NUMA WAYNE Capital Advisors

11 Key Things to Consider Before Selling Your Business

Selling your business should never be a spur-of-moment decision. You need to figure out things like if you should sell, when is the best time to sell, and what you need to consider before selling.

The rewards that come from selling your business can be great, and ultimately, life changing. However, selling a business is never an easy or simple process. So if you do decide to sell there are eleven key things you should consider to help you prepare and maximize your chances of success. Getting it wrong before you start can ruin any hopes of a sale and can mean many months of your time wasted.

1. Get Your House in Order.

Your business functions pretty well and is profitable just the way it is. You are aware of certain business processes that are lacking or key contracts that are not as clear as they could be, but the job gets done without major hitches. Consider, however, how your business would look to a cautious buyer or new key investor. What will they find when they put your business under a microscope? A careful review of key business processes, assets, and contracts can save you major hassles during negotiations and significantly increase the value of your business. Consider the following:

- ***Organize your financial statements.*** Are your financial statements ready for due diligence? Do they reflect the latest GAAP accounting methods? Have they been reviewed or audited by a respected CPA firm? You may be willing to put great trust in your relationship with your accountants, but how comfortable will the buyer be with their work? Organize your company's financial statements so they are transparent and allow prospective buyers and lenders easy evaluation.

- ***Normalize financials.*** Do you pay yourself above market compensation? Do you lease your car through the business? Do you pay for family members' health insurance through the business? Since many buyers value companies based on a multiple of EBITDA, it is important that you provide an accurate presentation of EBITDA to maximize value and to prevent disputes during due diligence. This involves normalizing your financials to eliminate non-recurring expenses, which are one-time, non-repeatable expenses incurred by a company that a potential buyer would likely not incur in the future and personal shareholder specific expenses that are unrelated to the operations of a company and expensed through the income statement.

- ***Build infrastructure to reduce dependency on the owner or key manager.*** Is your business over-reliant on you or a key manager? Could your business run smoothly if you or a key manager were not around? A strong business infrastructure will decrease a company's dependency on its owner and/or key manager, which increases value. In other words, strive to make yourself redundant. You can achieve this by properly training employees, bringing in modern equipment, or by implementing effective systems to manage financial reporting, inventory, and other facets of your company's operations.

Don't let a major customer or supplier hold up your deal. Find out what consents you need and how to obtain them well in advance.

- ***Convert related party real estate leases and any below market contracts with affiliates to arms-length transactions.*** Do you lease real property through an affiliated entity to your company at below market rent? Do you have any customer or supplier contracts with affiliated entities on terms favorable to you? These contracts will need to be converted to market rates to reflect what the costs would be to the business in the hands of a new owner.

- ***Be aware of concentration risks.*** Does most of your business come from one or two customers? Do you rely on one key channel partner for most of your sales? Do you rely on one supplier for most of your products? If you have too much concentration in a single customer, supplier or key channel partner, a prospective buyer might become nervous. A buyer may be concerned with the loss of this customer or supplier post-purchase of the company? One online retailer client of ours had a key channel partner that was responsible for 90% of her company's sales. If that key channel partner adversely changed the terms of the arrangement with the company or ceased doing business with the company post-sale, it could spell disaster for the buyer. Explore what steps you can take today to lower your concentration risks in the future.

- ***Find out what consents you may need.*** Do you need consent from customers, vendors or landlords to assign your contracts or upon a change of control of your business? Depending on the structure of the deal, you may need consent from customers, suppliers and landlords for a transaction. You should assess the difficulty that you may encounter in getting these consents so that a customer, vendor or landlord can't hold up a transaction. You don't want a customer, vendor or landlord to have veto power over a transaction.

- ***Consider potential tax exposure.*** Are you aware of all the taxes for which your business may be liable? While you have filed your federal tax returns on time and paid the tax, there may be certain industry specific taxes that you may not have been aware of. During the due diligence process, a client I represented discovered that certain services her business offered were subject to a sales tax that hadn't been paid. This placed the company in the position of having potential liability for unpaid taxes and fines. Due diligence teams representing the buyer will often discover this exposure, which can complicate negotiations. Buyers will typically want money placed in escrow to offset the potential liability exposure (calculated for a worst-case scenario).

  Perhaps a worse result occurs when the liability is discovered after the deal closes. Deal contracts always contain clauses that require the seller to represent that it is fully compliant with tax law in the jurisdictions in which it operates. If the business is audited after the deal closes and the audit results in a material assessment, the liability often becomes the responsibility of the seller. This places the seller at a significant disadvantage; because the seller does not own the business at the time of the audit, it must rely on the new owner for representation in the audit. Since the buyer believes the liability is the responsibility of the seller, it may not take the same level of interest in the audit that it would otherwise. This may not be in the best interest of the seller. This can lead to large assessments, with the seller paying the liability out of pocket (often after the sale proceeds have been otherwise invested or spent), or it can potentially lead to litigation activity between the buyer and seller.

- ***Consider employment contracts for key executives.*** Will your key executives stay with company once they find out the business is changing owners? What will keep them from leaving or competing with the business? Will they have incentive to stick around and help the business be successful after the sale? Review key employment contracts to make sure your best employees will work toward a successful sale.

- ***Examine your intellectual property arrangements.*** Have you had your business contracts reviewed by an intellectual property attorney? Are all intellectual property arrangements in writing? Is it clear who owns what in those arrangements? Ownership ambiguity often makes for bumpy negotiations with a buyer or investor. Intellectual assets are often the most important asset category on your balance sheet. When ownership is not clear, the value of the business can be diminished. For example, a client of ours used a contractor to write software for the company without requiring him to assign his rights to the company. This can create questions about who possesses critical rights, which can scuttle a deal.

2. Know the Buyer Types - Not All Buyers Are Created Equal.

- ***Who are the Buyers***

  ⇒ **Financial Buyers.** These are investment groups such as private equity firms that buy private companies. Financial buyers are focused on return on investment and are typically interested in the cash flow generated by companies that they buy since these investors often use debt to finance acquisitions.

  ⇒ **Strategic Buyers.** These buyers are typically more focused on the operational characteristics of the company than on the financial profile of a company. Strategic buyers focus on how companies will fit together and how anticipated synergies and operational improvements will drive earnings and profitability.

  ⇒ **High Net-Worth Buyers.** These are buyers typically looking to buy companies to operate themselves.

- ***Let the "pre-dance" inform you on what the "main event" will be like.*** If the buyer is hard-nosed but fair, and always well-prepared and demonstrates solid follow through, that tells you one thing. If the buyer is flakey and unprepared in the early stages, that tells you something very different. Don't let your excitement and desire to close a deal (or some inflated number your prospective buyer drops in the early stages of the negotiation) blind you to the character of your buyer. And that character is often previewed in how they behave in the early stages of the sales process.

- ***Sometimes the best offer isn't the highest dollar offer.*** Factor in the certainty that the buyer will in fact close. This means gauging your prospective buyer's commitment level, capacity to close, and track record with you and with other business dealings. Don't be shy about qualifying your prospective buyers carefully. If you're working with a seasoned investment banker, this is something she or he will do for you.

3. Understand the Value of Your Business from a Buyer's Perspective.

- ***How is a buyer going to value your business?*** The most important thing buyers look for in a business is a healthy income stream with consistent and predictable earnings and a strong outlook. Buyers want to see a steady or positive trend on earnings, regardless of industry or economic conditions.

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- ***Buyers expect verifiable claims.*** If you are going to claim revenue from a specific source, you need to have verifiable proof. For example, if you are selling advertising space directly, be prepared to show invoices as well as bank statements that show matching deposits. Be prepared to show the general ledger and trial balance from your accounting records. If you are generating revenue through affiliate offers or third-party ad networks with an online business, be prepared to show deposit records and provide access to your accounts online so prospective buyers can see the accounts live.

- ***Buyers are interested in cash flow, not revenue.*** Another common misconception is that buyers are impressed with revenue figures. Sure, significant revenue can sound good, but when it comes down to it the only number that matters is the cash flow a business generates. Let's take a look at two examples: Company A generates $20M in revenue but generates $1M in cash flow. Company B generates $10M in revenue but generates $2M in cash flow. Although Company A generates twice the revenue of Company B, it only generates half the cash flow. Sophisticated business buyers want to see cash flow. Cash flow is how a buyer evaluates return on investment.

- ***Buyers typically won't pay more for potential.*** I regularly speak to business owners who believe they have a potential gold mine and expect to command a high selling price based on perceived potential alone. This isn't how it works. If a business is simply a concept without a proven revenue stream then there isn't any value in the eyes of the vast majority of potential buyers. If they were interested in developing their own business from the ground up, there are numerous resources to help them get started and they would not be looking to buy something already established in the first place. Buyers want to acquire something that is already successful, not an unproven concept.

- ***Never judge a buyer.*** You never know whom you are dealing with or the buying power they possess. Someone asking what appears to be a simple question could potentially be a buyer that is new to the specific industry and has deep pockets for investing.

4. Fully Understand Your Vulnerabilities.

- ***All businesses face operational vulnerability.*** Many business owners that I talk to look at their businesses like new parents look at their children. It's easy to be protective and even defensive, and it can be difficult to be appropriately critical. Allowing yourself and your advisors to make realistic assessments will better position the team for a successful sale. Make sure that you embrace your company's operational weaknesses. In addition to the ones that are known, find those that are not yet discovered or understood. Similarly, be fully aware of contingent liabilities. If it's not practical to fully eliminate the problem before the transaction, acknowledging and owning the problem before the buyer discovers it allows you to formulate a plan and craft the narrative for how best to disclose and control the message to the buyer.

- ***Expect to answer a lot of questions.*** Prospective buyers will have a lot of questions and request a lot of information about your business, which can be a significant time drain on you. But remember a prospective buyer needs this information to evaluate and value your business. You will need to be prepared to answer all questions, regardless of how simple they sound. An experienced investment banker will take the laboring oar in fielding questions and information requests from buyers for you.

- ***Honesty is the best policy.*** The truth is always going to surface, so be upfront about everything from the beginning. Experienced investors understand that every business is going to have positives and negatives. There is no such thing as a perfect business. If you are honest and transparent from the start, there is less risk of a deal going sour because the buyer uncovered something during due diligence that wasn't accurate or an instance where the truth was stretched. Honesty is the best policy in all business transactions and selling a business is no different.

- ***Don't live in the past.*** The previous success of a business is largely irrelevant at the time of the sale, especially if it has been struggling lately. Buyers are interested in recent performance (usually the last 12 months) and future sustainability and viability, especially if you operate in a dynamic space (such as technology). I commonly hear sellers talk about how successful their business was in the past after a recent drop and "all it needs is a little work to get back on track." Unfortunately, buyers don't see it this way. They aren't interested in fixing and recovering your business, especially if you are expecting them to pay a premium. This does not mean that you should not showcase growth from earlier years, especially if the business has been growing steadily. Buyers love to see growing revenue and profit figures, especially if you have already made future plans for the business that seem realistic based on past performance.

5. **Stay Focused on the Business and Not the Deal.** We have all heard stories about how buyers came back to the table right before the deal was expected to be signed to ask for a concession because the financial results for the months just prior to closing didn't meet expectations. Often the primary cause of the weaker results is because everyone on the management team was focused on the deal instead of on the business. That can be expensive. Make sure your strategic plan establishes clear assignments on who is managing the business and who is working on the deal. This is another advantage to using an M&A advisor. Your management team may be great at growing and operating your business, but they may not be skilled at selling the business. It would be rare if they could successfully do both at the same time.

6. **Consider Your Tax Exposure Well in Advance of the Deal.** The deal structure (i.e., asset sale versus stock sale) will also influence the transaction price. Know that proper tax planning is essential in maximizing the net proceeds of a sale. Many business owners tend to focus too much on the gross proceeds (before taxes) of a sale rather than the net proceeds.

7. **It's a Marathon Not a Sprint.** Selling a business is a complex and difficult process that takes time. If marketed properly, most businesses sell within four to twelve months of being taken to market. I've got one client who sold her company for just over $47M. It took her over 2 years and three attempts to close the deal. Pace yourself.

8. **Consider Post-Deal Participation.**

   - ***Would you be willing to stay on if the buyer wants you to?*** Sometimes you can seal a deal by agreeing to stay on in a consulting role for a period that typically ranges from three to twelve months. But first, you need to determine whether it's really worth it to you. If you're willing to stay on, it might reduce the risk to the buyer and increase the value of the company.

   - ***Do you want future participation in the company?*** Your plan to sell should anticipate the extent to which you wish to give up control of the company, whether you want to continue as an employee, whether you want to accept rollover equity or options, how much authority you will have as an employee/officer, whether you will hold a board seat, and how these items may affect your participation in an earn-out plan. These are just some of the considerations that you need to evaluate before completing the deal.

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9. **Why Some Businesses Never Sell.**

    - ***Failure to get your house in order.*** See consideration number 1.
    - ***Failure to stay focused on the business, not the deal.*** See consideration number 5.
    - ***Unrealistic price expectations.*** The primary reason why some small businesses do not sell is that the seller has unrealistically high price expectations. It is very important for business owners/sellers to establish a realistic and credible idea of fair market value for their businesses and to support it with historical financial information and market comparables.
    - ***Insufficient marketing.*** Sellers should be prepared to have their businesses confidentially marketed for a minimum of three months. The M&A advisor hired to market and sell your business should create a competitive environment where multiple buyers bid for the business.
    - ***Commitment to the process.*** Business owners should be prepared to spend time with prospective buyers and provide sufficient information throughout the sales process when requested. This is most important after a letter of intent has been signed and the buyer has begun the due diligence process.

10. **Hire Skilled and Experienced M&A Advisors.** Navigating the M&A landscape can be a very tricky proposition for the unexperienced. Not only can experienced and skilled M&A advisors help you maximize the valuation of your company, but they can also increase the certainty of closing a transaction. Here are several important ways that an experienced M&A advisor can help you with the sale of your company:

    - ***Help you get your house in order.*** See consideration number 1.
    - ***Research and manage prospective buyers.*** Before marketing a seller's company to potential buyers, a list of potential buyers will need to be created. A significant amount of time will be needed to research the potential buyer universe and select suitable buyer candidates; perform due diligence on buyers; conduct buyer outreach; and manage communications and relationships with buyers. The quality of the list of prospective buyers has a significant impact on the number of offers received; the more offers received for a business not only creates more options for the seller, but increases negotiating leverage as well. A skilled M&A advisor has the expertise and resources to perform this essential role for you.
    - ***Increase valuation by creating a competitive environment.*** Creating a competitive environment where several potential buyers are simultaneously bidding for your company is the best way increase valuation. We had a client hire us after he had already received an offer from a competitor to buy his business. He told us negotiations with this prospective buyer had come to a standstill because the buyer was not willing raise the purchase price. Once we became involved, we created a competitive environment and got this prospective buyer to raise his offer significantly. Ultimately, we ended up selling to another buyer at a price of 2x the initial offer.
    - ***Preserve confidentiality.*** If employees, vendors, or competitors learn that a business is for sale, it could significantly disrupt the business. Employees may become discouraged and begin looking for other jobs. Vendors and customers may get nervous due to the uncertainty related to the new owner. Competitors may use this information to poach your customers. You want what you share to stay private. And you don't want your prospective buyers poaching customers or team members. A well drafted non-disclosure agreement (NDA) with a clear provision for non-solicitation of your staff or customers is a key protection you must have before you move past any generic, early conversations of selling your business.

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Stay focused on your business and don't allow financial performance to decline during the sale process. Opportunistic buyers will use a decline in company performance to renegotiate purchase price.

- ***Deal structuring.*** In many cases, offers with higher gross transaction values come with additional terms such as such as post-closing pay ments based on performance (earn-outs) and/or seller financing. However, sellers must seriously evaluate these payment options because they bear significant risks. The deal structure (i.e., asset sale versus stock sale) will also influence the transaction price. Know that proper tax planning is essential in maximizing the net proceeds of a sale. Many business owners tend to focus too much on the gross proceeds (before taxes) of a sale rather than the net proceeds.
- ***Minimize distractions for you to stay focused on the business.*** It's a strange dynamic—you emotionally start distancing yourself from your business before the sale actually goes through. But you've got to keep running the business through the closing because if the sale falls through or stalls, and the trend line drops down, it could literally cost you millions of dollars of enterprise value. In my opinion, this is the biggest reason why you want a talented M&A advisor or investment banker representing you and running the sales process—to leave you focused on running a great company.
- ***Help you manage communications.*** When do you tell employees that you are selling the company? How do you handle such communications with customers and suppliers? An experienced M&A can help provide guidance.
- ***Maintain perspective.*** The transaction process can be an emotional roller coaster for a seller. Often there is an emotional attachment to a company that the seller built from the ground up. We often don't make the best decisions when emotions are involved. An experienced M&A advisor understands this and will help you keep perspective and guide you through the transaction issues in a logical, detached, analytical manner.

11. How Much Does an M&A Advisor Cost?

- ***Typical fee arrangement.*** Reputable M&A advisors and investment bankers will typically require an up-front retainer to confirm you are committed to the sale process, but will earn the bulk of their fees after a sale is complete. Usually, the fee is a percentage of the selling price, typically starting at five percent and decreasing based on the size of the deal.
- ***Are the fees worth it?*** Business owners sometimes avoid seeking help from M&A advisors to avoid the fees. However, experience shows that the value business owners realize in terms of higher net proceeds, superior transaction terms and peace of mind by engaging good M&A advisors far exceeds the costs. A well-organized, competitive sales process will always increase the value of a business, in many cases quite significantly. After completing complex negotiations, many business owners recognize that they are at their worst when negotiating on their own account. Recognize that up-front, and take advantage of the benefits of having highly skilled M&A advisors represent your interests.