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WHITEPAPER

PREPARING TO SELL YOUR COMPANY

A SIKICH INVESTMENT BANKING WHITEPAPER

This document is meant to be a guide for business owners contemplating a sale of their company. As in many endeavors, proper preparation can have a dramatic impact on results. By paying close attention to a number of key issues, business owners can increase the chances of selling their business at an attractive valuation while reducing the stress and headaches that typically accompany the sales process. While it is not possible to identify and discuss all potential eventualities, this whitepaper attempts to identify the key steps business owners can take before initiating a sales process that can enhance both the experience and the value attained.

DETERMINING MOTIVATION AND GOALS

There are a wide variety of reasons for selling a company. It is important that the motivation for selling is well defined as it helps guide the process. Below is a short list of some of the potential motivations for selling a company.

Exit / Retirement

The business owner wishes to sell his company in order to retire—either from the particular business in which the company participates or in general. In this type of situation, it is important for the business owner to have determined, often while working with a personal financial advisor, what proceeds will be required in order to maintain a desired lifestyle. It is also important to give some thought as to the owner's ability and desire to remain with the company during a transition period after the sale.

Reduce or Eliminate Personally Guaranteed Debt

The business owner, out of necessity, has issued personal guarantees against company debt. This is an ongoing liability to the business owner for as long as the debt is in existence and guaranteed by the owner. A company sale most often eliminates (or at least reduces) this debt and removes liens against the business owners' personal assets.

Diversification of Assets

In many cases, the bulk of a company owner's net worth is tied up in the business. Not only does this increase the risks associated with financial asset concentration, the asset itself is very illiquid and cannot be readily converted to cash. Business owners may decide to sell all or part of the company to increase liquidity and/or diversify assets.

Need for Growth Capital

Businesses often reach a point at which they require a capital infusion to in order to continue growing and frequently look to sell equity in the company to raise this growth capital.

Need for Talent or Partnership

An owner may come to the conclusion that the company has been taken as far as able without bringing in a partner (or new talent) to augment the current skillset. It is an attractive option to sell a portion of the company to an investor that will be able to provide strategic guidance, operational expertise, or access to new customers or markets. In such situations, an owner can acquire key talent or a key partnership that will enable the continued growth of the company while simultaneously creating a near term liquidity event.

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It is equally important for the business owner to determine the goals of a sale. The following should be considered:

Timing

Identify the optimum time to sell the business. Many factors go into this decision such as:

- How much longer does the owner wish to work at the company? Many transactions may require that the owner remain part of the company for 1 to 5 years.
- Are there any anticipated tax law changes that will affect the owner's tax bill?
- Is the company approaching a critical point in its lifecycle that requires new investment and/or new talent?

Post Transaction Ownership

Business owners will often retain some ownership in the company after the transaction has completed. This provides the buyer with comfort that the business owner believes in the prospect of the company, as well as provides the business owner with the opportunity to participate in a future exit. Before entering into a sale process, the owner should decide what portion of the company he would be comfortable owning after the transaction is complete. This can often be a range like 10-30% and will depend on a number of factors including:

- the comfort level with the new owner,
- the track record of the new owner,
- the confidence in the business / growth plan of the new owner,
- the amount of control the original owner has in guiding the company going forward,
- the overall transaction value (is it high enough that owning a significant piece of the equity going forward still leaves the original owner with a minimum level of desired cash?), and
- the overall structure of the transaction (is the owner also taking some of his payment as a loan to the company? Is there a significant employment contract? Etc.).

Valuation

The valuation of the company is always a key consideration when selling a business. Owners can get a reasonable expectation of valuation through discussions with an investment banking advisor. Owners should work with a wealth advisor to determine the post-transaction (and post-tax) monetary needs to arrive at a required minimum valuation. A reasonable expectation of value for one's company is key to executing a transaction. If a business owner requires a minimum valuation that exceeds the likely sales price by a significant amount, a successful sale of the company will not be possible.

Post Transaction Involvement with the Company

A business owner should give some thought to what his ideal involvement level with the company would be after the sale. Many times buyers expect the current owner (assuming the owner is also a key operator within the company) to remain for some period of time. In some cases, this period can be relatively short and is used to transition the key management responsibilities to new senior management. In other cases, buyers would like the owner to remain with the company for an extended period of time in a form of partnership to help grow the business.

If the owner wishes to leave the business shortly after the transaction is completed, certain potential buyers would no longer be viable buyer candidates (for instance, a private equity group looking for a platform investment). Further, the desire of the owner to leave the company post-transaction can affect the optimum deal structure (an owner will be less likely to want to retain equity or provide a loan to a company that he has little control over).

Ideally, the desired post-transaction involvement will be clearly defined by a business owner, considering such factors as:

- number of months or years to remain involved
- various positions the owner would be willing to occupy (CEO, Board of Directors, consultant, etc.)
- high-level work requirements the owner would be willing to agree to (expected hours per week, vacation allowance, decision making abilities, etc.)

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Types of Consideration

There are many ways that owners can be compensated in a sale. Thought should be given to what types of consideration are preferred and what amount of the various types of consideration would be acceptable. Some of the more common types of consideration are outlined below.

- Cash is usually the most preferred form of compensation and often makes up the bulk of the consideration.
- Equity represents ownership in the company after the transaction. A seller should make sure to understand the type of equity being received (compared to that of the buyer) and what types of restrictions may come with its ownership, as well as what rights and priorities come with the buyer's equity. Even if there are no differences between the equity issued to the seller and the buyer, the seller should be confident in the company post-transaction and should consider owning equity in the company in the same way one would consider purchasing equity in any other company.
- Seller Paper is money lent to the company by the seller. It is almost always unsecured and will be "behind" the senior lenders, but ahead of the equity holders. The seller needs to understand the terms of this loan such as: liquidation preference, coupon, term, whether principal will be paid during the term of the loan, etc.
- Options on purchasing equity in the company are sometimes provided as consideration instead of or in addition to actual stock.
- The Earn-Out refers to compensation (usually cash) that is given to the seller upon the company reaching certain milestones or meeting revenue or profitability goals. Earn-outs can be structured in a wide variety of ways. Ideally, goals that trigger earn-out payments should be as unambiguous as possible. The seller should work closely with an investment banking advisor and legal counsel to ensure the earn-out is properly structured and codified.
- The Employment Agreement is created when a business owner will remain with the company in some capacity after the transaction is completed. Typically, the employment agreement will provide for compensation (salary, bonus, equity, options, etc.) that exceeds the "market rate" for an employee performing the functions specified. This excessive compensation is essentially additional consideration to the seller.
- A Non-Compete Agreement is often put in place to prohibit a seller from working at or establishing a business that would compete with the company that was just sold. Consideration for this agreement can be a condition to consummating the transaction.

Deal Structure

The structure of a transaction can have a dramatic effect on the value delivered to the business owner. Thought should be given to what types of structure are acceptable. For instance, most deals in the middle market are asset purchases as opposed to stock purchases. Asset purchases reduce ongoing liability to the acquirer and provide a step up in basis on the assets of the company that can be depreciated over time. On the other hand, asset sales typically have less favorable tax treatment for the seller. It is important to understand the tax consequences of a transaction's structure. Other factors can affect the post-tax compensation to the seller as well. Enlisting the help of a mergers & acquisitions (M&A) tax expert can help minimize the tax liability and retain as much of the value of the company as possible.

Finally, it is always a good practice to identify and quantify potential "deal killers." By identifying key issues before beginning a transaction process, the seller and his advisors can minimize the chances of the transaction failing—which can happen even if most of the seller's goals have been met. Transactions can be unpalatable for a variety of reason including, but not limited to:

- Low valuation,
- Poor personality fit with the buyer,
- Unaligned vision for the future of the company,
- Poor deal structure,
- Unanticipated tax consequences, and
- Unacceptable employment contracts or non-compete provisions.

In summary, clearly defining the motivations, goals, and key "deal killers" before entering into a process to sell the company can greatly enhance the chances of completing a successful transaction.

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DAD'S LAW

Child: "Dad, what is that worth?"

Father: "Son, it is only worth what you can get someone to pay you for it"

VALUATION DRIVERS

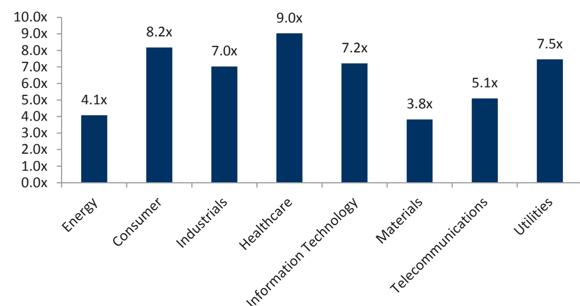
While appropriate representation can help to maximize the sales price of a business, most companies will have a value closely associated with its unique characteristics. There are a wide range of factors that drive the value of a company. While it is not possible to predict exactly what a company will sell for until it has gone to market, it is possible to determine a reasonable range of value for a company prior to entering the process. Below is a list of common valuation drivers that should be considered when estimating the value of the company and that will influence the ultimate sales price.

EBITDA

Most companies purchased in an M&A transaction are valued as a multiple of EBITDA (Earnings Before Interest Taxes Depreciation and Amortization) which represents a rough estimate of cash flow. Usually, the buyer considers the trailing 12 months of EBITDA when determining valuation. There are some instances that EBITDA is not typically used for valuation, most notably:

- Firms in specific high growth industries (like Software as a Service firms),
- Early stage/pre-profit firms,
- Certain service industries (including IT services),
- Distressed sales,
- Firms where value lies in the intellectual property, and
- Publicly-traded firms.

ENTERPRISE VALUE / EBITDA BY INDUSTRY 2012



Source: Capital IQ, accessed March 28th, 2013

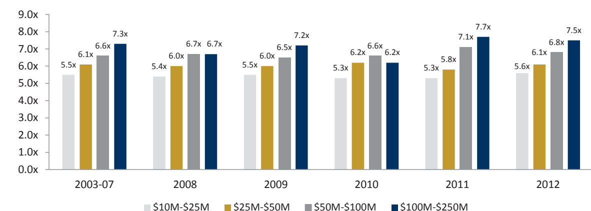
Industry

Not surprisingly, the type of industry in which a company participates affects the multiple at which it trades. Firms in low-tech and commodity industries command lower multiples than firms with highly differentiated offerings or firms in high-growth industries. Below is a chart that shows EBITDA multiples for several industries.

Company Size

Company size can also affect valuation. Historically, larger companies have commanded higher multiples of EBITDA than smaller companies. This increase in valuation is driven by a variety of factors—two of the most important are perceived risk reduction and increased availability of debt. Larger companies are, in general, perceived to be less risky than smaller companies within the same industry and thus will typically command a higher multiple of EBITDA. Similarly, banks more readily give loans based on a company's cash flow if it is of a larger size. Historically, cash flow loans are easiest to obtain if a company has more than $5M in annual EBITDA.

ENTERPRISE VALUE / EBITDA BY DEAL SIZE 2003 - 2012



Source: Capital IQ, March 2013

Below is a chart showing EBITDA multiples for various enterprise values since 2003. Disregarding a few exceptions, it is clear that larger companies command higher multiples.

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Consistency

Consistency of sales and profits can have an effect on valuation. Companies that show consistent (or better yet consistently growing) sales and profits command higher valuations than companies that have erratic revenue and profitability. Similarly, companies that have a high proportion of recurring revenue (such as subscriptions or long-term service contracts) often command higher valuations.

Growth Prospects

The ability for the company to grow in the future is always an important consideration to buyers. While most buyers will not apply a valuation multiple against projected earnings, they do pay close attention to the prospects of the company. Usually, a buyer is making a purchase because they feel the company has the ability to grow and return a healthy profit to them. A valuation multiple can be increased if the buyer believes the company has strong growth prospects.

Market

A company can have good prospects for growth in a flat or declining market. However, buyers often consider the market/industry in which the company participates when determining a valuation. A company that participates in a market that is growing and is generally believed to continue to grow in the future will be more highly valued than a company participating in a flat or declining market.

Customers

The price buyers are willing to pay for a company may be affected by the company's customers. Buyers typically place more value in companies with multiple credit-worthy customers. Companies that receive a large majority of their revenue from just a few customers are sometimes perceived as having a customer concentration risk. Similarly, companies that serve customers of low financial strength are considered to have credit risk in their customer base. Strategic buyers will sometimes place a higher value on a company that has a close relationship with one or more customers that the buyer lacks, but finds valuable.

Strategic Benefit

Buyers will typically pay more for a company that they believe is strategic to their existing business. For this reason, strategic buyers generally pay higher multiples than financial buyers such as private equity groups. Strategic benefit can be derived from any number of things: access to customers or channels, access to new markets, acquisition of talent, acquisition of intellectual property, ability to reduce costs post transaction, ability to increase sales by leveraging existing sales channels, etc. A seller's investment bank will usually look to identify strategic benefits to a buyer and use this as leverage to negotiate a higher price.

Intellectual Property

Intellectual property (patents, trademarks, trade secrets, copyrights, etc.) can have a profound impact on valuation. A buyer that perceives access to intellectual property as being key to its existing business will often pay large sums to obtain it (for example, the $4.5B purchase of Nortel's patent portfolio or Google's $12B acquisition of Motorola Mobility and its 17K+ patents). Patent protection for key products and processes that limit a company's competition will positively affect valuation.

PREPARING THE COMPANY

Ideally, business owners should begin preparing to sell three-to-five years before the desired date of a completed sales transaction. This allows the company time to create an uninterrupted series of records that will be valuable during the sale process—including clean, monthly financial statements and detailed customer data. It also allows the company to attempt to fill in any gaps they have in their business plan or management team prior to going to market.

Financial Statements

Professional financial statements are essential to facilitating a company sale. Ideally, the company will have audited financial statements, but reviewed statements can also work for privately-held middle

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market companies. In most cases, it is important to have three-to-five years of monthly financial statements (Income Statements and Balance Sheets) available for the buyer to review.

The Income Statement should be as clean as possible. Ideally, only revenue and expenses related to the operation of the company will be included. Often business owners have various expenses on the income statement that have nothing to do with the operation of the business such as personal travel, non-business related entertainment, family members on payroll, etc. While buyers understand this and will often make allowances for these items by "adding back" these expenses in an adjusted EBITDA calculation, the transaction will be much easier with as few add-backs as possible. Further, unless the company has impeccable records for these expenses and can prove their non-business related nature, buyers will be reluctant to provide full (or any) credit as an add-back. As most transactions are valued as a multiple of EBITDA, this can become quite expensive for the seller (for example, a $25K vacation could cost $150K in sales price if the company is valued at 6X EBITDA). A company's investment banking advisor will help to identify appropriate EBITDA add-backs.

The Balance Sheet should also contain only business-related items. Loans to other companies in which the owner has an interest and similar assets should be removed from the balance sheet prior to sale. Similarly, the company should take care to use various debt products as intended. For instance, a revolving line of credit should not appear to be a term loan that is never paid off.

Customer Information and Sales Data

A company that keeps detailed records on its customers and their purchasing habits often has a competitive advantage as this information can be used to identify opportunities for high-margin growth, as well as to help guide marketing efforts in attracting new customers. As the ultimate goal of any buyer is to increase revenue and profitability, a company that has organized, easy to access customer records will prove to be more attractive to a potential buyer than one with disorganized or non-existent records.

Business Plan

While it is always a good idea for a company to operate from a plan, it is even more important to have a well thought out business plan to share with potential buyers. In addition to an overview of the business, a complete business plan that outlines its operations, customers, historic and projected financials will clearly identify key opportunities for future growth. The discussion of these opportunities should include at least two categories. First, the plan should outline growth opportunities that are currently being pursued by the company or that will be pursued in the event of a buyer not being identified. The second set of growth opportunities should outline specific growth-related activities that could be with the appropriate partner or access to additional capital. A good business plan that clearly describes the opportunities of the company will help facilitate its sale. The company's investment banking advisor will also include this information in the Confidential Information Memorandum created to market the company. He may also help write the plan if none exists.

Management Team and Succession

A company with a strong management team is always more attractive than one that has weak members or is missing key functions. Ideally, a company will put in place a strong management team well ahead of selling the company. This allows the company to get a track record with the management team and also allows the team to develop into a cohesive unit. If the owner or other key senior managers plan to exit the company after the sale, it is important to have identified key successors, if possible. If key members of the team will likely exit the company upon the sale, it is still very important that all of the key functions of the company are filled with the highest quality employees possible.

OTHER ISSUES TO CONSIDER

It is not possible to identify every key issue that should be considered before selling a company as every situation is slightly different. However, some additional issues that are more common are identified below. While it is not necessary to disclose every issue to buyers up front, it is very important to disclose any known issues once diligence has begun.

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Employee Issues

Careful thought should be given to any employee-related issues. These can range from access to talent and issues with a union to "problem" employees.

Legal Issues

The company should identify any pending or anticipated legal issues / suits, including potential damages and the likelihood of incurring them.

Contractual Issues

All contractual obligations should be identified. Further, contracts with customers or suppliers should be reviewed to see if they will be impacted by the sale of the company and whether or not they are assignable.

Liens and Judgments

In general, obligations that result in a lien against a company will need to be paid off at or before the closing of the sale of shares or assets of the company. Sellers often forget that personal obligations, such as a personal guarantee on a loan or a personal judgment, can adversely affect the potential sale of a company or its assets. It is a good practice to identify any obligations of the company or its shareholders and review them with legal counsel or a transaction advisor prior to entering into a sales process.

Assembling a Transaction Team

One of the most important things a business owner can do to facilitate a smooth transaction and maximize the benefit he receives is to assemble the right team to sell the company. There are four key functions that need to be filled: investment bank, legal counsel, tax advisor, and wealth management.

Investment Bank

The investment banking advisor acts as the "quarterback" of the sales process. This advisor is involved and leads the sales process from beginning to end and should be the first person the business owner calls with any questions about the process. It is important that the investment banker be experienced in M&A, familiar with the company's industry, and have a good working relationship with the owner. A good investment banker will be able to maximize the sales price and keep the process moving forward.

Legal Counsel

The company's lawyer is responsible for all legal aspects of the sale of the company (purchase agreements, employment agreements, etc.). Legal counsel can have a dramatic effect on a transaction—either for the good or bad. It is important to note that the lawyer used in the sale of a company may not be the same lawyer used for general corporate purposes. It is critical to retain legal counsel that is experienced in mergers and acquisitions—not only to keep the transaction moving by focusing on the important aspects of the legal documents, but also to help avoid common pitfalls that inexperienced counsel may neglect.

Tax Advisor

Taxes can have a large impact on how much money the seller receives upon selling his company. The same sales price can have very different tax consequences to the seller, depending on how the deal is structured. The business owner should identify tax advisors well versed in M&A tax law. It is important to note that this is not always the same firm/person used by the company for its general accounting work.

Wealth Management

A business owner should work with a wealth management expert to create a plan for the sale proceeds to help various lifestyle goals. Early involvement with a wealth manager will help formulate transaction goals (minimum price, minimum cash vs. other consideration, etc.).

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The investment banking advisor should be consulted if an owner is unsure about the qualifications of his legal counsel or doesn't have an M&A tax advisor or a good wealth manager.

The investment banking advisor should be consulted if an owner is unsure about the qualifications of his legal counsel or doesn't have an M&A tax advisor or a good wealth manager.The Process

From beginning to end, the process of selling a company can be accomplished in 24 to 30 weeks. Some sales processes can take much longer if complexity is high, goals are not clearly set, parties to the transaction move slowly (sellers in providing company information, buyers in evaluating information, etc.), or legal counsel has little to no experience in M&A. Broadly speaking the process can be divided into four phases: preparation, process initiation, buyer selection, and transaction execution. Sikich Investment Banking has published a whitepaper describing the sales process in detail (http://www.sikich.com/sales-process-whitepaper).

Post Closing

After the company has been sold, there are usually several key issues of which the seller should be aware.

Employment Agreement / Non-Compete

As discussed earlier, in most transactions owners that were heavily involved in the operations of the company will usually be required to remain with the company for some period of time or will be required to enter into a non-compete agreement. In either case, the seller will be limited in his activities within the industry in which the company operates. These documents are key negotiated pieces of any sales transaction. Special care should be given to assure they are structured in a manner that is acceptable to the seller.

Escrow

A portion of the proceeds from the sale of the company is placed into an interest bearing escrow account, generally held by a third party. This money, which can be up to 15% of the transaction value, is held in reserve to account for any balance sheet shortfalls that are identified after the transaction closes and to provide assurance of payments towards any claims against the representations and warranties provided by the company to the seller. Usually, monies within the escrow account are released to the seller at various milestones (after the first audit, on the one-year anniversary of closing, etc.).

Earn-Out

In some transactions, a portion of the consideration can come in the form of an earn-out. As mentioned earlier, it is important that the goals for the release of earn-out monies be clearly defined and as simple as possible to avoid future disagreements between the buyer and seller.

Continued Investment in the Company

A portion of the consideration for the sale of the company often takes the form of a continued equity interest in the company or a direct loan to the company. Regardless of the seller's ongoing relationship with the company, it is important to monitor the company's progress and financial condition moving forward.

A Note on Unsolicited Offers

Most unsolicited offers to purchase a privately-held company are lower than market prices as there is no competition to help drive the price up. A business owner who receives an unsolicited offer and, as a result, is considering selling the company should consider hiring an investment bank to represent the company in the sale. An investment banking advisor can often facilitate a higher price by identifying other potential buyers and creating an auction-scenario that includes the original bidder. Often the investment bank will structure its fees in this scenario so the seller pays only a nominal fee unless the end price is above the original offer. In most cases, the investment banking advisor will be able to determine with a high degree of confidence if a higher price can be obtained before they

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are hired. The combination of an initial evaluation of the offer price and the fee structure weighted toward increasing the transaction price minimizes the downside risk for the seller. However, the upside to the seller can be substantial and in most cases far exceeds fees paid for the representation.

Summary

It is important for to give thought to the various goals for conducting a sale of a company long before actually engaging in the process. Proper preparation and attention to detail can result in maximizing the sales price while minimizing risk and headache. A company owner is well served in hiring experienced professionals to represent him in all aspects of the transaction (legal, tax, sales, and wealth management).

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