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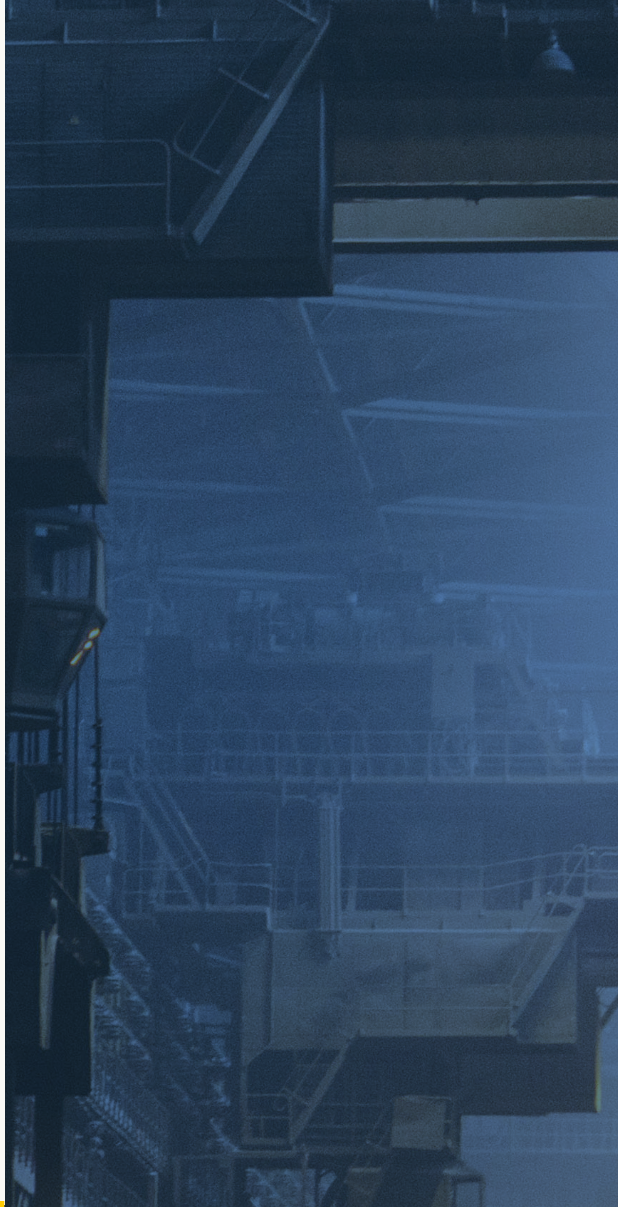
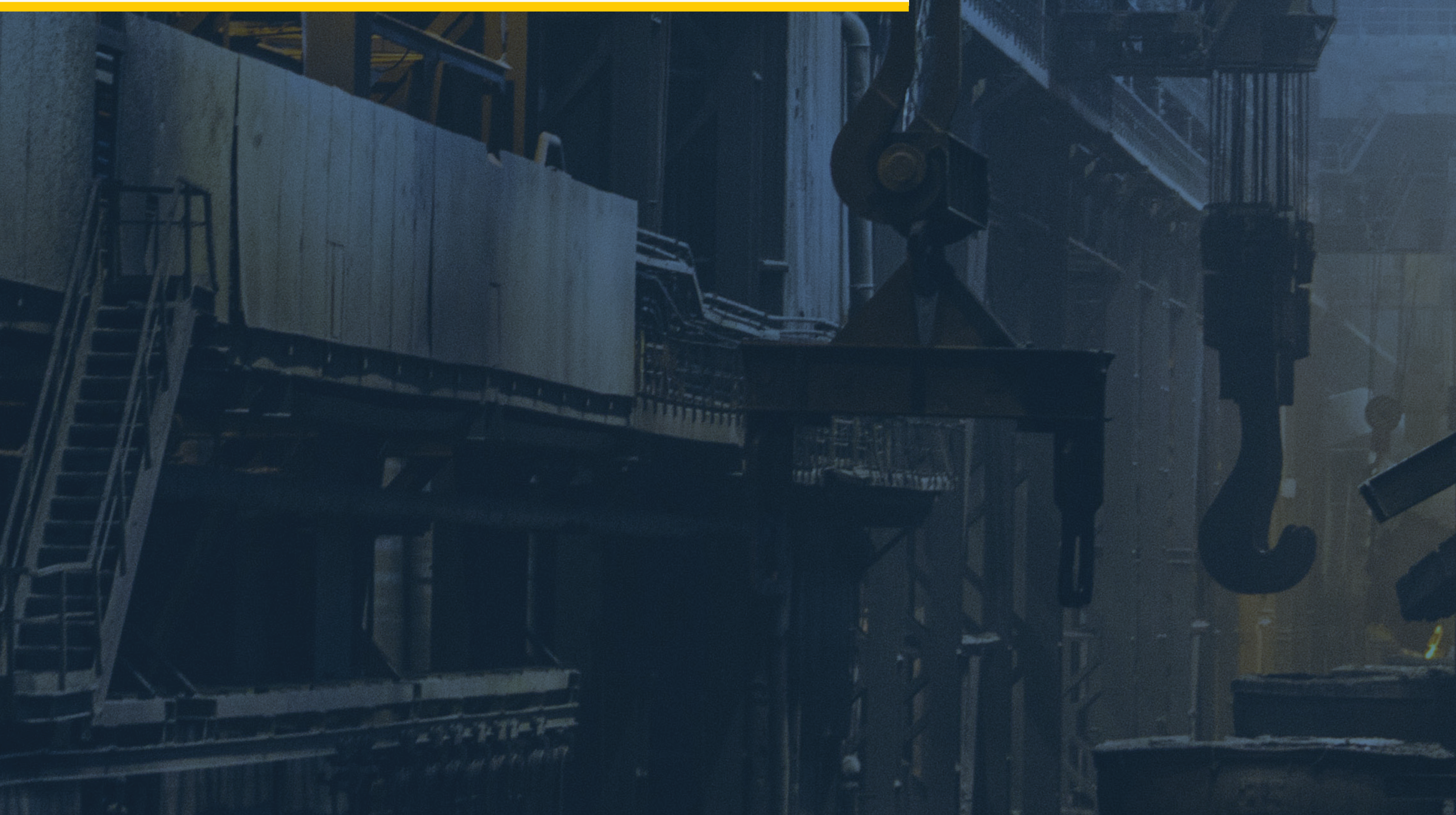
# Executive Guide:

## HOW TO PREPARE YOUR COMPANY FOR A SALE (AND MAXIMIZE THE SELLING PRICE)

If you're thinking about selling all or part of your company in the near future (or farther down the road): optimize your business for a transaction now, so you can get the best price when the time comes to sell. In this Executive Guide, we'll show you:

- What you need to know about different types of buyers
- 10 factors that can drive up (or down) the value of your business
- Changes you can implement now to achieve higher transaction multiples
- 3 questions to ask yourself before you sell

If you're an owner-operator of a privately held or family-owned company, you've probably thought about how, and when, to transition ownership — whether business is currently strong or slow, whether retirement is on the horizon or many years away.

In the past, owners often passed their businesses to their children, and perhaps you're a second- or third-generation business owner yourself. That practice isn't quite as prevalent today, for many reasons (which we won't delve into here). But it's a shift with a massive implication for modern business owners: it behooves you to start running your company in a way that will attract the best price from a potential buyer — regardless of when you'll be selling.

Chances are, if you've got a successful business, you're already doing a number of things that will maximize your purchase price. But we've found that **many owners overlook key factors that significantly impact value.** The sooner you put these on your radar, the better outcome you'll have when it's time to take your company to market.

## Who's buying?

Before we jump into the factors that influence business value, it's important to understand the types of buyers that might be purchasing your company.

The bottom line: you've got options. No longer do you have to choose between your kids and your competition. Today, there are more possible ways to exit a business than ever before, due mainly to the increase in the number and types of potential buyers. There are several reasons for this:

- the influx of capital into Private Equity Groups (PEGs).
- the increase in cash on operating companies' balance sheet.
- Many companies cannot generate shareholder returns through internal growth (organically) and must do so through acquisitions

**Pro tip:** It's not uncommon for owners to receive solicitation letters from companies or advisors seeking acquisitions. **Be wary of these solicitations** — we can't stress this enough. In some cases, the buyers may be legitimate, but the advisors contacting you represent the buyer's interest, not yours! Without a process by which multiple buyers compete for a business, it's highly unlikely that you'll receive the maximum price.

There are three primary types of buyers: **strategic, financial** and **hybrid**.

1. Strategic buyers are operating companies. Many large companies have recognized the importance of growth through acquisition and have established corporate development departments staffed with former merger and acquisition professionals.

2. Financial buyers are PEGs or individuals interested in buying companies for a financial return. Their goal is to maximize returns by leveraging a company with debt, growing it rapidly, and selling it in three to seven years. PEGs acquire companies with a minimum EBITDA (earnings before interest, taxes, depreciation and amortization), a proven management team, and infrastructure to grow. Several years ago, the minimum EBITDA for PEGs was in the neighborhood of $10 million, but the proliferation of PEGs over the past decade has driven that minimum down. Today, it's not uncommon to find PEGs that seek companies with $1 to $3 million in EBITDA and revenues as low as $5 million. Sub-categories include:

   - PEGS with committed capital-these groups have raised funds from college endowments, pension funds or high net worth individuals and have cash readily available to make acquisitions..

   - INDEPENDENT SPONSORS-these groups do not have a formal fund with cash in the bank, but have a network of investors that are familiar with them and will deploy capital on a deal by deal basis. Once the sponsor locks up an acquisition with a Letter of Intent, they then have to "sell" their investors on committing capital to the transaction

3. With the advent of PEGs, a hybrid buyer—a strategic buyer owned by a PEG—has emerged. This buyer systematically makes add-on acquisitions of similar companies with no minimum EBITDA.

4. Family Offices-these investment groups are composed of high net worth individuals or families that typically made large sums of money by operating companies in the past. Many used to invest in private companies through PEGS, but in doing so have to pay the PEG a portion of the profits and a management fee. These groups now invest directly, have very little restrictions on how and what they can buy, and have no set time horizon for re-selling a company.

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Transaction structures differ by buyer, and we've outlined those at a high level here:

### Strategic

- Sale of entire company
- Owner may or may not exit business
- Typically all cash transaction
- Branding, culture, etc. may be subject to change
- May be able to invest a portion of proceeds in acquirer

### Financial (Platform)

- Sale of 70-80% of company
- Partial equity rolled into new company
- Key management remains
- Substantial leverage utilized
- Mandates for growth
- Opportunity for owners and management to realize significant proceeds from subsequent sale of the company

### Hybrid (Add-On)

- May or may not be sale of entire company
- Owner may or may not exit business
- Potential for cash and stock transaction
- Branding, culture, etc. may be subject to change

## 10 Factors That Can Help (or Hurt) Your Company's Value

Now that you know your options when it comes to an exit, let's turn our attention back to your business — and what you can do to ensure that you get the best price from a potential buyer. In order to create meaningful, sustainable value, owners should evaluate and, if appropriate, consider taking action in these 10 core areas of their business.

1. Products and services: Attempt to move toward value-added products and services, which are more profitable than commodity products and usually more defensible in the marketplace due to less competition.
2. Customers: Diversify the customer base and reduce customer concentration. This is a top problem for many middle market businesses, and it typically results from having large customers such as Wal-Mart or Home Depot. While the sales growth is attractive, any concentration that is more than 25% of total sales for one customer can significantly lower company value. Ideally no single customer should exceed 10% of total sales.
3. History of and Visible path for growing revenues and profits: All of the potential buyers discussed previously are buying companies to generate a Return on Investment (ROI). While a company with steady revenues can be attractive to acquirors, higher valuations are realized when a buyer can see a track record of increasing growth and/or a defensible specific strategy for continued growth in the future.
4. Management: Have a solid senior management team in place and ideally a strong middle management group as well. Value increases if buyers feel they do not have to find new management to continue operating and grow the company.

5. Solid Financial Reporting: While the amount of available capital is creating a demand for private companies, the buyers continue to be "risk averse". Having a capable CFO or Controller, systematic monthly financial reporting and internal controls relating to costing, inventories, and cash management can give comfort to a buyer. Virtually all buyers engage a CPA firm to perform a "Quality of Earnings" analysis to confirm that "the numbers are the numbers". Companies receiving higher valuations typically have an annual Audit or at least a Review or Compilation performed by an outside firm.

6. Contracts: Retain an experienced corporate attorney. Structuring the business improperly can cost an owner hundreds of thousands, or even millions, of dollars in taxes or in the selling price. An owner should always be conscious of the effect of provisions in customer and vendor contracts on the marketability of their company. Assignment, change of control, and termination provisions or rights of first refusal are all examples of major stumbling blocks during transactions.

There are several factors beyond day-to-day operations and processes that affect transaction multiples; while owners can't control all of them, they should take these into consideration as they optimize their business strategies to position their company for a future sale.

1. Barriers to entry: High capital investment in plant and equipment and the cost of acquiring customers are examples of effective barriers to entry.

2. Condition of Company Assets: Similar to an individual buying a house, if your company's operating assets need updating, repair or even a new coat of paint, acqirers factor that into the purchase price

3. Industry: Historically the size of end markets were a very important indicator of value. But recent buyers have shown more interest in niche markets with higher growth because they offer higher profitability opportunities.

4. Economy: Businesses that operate in "cyclical" industries may be perceived to have higher risks for a buyer./or. Any effort that reduces the cyclicality by offering counter-cyclical products and services can add value. In the current economic environment, healthcare, IT, energy and other defensive industries are more active.

# 3 Questions You Need To Answer Before You Go To Market

If you evaluate and optimize the areas of your business discussed above, you'll likely be in a much better position to achieve the maximum value for your company. But if you feel that a transition in ownership might happen sooner rather than later — don't stop there. To prepare yourself and your company for a sale in the near-term, make sure you've got good answers to these three questions.

## 1. What's my why?

There are a number of reasons for considering a sale. Often, owners want to retire and lack a succession plan. Sometimes, they want to grow; other times, they just want to take some chips off the table. Or maybe one partner wants out. The net worth of a majority of business owners is tied up in their businesses, and owners should consider monetizing business assets in order to reduce risk. Whatever your reason for selling, the first step to closing a deal with the right buyer, at the best price, is having a clear understanding of your purpose, objectives and intended outcomes.

## 2. Is the time right?

Another important consideration is timing. It's almost impossible to perfectly time any market, but generally speaking, most owners should consider selling when times are good in their business and industry. As with other investments, owners can become emotional about the prospects of their businesses and, as a result, hold on too long. Keep in mind: sometimes, events out of an owner's control affect value — such as shifts in the industry to more technical products or to offshore production — so if you know a transaction is looming, it's best to get a move-on while business is humming.

"Just the presence of an investment banker can sometimes increase the transaction price because buyers realize that they cannot take advantage of the seller."

## 3. Who's in my corner?

Selling a business is typically a one-time, life-changing event for owners. It's imperative to have competent advisors, both financial and legal. A financial advisor may take the form of a business broker or an investment banker.

- Business brokers typically sell businesses to individuals in transactions with a price of less than $5 million.
- Investment bankers are usually licensed by FINRA (Financial Industry Regulatory Authority) and focus on selling businesses for more than $5 million to strategic or financial buyers. Similar to large investment banks, such as Merrill Lynch and Goldman Sachs, boutique investment banks run a confidential and professional auction for smaller companies.

An investment banker plays the role of quarterback, providing guidance to a client around price expectations and running a deliberate, competitive process designed to maximize transaction value. During the closing phase, it is the investment banker's job to facilitate due diligence and assist legal counsel in incorporating the business terms into legal documents (e.g. asset purchase agreement, management contracts, non-compete agreements, etc.). Just the presence of an investment banker can sometimes increase the transaction price because buyers realize that they cannot take advantage of the seller.

Most owners don't like to spend exorbitant amounts of money on legal counsel. However buyers typically retain large firms that have executed hundreds, if not thousands, of transactions. Legal documents are complex and significantly affect a seller's liability after the sale. An experienced merger and acquisition attorney working on the seller's behalf will understand market terms on key contract provisions—such as representations, warranties and indemnification—and can level the playing field.

Without a doubt, there have never been more options available to business owners seeking a full or partial liquidity event. By understanding exactly what those options are — and the factors that affect the value of your business — you can take action today so that you will achieve the best possible price for your company when it's time to sell.

If you've got questions about the current market, the business-selling process, or what kind of purchase price you can expect, contact us today at 423.266.7490, or email Managing Director Andy Stockett at astockett@fourbridgescapital.com.