOs) are often funded by Leveraged Buyout (LBO) firms who sponsor management in their bid to purchase a company. The LBO firm sponsors management while taking a substantial stake in the company. In companies with sufficient profits to support leveraged Employee Stock Option Plan (ESOP) buyouts, employees in effect buy the business by leveraging the expected future cash flows of the business. Owners receive liquidity via a sale of stock to the ESOP (funded by an ESOP loan). While the purchase price is more in line with financial buyer's prices, favorable tax treatment can bridge the gap between strategic valuations and the financial valuation used for calculating the ESOP purchase price. Fair valuations, rigid structural considerations, and reinvestment of proceeds must occur in a leveraged ESOP buyout in order for the seller to obtain the favorable tax benefits.

Financial buyers

Financial buyers are in the business of buying, building, and selling businesses for purely financial returns. They typically own a portfolio of unrelated or distantly related businesses and either hold those businesses for a financial return on their investment (ROI) or are building the businesses with a view toward an eventual sale. As a result of their focus on ROI and their need to achieve certain internal rates of return (IRR) for their investors, financial buyers are typically much more price sensitive than strategic buyers. More often than not, the acquisition of the business will bring limited business synergies to their existing portfolio companies. As a result, financial buyers are less able/willing to pay meaningful premiums. They do, however, bring certain advantages. Financial buyers are less likely to make major changes in management or business strategy, since the business will typically survive as a stand-alone entity. While these non-monetary benefits would not appeal to all sellers, some are more concerned with intangible factors. In those cases, financial buyers may provide an attractive alternative. Recent competition for quality deals has led to better multiples than have historically been paid by financial buyers. Where financial buyers have generally paid between 4 and 6 times EBITDA, recently multiples have moved toward the upper end of that range and several deals have brought multiples as high as 8 times EBITDA.

Strategic buyers

Unlike financial buyers, strategic buyers have historically paid more because they expect to be able to create synergies between their existing business and that of the target to increase overall value. Areas where strategic buyers can leverage their existing business to increase their financial returns include:

- Elimination of duplicate management;
- Leveraging their existing sales channels to drive revenue;
- Synergies in product or service marketing;
- Utilization of plant, equipment and other fixed overhead across both organizations;
- Brand synergies to drive sales in one or both businesses, and
- Technological synergies in product development or enhancements.

As a result, premiums paid by strategic buyers typically exceed those paid by financial buyers.

Given those premiums, strategic buyers make good financial sense. However, the process for identifying strategic buyers is more time consuming and the approach more complicated. As a general rule, before approaching a strategic buyer, the seller should be prepared to articulate the specific synergies that exist between the buyer and the seller. Because these synergies (the unique value proposition) change with each potential buyer, research and planning is required to prepare the seller for these conversations. However, the price premiums paid are worth the expenditure of time, effort, and money. In recent months, strategic buyers have begun to re-enter the market, and a number of key players have active buy-side programs.

Competitors

Competitors are typically looking for market share and place little value on the company's capabilities. The acquisition is usually either an offensive move to gain market share or a defensive move to eliminate competition. Either way, they are seldom willing to pay the prices paid by other strategic buyers. Furthermore, selling to a competitor is particularly precarious because buyers seek disclosure of sensitive information that could be used to compete before completion of the sale. In this situation, the risk is that word will get to the seller's customers that the business is for sale, allowing the competitor to steal key customers/accounts. Competitors are the easiest group of potential acquirers to identify, but the least willing to pay premiums for the seller.

What are the seller's goals?

It is natural to assume that a seller's primary goal is to maximize price. While important, price is often not the sole concern of a seller. To strike a deal that fits the seller's needs, an advisor must understand the seller's concerns and the way those concerns impact a potential deal. Below is a list of some non-price concerns and how they might impact the terms or structure of a transaction.

Factor/Consideration	Impact Upon Strategy
Taking care of the existing employees	In many closely held businesses, owners develop personal attachments to loyal employees and desire to see those employees taken care of once the business changes hands. Buyers are generally not receptive to personnel interference, but may make concessions around key employees for the ongoing success of the business. Buyers may express concern if a seller is overly generous with their employees as a result of the sale,

	fearing the loss of key people who can walk away with large sums of cash. Often these issues are addressed by employment contracts for key personnel, stock options, and other incentive plans designed to increase retention.
Desire to retire/exit entirely	An owner's continued involvement for some transition period is often critical to the continued success of the business. If an owner insists on not staying involved, a significant decline in the price/salability of the business can result. Advisors should let their clients know that 2-4 year employment agreements are not unusual in many sales. For this reason, those owners looking to retire should consider beginning to look for a buyer 2-4 years before their desired retirement.
Financial difficulties	Often owners wait too long to begin exploring the sale option. They know the business is experiencing financial difficulties, but hold out hope that a miracle will save it. Only after it is painfully obvious that they cannot survive without an equity investment do they consider selling the business. In this case, an advisor should manage the owner's expectations around price and other terms.
Desire to leave the business in the "right" hands	In most sales, the seller has some desire to see the business continue to succeed after their exit. However, some sellers refuse to sell to a purchaser they do not like, trust, or believe can help make the business successful. This desire often leads sellers to make emotional decisions in cases of multiple potential purchasers. With single owner businesses, this is understandable, but where minority shareholders are involved, fiduciary duty requires maximizing the return for all shareholders. A discussion of these obligations is beyond the scope of this paper, but they are worthy of consideration when working with sellers.
Desire to extract value for future financial upside	While many sellers look at a sale as an ultimate liquidity event, buyers and sellers often differ in their value assessments of the business. Sellers who do not believe they are receiving a "full" price should consider how they can participate in the continued financial performance of the business following closing. This can be achieved through a number of structural vehicles including earn-outs, stock in the acquiring company, retention of some level of ownership in the company being sold, options, or warrants. A seller's desire affects the structure of a transaction, but it also has certain strategic implications for the sales process. Many buyers gain comfort around the fact that the seller wants to participate in the future risk/reward of the company. He is willing to "put his money where his mouth is," giving subtle credence to projections of future upside and synergistic value. A seller must consider the complexities of structuring an earn-out that measures the business's future

	performance, keeping in mind that the seller has relinquished ultimate control. This balance is a difficult one and sometimes leads advisors to discourage earn-outs. But that could hamper the seller's attempt to maximize their return.

In all circumstances, there are tradeoffs between a seller's ability to demand a higher price and other non-financial considerations. As the list of "non-negotiable" factors increases, the likelihood of getting a deal done at a reasonable financial value decreases. As in any negotiation, the give and take between price, legal, and practical considerations has a cost that a seller needs to count before they draw hard boundaries around a deal.

For this reason, we encourage clients to avoid inflexibility early in the negotiation process. Once acquirers become comfortable with the business, they are more likely to accommodate a seller's needs/desires. Additionally, it is essential for a seller to understand what issues are deal breakers, and what issues are nice but not essential. This concept will be discussed later in the paper.

III. Financial Considerations

What is the business worth?

Valuation methods are beyond the scope of this paper, but a few comments on valuations are warranted. Many business owners think they intuitively know what their business is worth. Or perhaps they have received single data points on valuation for estate planning or other reasons. But valuing a business for purposes of a sale is fundamentally different than valuing the business for tax, estate planning, or other purposes. When an M&A firm does a valuation, they value the business using a number of methods, including:

- Discounted cash flow;
- Public comparables;
- Private transactions;
- Relative contribution;
- Book value; and
- Industry specific methods.

This more rigorous approach produces a fuller picture of how a company may be valued.

In each of these methods, the firm doing the valuation applies a number of discounts or premiums to the calculation that reflect the realities of the transaction and relative strength of the business to produce a range of expected value. These discounts or premiums include such items as:

- Control premiums;
- Discount for lack of marketability, and
- Adjustments for company specific factors such as:

- Dependence on key people, customers or products
- Technology or facility obsolescence
- Exceptional or substandard financial performance
- Small company size
- Market share
- Brand strength
- Other risks.

The acquisition value of a company may be greater than the stand-alone value due to the joint strategic benefits of the merger/acquisition. These benefits must be evaluated on a case-by-case basis. The seller doesn't get 100% credit for these benefits in the purchase price, but they certainly help increase any acquisition premium the buyer is willing to pay.

In the final analysis, the firm should indicate a range of likely fair market values for the business. These values, while providing a range of likely sales prices, are not dispositive of price. Price may be affected by a multitude of factors including: the continued performance of the company during the sales process, a change in market factors following the valuation, and the synergies that exist for a specific acquirer. A valuation does not determine price, but it is valuable as a benchmark for management/ownership to use in price negotiation. Ultimately the value is what a buyer will spend. A good financial advisor will be able to help gauge the level of interest of the buyer and what strategic value exists. These factors may enable the seller to command a price greater than what a valuation will produce.

Does structure really matter?

Structure impacts a number of financial aspects of a proposed transaction. In its most simple form, structure affects what percentage of the proceeds is owed to the IRS in taxes. In other cases, structure can be used to bridge gaps between the buyer and seller in purchase price discussions. No matter how you slice it, structure has financial implications in every transaction.

Negotiations over even the most basic elements of transaction structure are often ignored until it is too late. One example is the naive seller who does not understand the tax implications of an asset sale. Or, the owner trades purchase price for an employment contract with above-market salary or benefits, not understanding the difference between capital gains and ordinary income treatments. Maybe an owner stubbornly insists on a given "price" without considering other structures which would net him more money on an after-tax basis. Not realizing what they are giving up, sellers often agree to, or insist upon, a structure without the benefit of seasoned advice and well-placed counsel. It can cost them more than they will ever know.

While lawyers understand structure, they must keep in mind the net financial impact of structure on price. Every lawyer's charge is to minimize their client's legal exposure. But occasionally, clients can knowingly take on legal risk in exchange for purchase price. For example, a client who takes more personal exposure to reduce the escrow may know there is little to no risk of a post-closing breach of the representations or warrantees. A client may agree to an onerous material adverse change (MAC) clause because aggressively negotiating the MAC may send a signal to the buyer that he is concerned about a slowdown in business. Another seller may agree to a larger earn-out because the next 18 months sales are "in the bag." All of these sellers have made business decisions that impact risk, and their attorneys are best positioned to help them understand that getting to a deal is often a series of trade-offs between legal, financial and other factors.

Buyers generally want to purchase assets. This allows them to leave behind certain unwanted liabilities and step up the basis of assets purchased to market, increasing allowable depreciation and reducing taxes. Sellers, on the other hand, usually want to sell stock, allowing a clean break from liabilities of the company and avoiding double taxation. Even more favorable tax treatment can be gained by a tax-free (tax-deferred) exchange of stock. Of course, the seller must have some confidence that the purchaser's stock provides an opportunity for appreciation versus a significant risk of decline.

Sellers and buyers may not initially agree on structure, but creativity on the part of legal, tax, and financial advisors may provide solutions that address both buyers' and sellers' concerns. Through creative structuring, a seller can benefit by selling stock, and the buyer can benefit by buying assets, thereby increasing financial returns to the seller at little incremental cost to the buyer. In other cases, the seller's structure and balance sheet may accommodate a buyer's desire to acquire assets and provide an actual tax benefit to the seller (especially where the seller is not concerned about unknown liabilities and the buyer is assuming all known liabilities). Astute financial, tax, and legal advisors can identify when these opportunities arise, and put together a deal that meets the needs of both parties.

In every transaction, structure is a subject for negotiation. Typically the party negotiating from a position of strength gets to drive overall deal structure, but there are a number of subtle tweaks that can make a real financial difference to your client. Creative structural alternatives and structural negotiating tactics are beyond the scope of this paper. However, it is well worth an advisor's time to become thoroughly familiar with commonly used techniques and the potential advantages they offer in a transaction. Also worth noting is that with the demise of "pooling of interests accounting," financial and legal advisors for buyers and sellers are becoming more creative in structuring deals, and this trend is expected to continue.

IV. Auction Approach

A question asked by many sellers is – *What process is most likely to maximize price?* Advisors use two main processes to market businesses for sale. The first is a traditional auction, and the second uses many of the principals of the traditional auction, but is more discreet in its approach.

The Traditional Auction

The traditional auction begins with the drafting of an information memorandum (the "book") describing the company, its industry and its financial performance. Prospective buyers are then identified and receive the book. They are invited to submit indications of interest, based upon their review of the book and their independent research.

The seller and its advisor review the indications of interests, and if appropriate, narrow the field. Bidders are then provided access to additional information about the seller, often in the form of certain documents relating to the business, and are invited to attend meetings with the seller's management. After diligence visits, bidders are asked to make definitive bids by a fixed date. The advisor usually stresses that these proposals should contain the best and final price and terms, and that due diligence should be complete and financing arranged.

The traditional auction works well for large mature companies that need a structured process and for whom there is a clear list of interested bidders. The process promotes certainty and forces bidders to abide by defined parameters concerning the timing and form of offers. However, the traditional auction has its drawbacks:

- It can difficult to maintain a confidential process. In a traditional auction, possible bidders are contacted in large numbers to create a competitive environment. They often receive the book, or a written teaser, before speaking with the seller's advisor or qualifying their level of interest;
- Some potential acquirers refuse to participate in the traditional auction. They are either reticent to engage in a formal auction or do not fully understand why the seller is a good strategic fit. The most strategic acquirer, the one who should pay the highest price, may never take part in the process;
- The process of a formal auction is considered by many to be the most disruptive M&A process for the seller. Employees become concerned over potential buyers, resulting in meetings and data rooms that require an extremely large portion of management's attention; and
- The traditional auction is costly. The seller must set up a data room with copies of all relevant due diligence material, draft form acquisition documents and run a formal process.

So, how can a small business get the benefits of the traditional auction without its drawbacks?

The Discreet Auction

Like the traditional auction, the discreet auction begins with the drafting of an informational memorandum (the "book"). However, there the similarities end. In a discreet auction, an advisor works with the seller to develop a list of potential bidders that should have a strategic or financial reason for being interested in acquiring the company. The seller's advisor not only helps develop the list, but identifies the specific value proposition that should appeal to each potential bidder.

Unlike the mass mailing that often accompanies a traditional auction, in the discreet auction, the advisor makes contact with management of each potential bidder. In those conversations, the advisor articulates the unique value proposition that the seller offers and gauges the potential bidder's level of interest. Following these initial conversations the advisor, along with the seller, decides whether to disclose the identity of the seller and send the potential bidder a book.

In the discreet auction, the focus is on moving each of the potential bidders along a fluid process that results in multiple offers being made at or about the same time. Each bidder should

understand and appreciate the unique value proposition the seller offers and why that value proposition justifies the bidder paying a premium for the business.
This process requires more work, but it pays dividends where the value of the seller exceeds its financial returns. The discreet auction has particular application in companies where much of the real value is pent up in intellectual property, the team, or future/emerging growth prospects. Technology and other high growth companies find the strategic auction particularly appealing. It offers them the ability to extract intrinsic value that is not yet fully reflected in traditional financial measures. Middle market or private sellers also find the discreet auction appealing, as they seem to be more concerned about confidentiality and are not as well positioned to extract value through the traditional auction (e.g. less information about them is known publicly and it can be more difficult to generate substantial interest without additional disclosures).

The formal auction creates competition by maximizing the number of parties that know about the sale and giving them a chance to bid on the company. A discreet auction generally identifies a shorter list of acquirers, contacts those acquirers on a confidential basis, and manages the process so that multiple parties are prepared to make an offer at about the same time. The acquirers are not put in a formal auction process, but in the end, the advisor is able to bring multiple parties to the table and facilitate a competitive process.

Making it Work
To ensure an effective discreet auction, an advisor must be willing to expend substantial effort on behalf of its client. It must manage multiple parties who often have varying senses of urgency and work closely with the client to identify likely candidates. In short, the process is much more focused on the needs of the client than the convenience of the advisor. As a result, some advisors resist the discreet auction. They favor a less arduous process that allows them to widen the number of parties contacted, conducting a mass fax/mailing campaign to measure interest in the seller's company.

Should the seller elect to pursue a discreet auction to maximize value, it should ask potential advisors to describe their typical sale process and carefully scrutinize their approach. Advisors demonstrate varying levels of professionalism, judgment, and experience in running this type of process. It is important to be comfortable with the personality and experience of the professionals representing the company in the sale.

V. Practical Rules Of Thumb

Multiple bidders increase price and help move the process along
Managing a multiple bidder process requires more work on the part of the seller and includes a greater degree of complexity. It also often results in a significantly higher sales price. Where there is a single bidder, the seller's options are limited and the buyer is largely in control of the process. However, where multiple bidders are at the table, premiums paid increase and the time to close often decreases.

The single bidder process greatly diminishes the seller negotiating leverage. The seller is not able to play multiple bidders against each other, driving up price. For this reason, many potential suitors try to extract "no shop" agreements from a seller well before such agreements are appropriate. If the buyer can be the only party at the table, they are more likely to keep price down and less likely to be pressured into closing before they are ready.

These goals on behalf of a buyer are not unreasonable, but often sellers have their own agenda around price and the timing of a transaction. And the buyer's agenda is often in conflict with the best interests of the seller. In any sale transaction, the name of the game is leverage. And the party that can create the most leverage is likely to negotiate the best deal. In a single bidder process, the buyer determines the pace at which the transaction progresses. They are more likely to "take their own sweet time" in negotiation and due diligence. Where there are multiple parties interested in the same business, the process moves along more quickly and buyers show greater flexibility around most aspects of the transaction. It's all about creating leverage for your client as the client negotiates with the other party.

Being "for sale" can hurt the business

When customers, competitors, and suppliers hear that a business is for sale, it is at a minimum awkward and at a maximum disastrous. Steps can be taken to minimize the chances that sale plans become public before the owner is ready. Non-Disclosure Agreements and Confidentiality Agreements are necessary, but can sometimes hamper the process if required too early. Below are a number of other suggestions on how to minimize the likelihood of customers, competitors, and suppliers finding out the business is for sale until you are ready:

- Be careful about who you tell within the organization, socially and in business (if they don't need to know, don't tell them);
- Be intentional about the list of potential acquirers (contact those you trust first and competitors last);
- Make contacts at the top of the organization and request a limited number of reviewers in the organization;
- Reinforce that the process is confidential (even though no NDA is being signed yet);
- Use an intermediary who can gauge interest before disclosing the sellers identity;
- Use incremental disclosure to assure that only the most serious parties see the most sensitive information;
- Once a party knows enough to indicate an initial level of interest, request an NDA; and
- Never let an advisor send out unsolicited "books," place ads, or broadcast that the business is for sale (it hurts the business and the chances of maximizing price).

Be realistic about price

Unrealistic price expectations lead to time wasted and opportunities lost. Before beginning the process, a seller should know the likely range of values for the business. If they are unwilling to sell within that range, they should not waste their time or that of potential acquirers. While sellers should use every effort to maximize price, beginning with unrealistic expectations undermines the process and often results in a dissatisfied seller and buyers. A good advisor should talk to a seller about value expectations before being engaged and should be able to provide the seller with a range of values likely in a strategic or financial sale.

Large gaps between buyers and seller expectations are non-starters for acquirers. If they conclude that the seller has unrealistic expectations, the conversations usually end there. It is rarely effective for a seller to return with a substantially reduced price. The seller has lost credibility in the negotiations and is likely to be viewed as posturing.

For these reasons, we suggest sellers understand the reasonable range of value for their companies and be prepared to discuss price within those ranges. A savvy advisor will avoid providing the range to purchasers, so that if the initial offer comes in above the range, they have not compromised the seller's ability to extract an extraordinary premium. If the offer is below or within the range, quantitative data can be used to move the buyer's bid upward.

Sufficient runway is needed
In today's market, selling a company takes 6 months of hard work and in some industries, the time frame exceeds a year. In light of this reality, sellers need to begin the process early and allow sufficient time to identify and negotiate with potential acquirers. Things like insufficient cash can greatly compromise leverage in the negotiations and very often decrease sales price.

Good execution during M&A process
Too often management becomes distracted during the sales process. Revenue, profits, customer satisfaction, and other indications of the business's health begin to slip. Once the numbers begin to trend down, buyers extrapolate the downturn and exact price concessions from the seller. For these reasons, management must stay focused on running the business, and they must meet or exceed <u>ALL</u> projections and milestones during the sales process. For many management teams this means extra hours juggling their regular duties and those that are created through the sales process. CEOs are especially susceptible to the risk of focusing exclusively on the sale and not driving the performance of the business. Advisors should help management to stay focused on the business and let the advisors do the bulk of the work associated with the sales process.

Be realistic on structure
Structure matters financially, but earn-outs and seller financing are often necessary to get a deal done. Seller financing can bridge valuation gaps and buyers often want sellers to stay active in the business after closing. That means employment agreements, retained ownership, and earn-outs.

Employment agreements carry a caution. The owner's new boss may not be willing to pay him the in the same way he paid himself. Creating reasonable expectations on the terms of employment in light of the owner's recent liquidity event may be necessary. Far too many deals with full valuations run into trouble because the seller wants too much under an employment contract. A good advisor should be able to indicate what is normal in terms of employment in the industry.

VI. Common Mistakes

Inflated projections	Missed projections can jeopardize deal. They create doubt in the minds of buyers and raise questions around the company's ability to execute on its plans. Realistic projections that are attainable are a wiser approach. At the same time, projections cannot show a lackluster business with no growth potential. So realistic projections that give the company full credit for what they expect are generally the best balance. Owners should be careful about inflating projections because of the likelihood that any earn-out will be tied to meeting those projections. It is difficult to argue that earn-outs should not be tied to the projections owners are providing buyers in the sales process. Finally, if a company provides a buyer with consistently missed projections, the buyer may begin to question the credibility of the owner and management. If this occurs, the acquirer may more closely scrutinize the transaction and all information provided by the seller. In the worse case, the buyer may lose interest and walk the deal.
Majoring on the Minors	Sellers should clearly understand their objectives before entering into the sales process. They should then keep those objectives front of mind as they proceed through the negotiation process. Understanding a seller's important points allows them to be flexible on the non-important ones and not fall into the trap of using their negotiating leverage on things of little or no consequence. Sellers should keep in mind that their negotiating leverage is highest after the buyer is comfortable with the business, but before a term sheet is sign. Therefore, getting advisors involved earlier will result in a better deal. Finally, in most cases, the seller and buyer will continue to have a relationship post-sale, even if only until the escrow is released. Therefore, the seller should try to maintain a good relationship with the buyer. The seller should also use advisors to press the difficult issues and be seen as "the reasonable seller" by the acquirer.
Focusing on the balance sheet	The value of a company can exist in several places. In some businesses, the value is tied up in hard assets. But more often, it is in people, relationship, intellectual property, and other intangibles. While looking at a company's book value can be helpful, focusing largely on the balance sheet can result in undervaluing a going concern. Because many acquirers tend to look at the balance sheet and income statement first, it is wise to focus on the strategic value of an acquisition as well as financial metrics.

Irrational love of the business model	Purchasers often desire to make certain changes to the business of the companies they acquire. Those changes range from minor tweaks of the operations to wholesale changes to the company's business model. When sellers learn about a buyer's plans to make major changes to the business, they often grow nervous and are sometimes reluctant to consider selling. Earn-out and other retained interest issues aside, many sellers have grown emotionally attached to the businesses they have built. They are reticent to have anyone change them, even after the sellers are gone. Buyers, on the other hand, see opportunity to improve the business by making changes, integrating, rationalizing, or even scrapping parts of the business that the seller sees as valuable or even core. In many cases, the seller needs to be gently helped to see the reality that he cannot have it both ways. Either he wants to exit and maximize value or he wants to control the direction of the company, but he cannot do both. In the case of earn-outs or other retained interests, there are a number of mechanisms to reduce or eliminate the risk to the seller associated with a fundamental change in the business. Some of those are structural (how the earn-out is calculated), some are practical (amount allocated to the earn-out), and some are a question of hedging the risk (typing a portion of the earn-out to performance of the acquirer and not just that of the acquired company, collars on the minimum earn-out, etc.).
Not being organized	Once an interested buyer is identified, the seller needs to be prepared to "strike while the iron is hot." This means being prepared to make the necessary disclosures in a form acceptable to acquirers. Financials should be prepared (or restated) in accordance with GAAP. Intellectual property protections should be in place and properly documented, and outstanding litigation should be resolved wherever possible. R&D development and processes must be documented, and management should be prepared to answer questions about backlog, planned products, financials, and the like. When the seller is ill-prepared, it reflects poorly on the business. It creates questions about how well the business has been run, and what skeletons may be in the closets. This generally increases the level of ultimate scrutiny that the company will undergo before closing. On the other hand, well-prepared companies instill trust and confidence in acquirers and reduce the level and length of scrutiny before closing.