THE COMPLETE GUIDE TO

SELLING A BUSINESS

TABLE OF CONTENTS

Stage 1: Build a Team 4

Stage 2: Defining Potential Options and Exit Strategies 9

Stage 3: Determining a Valuation Range for the Company 15

Stage 4: Marketing Materials Presentation 21

Stage 5: Building the Buyer List 24

Stage 6: Negotiation 27

Stage 7: Structuring the Transaction 29

Stage 8: Due Diligence 31

Stage 9: Ensuring a Successful Transition 35

Selling a company is a long and complex process

Whether you're ready for a transaction this year or just curious about what one might entail, this ebook can help. We break the business sale down into nine core stages — from who you need to hire, to what questions you should be prepared to answer, to how to hand off your company once you've signed on the dotted line.

You'll learn:

→ How to build an effective team to support the sale

→ How to define exit options

→ How to determine a valuation range for your company

→ How to improve marketing materials

→ What to consider when building a buyer list

→ How to improve your negotiation skills

Stage 1: Build a Team

When it's time to sell your business, don't go it alone.

Surrounding yourself with a team of trusted experts and advisors that have experience completing transactions in your industry is key. The first step is engaging an M&A advisor or investment banker to guide you through the process. We recommend finding an advisor you trust as early as possible. Engaging a professional 2-3 years before you need, or even want, to sell your business can help ensure that you ultimately get the valuation you expect and deserve.

How M&A Advisors Increase Value

A recent study found that "private sellers receive significantly higher acquisition premiums when they retain M&A advisors." The higher acquisition price derives from an M&A advisor's ability to run smoother processes with better buyer lists. Financial intermediaries have "greater economies of specialization and information acquisition, and have lower search costs than their clients." A smooth process means that the M&A advisor is particularly adept at keeping multiple, relevant bidders engaged simultaneously. This concurrent interest from several interested parties is critical to obtaining the best sale price.

A good M&A advisor can also help a business owner identify the best process and timeline for exiting the business. Since many closely-held businesses often experience intense family or shareholder dynamics, which may complicate the transaction, having a full understanding of the available options is essential. For example, if you want to sell the business to family or friends, a management buyout (MBO) or an Employee Stock Ownership Plan (ESOP) may be most appropriate. For transactions involving highly complex family or shareholder dynamics, your advisor can also serve as objective, third-party counsel that helps your business make decisions that maximizes a successful outcome for all stakeholders.

Often, advisory firms will make suggestions for small strategic or management changes to help a company increase its value in the time before a sale. These are not massive upheavals, but rather small tweaks to help make a business more attractive to potential buyers in a reasonably short period of time (e.g., 6-12 months). Working with a knowledgeable banker or informed board members that have relevant industry experience and business strategy context can be very valuable.

Once you've signed an engagement letter with an advisor, it's crucial to spend the time to properly aggregate, interpret, and present your company's financial and business history and future projections. Business owners typically prepare their financial statements for tax purposes, not for business sale purposes. Using tax statements for business sale presentation is a major mistake, as it usually obscures the earnings capability of a business. The "Quality of Earnings" report is a key aspect of the due diligence process of a sale, during which investors will review your company's financial performance in detail. Making sure that the appropriate financial adjustments are made is an important step and takes time and analysis by your accountant and M&A team.

How to Choose an M&A Advisor

Like most M&A activities, there is no perfect formula for choosing an investment banker or M&A advisor. As CEO, you know you need an intermediary, but have no guide for navigating the courting process. The following scorecard can serve as a guide to help CEOs make sense of cultural fit and indicators for future success before signing an agreement with an intermediary group.

Use this scorecard as an internal tool to benchmark one intermediary group from another. After meeting with an investment bank, you can score the bank's performance in each stage leading up to exclusive engagement. This exercise, if nothing else, can help you discover your preferences and place emphasis on the categories that are most impactful to your business outcomes.

The score for every category should total at least 12, otherwise there is likely not a long-term fit between your company and the bank. As CEO, this scorecard can help you feel confident about picking up the pen and signing an investment banking engagement agreement.

Ensure that the children and grandchildren who will inherit the family wealth are prepared to handle it.

THE INVESTMENT BANKER SCORECARD			
ADVISORY PROFILE	ATTENDEE PROFILE	POST-MEETING	OTHER CONSIDERATIONS
Industry Expertise 1 2 3 4 5	Level of Seniority 1 2 3 4 5	Storytelling / Specificity 1 2 3 4 5	Tone 1 2 3 4 5
Advisory Style 1 2 3 4 5	Personal Experience 1 2 3 4 5	Individualization 1 2 3 4 5	Question Quality 1 2 3 4 5
Size / Turnover 1 2 3 4 5	Number of Attendees 1 2 3 4 5	Communication of Value-Add 1 2 3 4 5	Response Quality 1 2 3 4 5
Current and Historic Transactions 1 2 3 4 5	Competition / Market Leader? 1 2 3 4 5	Timeliness of Communications 1 2 3 4 5	Meeting Duration 1 2 3 4 5
TOTAL	TOTAL	TOTAL	TOTAL

Download as a PDF here.

Here are some questions to consider as you score each investment bank in the categories on the scorecard.

ADVISORY PROFILE

Industry Expertise

- How well does this group understand my business and the things that impact it on a daily basis?
- Have they ever successfully navigated a transaction in this industry in the past?

Advisory Style

- How appropriate is their engagement structure for my needs?
- How fair is their fee structure?
- How much time should I anticipate spending with this group per week?

Size / Turnover

- Does the team have high turnover or limited resources that might affect the success of the transaction?

Current and Historic Transactions

- What is the firm's bandwidth to dedicate time/resources to my company, versus another client?
- How many transactions have they intermediated in the past and did those follow the proposed timeline?

ATTENDEE PROFILE

Level of Seniority

- Does the firm have a director-level member of the team to dedicate to my transaction?
- Will that person be the main point of contact moving forward?

Personal Experience

- Is the investment banker sitting across from me personally responsible for successful transactions, or speaking on behalf of the firm?
- How well does he or she provide anecdotal information about experience?

Number of Attendees

How many people did they take out of the office to meet with me?

Competition / Market Leader?

- Has this firm ever worked with a company I compete with?
- How well-regarded are they among the other investment banks in their geography or industry?

POST-MEETING

Storytelling / Specificity

- How well does the firm understand my company's story and both past and future plans?
- How confident do I feel that the firm is committed to our specific strategic initiatives?

Individualization

- Did the bank specialize their outreach to me or address the executive team and me as a group?

Communication of Value-Add

- How well did the firm or banker communicate the services and value that would be delivered as a result of our exclusive engagement?

Timeliness of Communications

- How long after the meeting were next steps and expectations delivered back to me?

OTHER CONSIDERATIONS

Tone

- Did our two groups achieve peer-voice?
- Does their tone match mine during uncomfortable scenarios or questions?

Question Quality

- How strong were the questions they asked me?

Response Quality

- How well did they answer the questions I asked?

Meeting Duration

- Was the firm respectful of my time and bandwidth?
- Were there inefficiencies before or during the meeting that would potentially be an annoyance or deterrence in the future?

Building Your M&A Deal Team

Your advisor or investment banker is the linchpin of your deal team. But you'll also need a team of specialists throughout the transaction process. In addition to your advisor, most deal teams consist at minimum of company executives, your board of directors if applicable, attorney, accountant, and wealth manager.

These professionals are critical in gathering the data required to place a proper value on your business, and in organizing financial statements requested by the buyer during the due diligence phase of negotiations.

Stage 2: Defining Potential Options and Exit Strategies

When considering the sale of a business, there are potentially a wide variety of transaction options. These options must be understood and evaluate by the CEO, owner, and/or board. Look to your M&A advisor to introduce you to the range of transaction options that make sense for your business.

Three important initial questions you should ask yourself before selling your company are:

- whether to sell to a strategic buyer or a financial buyer,
- whether or not you would want to stay with the company once it's under new ownership, and
- whether right now is the right time to sell your business.

5 Differences Between Strategic and Financial Buyers

Understanding the key differences between strategic and financial buyers can help you understand their decision-making processes as you approach the sale process.

Strategic buyers are operating companies that provide products or services and are often competitors, suppliers, or customers of your firm. They can also be unrelated to your company but looking to grow in your market to diversify their revenue sources. Their goal is to identify companies whose products or services can synergistically integrate with their existing P/L to create incremental long-term shareholder value.

Financial buyers include private equity firms (also known as "financial sponsors"), venture capital firms, hedge funds, family investment offices, and ultra high net worth individuals (UHNWs). These firms and executives are in the business of making investments in companies and realizing a return on their investments. Their goal is to identify private companies with attractive future growth opportunities and durable competitive advantages, invest capital, and realize a return on their investment with a sale or an IPO.

Because these buyers have fundamentally different goals, the way they approach your business in a M&A sale process can differ in many material ways. Here are five key differences.

1. EVALUATION OF YOUR BUSINESS

Strategic buyers evaluate acquisitions largely in the context of how the business will “tie in” with their existing company and business units. For example, as part of their analysis, strategic acquirers will ask questions like:

- Are the products sold to their customers?
- Does your company serve a new customer segment for them?
- Are there manufacturing economies of scale we can realize?
- Is there intellectual property or trade secrets that you’ve developed that they want to own or prevent a competitor from owning?

Conversely, financial buyers won’t be integrating your business into a larger company, so they generally evaluate an opportunity as a stand-alone entity. In addition, they often buy businesses partially with debt, which causes them to scrutinize the business’ capacity to generate cash flow to service a debt load. Financial buyers are also focused on understanding how to quickly increase the long-term value of the company to ensure an acceptable return on their investment.

While both buyer groups will carefully evaluate your business, strategic buyers focus heavily on synergies and integration capabilities whereas financial buyers look at standalone cash-generating capability and the capacity for earnings growth.

One note of caution is that all buyers cannot be neatly categorized. Sometimes strategics are just looking to boost their earnings and end up acting like financials. Other times, financials already own a company in your space and are looking to make strategic add-ons, so they’ll evaluate your business more like a strategic. By understanding the motivations of the buyer, you can understand how they’re determining your business value.

2. FAMILIARITY WITH YOUR INDUSTRY

Strategic buyers usually are more up to speed on your industry’s competitive landscape and current trends. As such, they will spend less time deciding on the attractiveness of the overall industry and more time on how your business fits in with their corporate strategy. Conversely, financial buyers are typically going to spend a lot of time building a comprehensive macro view of the industry and a micro view of your company within the industry. It is not uncommon for financial buyers to hire outside consulting firms to assist in this analysis. With this analysis, financial buyers might ultimately determine they do not want invest in any company in a given industry. Presumably, this risk is not present with a strategic buyer if they are already operating in the industry.

As the seller, the risk of having a sale process fail due to “industry attractiveness” factors is reduced by ensuring that you are soliciting strategic buyers.

3. STRENGTH OF BACK-OFFICE INFRASTRUCTURE

Strategic buyers are going to focus less on the strength of the target company's existing "back-office" infrastructure (IT, HR, payables, legal, etc) as these functions will often be eliminated during the post-transaction integration phase. Since financial buyers will need this back-end infrastructure to endure, they will scrutinize it during the due diligence process and often seek to strengthen the infrastructure post-acquisition.

As such, you'll likely want to de-emphasize the importance and/or value of your back-office infrastructure in discussions with a strategic, whereas it's important to be prepared for thorough evaluation of these functions when having discussions with a financial buyer.

4. INVESTMENT HORIZON

Strategic buyers intend to own an acquired business indefinitely, often fully integrating the company into their existing business. Financial buyers typically have an investment time horizon of four to seven years. When they acquire and subsequently exit the business, especially in the context of the overall business cycle, will have an important impact on the return on their invested capital.

For example, if your business is purchased at the peak of a business cycle for 8X EBITDA and the buyer can only sell it for 6X EBITDA 5 years later, it's tough to make an attractive return. As such, financial buyers are going to be more sensitive to business cycle risk than strategic buyers, and they will be thinking about various exit strategies for your company before making the final decision to buy your company.

5. TRANSACTION EFFICIENCY

Financial buyers are in the business of making acquisitions. It it one of their core competencies to execute deals in a timely fashion. Strategic buyers may not have a dedicated M&A team, may be encumbered by slow-moving boards of directors, bureaucratic committees, territorial division managers, necessity to check acquisition against internal projects, etc.

From our experience, combine these factors and the process with strategic buyers can often take longer than with financial buyers. No matter what, be prepared for a 6-12 month process before you decide to sell.

Should You Stay of Should You Go?

The second important question to consider is whether you want to stay on in some capacity with your company post-sale. This will help determine what buyers you look for and how you evaluate them.

Every CEO should think about what they're trying to accomplish with a sale, says Adams Price, managing director at The Forbes M&A Group, an Axial member. "Where do they want to be in five years? What role do they want to have post-transaction? Are you looking to pull the ripcord and leave now? Or, are you looking for a partner to realize further financial or operational goals?"

The answers to these questions, says Price, have "a big bearing on how you position the company to the marketplace."

Often, CEOs will still be weighing their options when they first meet with an advisor. "It's incumbent upon us to help them understand the consequences of both options," says Bill Nack, also managing director at The Forbes M&A Group. Private equity firms will typically require a management team to stay on board; if the management team wants to leave, then it's time to focus on strategic buyers. "A strategic buyer will likely tolerate a weaker or more uncertain management team, because they'll have the ability to insert their own people."

Is Now the Right Time to Sell Your Business?

"It's always a great time to sell!"

At some point in time, every business owner or operator will hear this phrase from investment bankers, M&A advisors, and business brokers. In other cases, business owners may find themselves independently contemplating selling their business and cashing out.

The reasons business owners start thinking about selling their companies are as varied as the companies themselves. Regardless of the instigating factor, owners should take a step back and conduct a holistic assessment of whether or not it truly is the right time to sell.

Changes in ownership are inevitable throughout a business's lifecycle. When planned for and managed well, the transition can reinvigorate and renew a company's mission, culture, values, and productivity. When mismanaged, however, a change in ownership can destabilize financial performance, erode competitive market advantage, shake employee and investor confidence, and damage company culture.

Using a mix of best practices focused on leadership development, practical preparation, and rigorous assessment of the underlying fundamentals of a business — both internal and external — and its current management improves the chances that an ownership transition will create value, rather than diminishing it.

There is a distinct contrast between a carefully planned transition and one made amid corporate distress. A company's readiness for and approach to exit planning is most noticeably put to the test in times of crisis and abrupt industry changes. Whether a business is being sold at the end of a long-planned transfer or quickly being sold during a troubled time, CEOs can enhance the process by concentrating on preparation and assessment.

EVALUATE YOUR COMPANY'S FUNDAMENTALS

Closely examining your company's business fundamentals in the years and months leading up to sale will help you more easily determine when is the right time to exit.

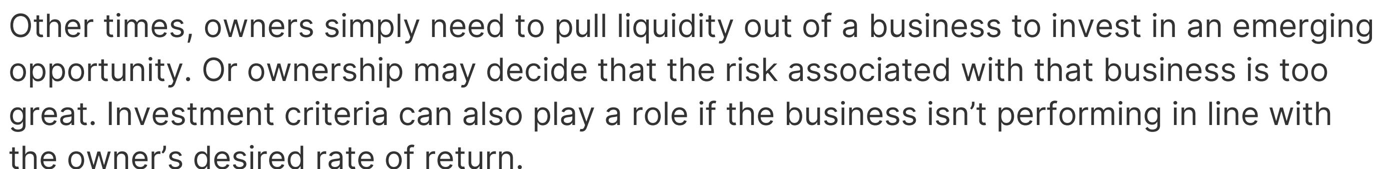
Leadership: Do you have the right people in the right positions to lead your company to the next phase of growth under the new owners? Prospective buyers will assess the executive leadership in the same way they would the selection of a new leader for any company. Before putting your company on the market, ask yourself whether your company's leadership is strong enough to withstand the scrutiny.

Value protection: Now more than ever, businesses in every industry need to find innovative solutions to challenges brought about by disruption in the forms of new technologies, evolving business models, and ever-increasing customer expectations. In the post-2007, low-growth world characterized by frenetic change, potential buyers consider innovation a necessity.

Innovation: Before you sell, work to foster a culture of innovation. At the end of the day, successful innovation is not the result of luck or lone genius — rather it is the result of a disciplined, continuous improvement process with an unrelenting focus on creating the highest customer and shareholder value. Carve out time outside the day-to-day demands of deadlines and budgets to focus on strategy and exit planning.

THE THREE DETERMINING FACTORS

At the highest level there are three critical factors that inform whether or not it is the right time to sell.
1. *Ownership has a highly compelling reason to exit the business.*
In some cases, the current ownership may have personal reasons to exit such as irreconcilable differences between the co-owners, lack of an heir, or health problems.



Other times, owners simply need to pull liquidity out of a business to invest in an emerging opportunity. Or ownership may decide that the risk associated with that business is too great. Investment criteria can also play a role if the business isn't performing in line with the owner's desired rate of return.

2. *Ownership is fairly confident their strategic goals will be met through a sale.*
This may depend on current industry multiples or other market factors outside of the owner's control. But in some cases, ownership and the business's executives can play an instrumental role in increasing the probability of success, by a) valuing their company at or near a realistic number and b) employing a diligent and thorough process in marketing the company.

This is possibly the most important factor when deciding if it is the "right" time to sell, and is related to several external factors: this area is related to several exogenous factors:

- Overall performance of the global, national, regional, and local economy
- Idiosyncratic risks/outlook associated with that industry
- Individual company performance relative to overall market performance
- individual company performance relative to its competitors
- Socio-political and regulatory environment

3. *Ownership is mentally prepared to divest.*
Are you ready to exit the business you've worked so hard to build? Ambivalence on this front may negatively affect the exit planning process. To prepare yourself for divestiture, think about what you will spend your time doing after you've exited the business, and be realistic. If you're used to working 12-hour days, and find satisfaction in your work, you may not enjoy constant relaxation as much as you think. You might plan to start a new venture, or dive headfirst into a passion that was formerly a hobby. Perhaps you'll spend your time traveling. Whatever it may be, crafting a plan will help make exiting your business easier.

Stage 3: Determining a Valuation Range for the Company

Open up any corporate finance textbook and you'll find thousands of pages devoted to valuation theory, valuation principles, and techniques for arriving at a rational and dispassionate value for your company.

No matter how sound the valuation theories are, companies are valued in the real world, by real people with varied motives, amidst a dynamic market and uncertain future that no one can perfectly predict. And so entrepreneurs must focus on driving their company's valuation by building the best business they can build, engaging with real-world investors and potential buyers, and painting a picture of their company's future that is both expansive and credible.

Supply and demand factors are key to how high valuations are going to be. "What it comes down to, more than anything, is supply and demand of capital in the market versus those companies that are available to invest in," The Forbes M&A Group's Adams Price says. Recently, the large amount of cash reserves on corporate balance sheets both domestically and internationally as well as the historically high private equity overhang are driving up valuations. "There's just a tremendous amount of money available in the marketplace and banks are also extremely aggressive right now in deploying money," says Price.

By the time you've decided to actively sell your business or raise a round of financing, you've got to put building the business on hold and devote your attention fully to the capital raising process. At this point in time, the two most important drivers of your company's valuation will be:

- **Its future**
- **Competition among investors**

Let's address these one by one.

THE FUTURE

Investors only care about the future of your company. When an investor studies your company's historical track record, reviews your financials, or interviews your customers, they are doing it to look for clues about the future prospects of your company. The quality and credibility of the picture you paint of your company's future — the size of your market opportunity, the speed and predictability with which you can serve your customer base, and the defensibility of your product offering — is the most important driver of your company's value.

In an uncertain world, the more predictable and sustainable your company's future profits are, the more valuable it becomes to investors, who constantly assess the risks and rewards of an investment opportunity.

Many entrepreneurs get mired in the details of valuation or put their head in the sand and simply pick a number based on their personal needs or what they heard was "right for their industry." This is wasted time.

COMPETITION AMONG BUYERS

A credible and compelling future makes it easier to attract investors. And if you're raising money or selling your company, competition is a must-have. You will not dependably realize a fair value (let alone maximize your offer) for your business without multiple uniquely interested and credible parties at the table. It doesn't matter if your business has been growing at 100% top-line with 50% EBIT margins for 10 years straight — if you only have one interested party at the table, you have created no competition for your business and will struggle to achieve a fair outcome. For entrepreneurs more familiar with selling to customers than with raising capital or selling their company, think about your sales process: the richer your pipeline of customer prospects is, the more choosy you can be about which prospects you focus on closing, and the more disciplined you can be in negotiating the pricing and terms of the customer contract. The exact same concept applies to raising money or selling your company.

Creating competition in a financing or exit process is one of the most important reasons the investment banking profession exists — similar to a good real estate agent, a great investment banker helps business owners drive to a fair outcome by attract multiple, interested parties that are acutely and uniquely motivated to buy or finance your business.

As you prepare to raise money or sell your company, ignore all of the noisy free advice you'll get and focus on two things: how to crisply and credibly articulate the future of your business in the most predictable and expansive way possible, and devoting meaningful time to doing the necessary networking and relationship development (meeting with investors before you formally initiate a process, meeting investment bankers who can help you) in advance so you can attract a set of uniquely and acutely interested partners to the table.

Discounted Cash Flow (DCF) Valuation Model

There are several ways to value a business. By far the most popular is the discounted cash flow (DCF) methodology. The DCF is grounded in a simple concept: that the value of any given company is equal to the sum of all the future cash flows of that company, discounted to reflect their value today.

Should you want to sell, or conversely, buy, a business, this is the price that you would ask for in order to break even.

Building a DCF model is both exceptionally complicated and very time consuming. **Use Axial's free downloadable DCF Excel Template** to value your company today.

The DCF model is grounded in a simple concept: the value of any given business is equal to the sum of all future cash flows of that business, discounted to reflect their value today. The basic equation looks like this:

Discounted Cash Flow = $$\frac{CF^1}{(1+dr)^1} + \frac{CF^2}{(1+dr)^2} + \ldots + \frac{CF^n}{(1+dr)^n}$$

CF = Cash Flow
dr = discount rate

For example, let's say you're looking to purchase a Florida-based manufacturer of niche industrial products. For the sake of simplicity, we'll assume the factory will be productive for only two more years and will have no terminal value. (The builders chose a rather shortsighted location on the precipice of a sinkhole.) Cash flow for year one is projected to be $1,000 and it will grow by 3% to $1,030 the following year. The proper discount rate is determined to be 6%. The formula for the appropriate DCF model would look like this:

Discounted Cash Flow = $$\frac{\$1{,}000}{(1+.06)^1} + \frac{\$1{,}030}{(1+.06)^2} = \$1{,}860$$

This raises the question of where the formula's inputs came from. Here's where the DCF business valuation technique breaks down. A discounted cash flow valuation is only as good as the assumptions that create the valuation's inputs. In the above example, we made assumptions about discount rate, cash flows, lifespan, and growth rate. If any of these prove off-target, the end result can be misleading. As the saying goes: garbage in, garbage out.

Below we look at how to make better assumptions for valuing private companies. We'll also look at the limitations that come with DCF valuations.

CASH FLOW ESTIMATION

You'll find it hard to know where you're going if you don't know where you're coming from. Unfortunately, the history of a private company is almost always more obscure than that of a publicly traded company. There are a few reasons for this. Often:

Private firms are younger than their public counterparts. There is less of a track record you can use to build your pro formas.

Private firms don't face the same accounting and information sharing requirements from regulatory agencies and exchanges as public firms.

Private firms' financials might not account for the true cost of running the business.

WORKING WITH AN INVESTMENT BANKER

"Be wary of the investment banker or broker who agrees with everything you say about the value of your business and is immediately prepared to bring your business to market at exactly the price point you want... This isn't what you hire a professional investment banking advisor to do.

"If you want the most productive exit strategy, find an advisor that will give you fact-based market information, constructively offer recommendations that will enhance business value, and help you do all of the needed preparatory work to bring your business to the market with high confidence in achieving the value that you both desire and can actually achieve."

-Karl Edmunds, SDR Ventures

For example, an entrepreneur that founded a private business might work for a below-market wage prior to the sale of the company.

These points all underscore the added care one must take with a private company DCF valuation. With young companies, an investor must realize his cash flow predictions will rely more heavily on assumption and less on history. When examining the financials, he will have to be careful to make sure the accounting is acceptable for the purposes of the analysis.

And the idiosyncrasies of a small private company must be included in the estimations. What if the founder will leave after the sale? Does her current salary reflect the true cost of replacing her?

DISCOUNT RATE ESTIMATION

The discount rate is the rate of return the investor requires from this investment. If he perceives the investment relatively risky, he will require a higher discount rate.

When valuing public companies it's assumed the investor is properly diversified. This eliminates some of the risk of the investment. With a private company no such assumption can be made. For example, the investor might be a private equity fund specializing in a specific sector and making an investment in that sector.

Discount rates should also typically be higher for a private firm than a public firm because of a difference in expected longevity. With public companies, there's an assumption that the business will continue indefinitely. Smaller private companies with a key founder involved in operations have a shorter expected lifespan.

CONTROL PREMIUM AND ILLIQUIDITY DISCOUNT

There are a couple other key items that should be taken into account for a DCF valuation of a private firm. One increases its value, the other decreases it.

The premium derives from control and the value that control can realize. Unlike most purchases of shares in publicly traded firms, the purchase of a private company often comes with a great deal of control over the company. If the business is poorly run and the investor believes he can improve financial performance by exercising their power to change management, there will be a significant control premium.

The transaction costs to buy and sell shares in a public firm are virtually nil; the resources and time required to buy and sell a private company are significant. The DCF valuation should account for these costs. This illiquidity discount is widely attributed for the 20 to 30% price discount sales of private companies exhibit relative to sales of public companies with comparable financial performance.

LIMITATIONS OF DCF VALUATIONS

DCF valuations can be a powerful tool if used properly but also have serious limitations. We discussed above the difficulty of properly estimating cash flows from a private company. Estimating a trustworthy discount rate is not an easy matter either.

These issues are compounded because tiny changes to the inputs of a DCF valuation can have big effects. Discounted cash flow models often assume a business will operate for a long or infinite period of time. A tiny change in the growth rates of cash flows or discount rate can cause a huge swing in value.

Let’s go back to our example. Say the sinkhole next to the widget factory stops expanding. We now assume the factory can operate as a going concern forever with a constant growth rate. In this case, we would use an infinite period constant growth rate DCF model.

If we expect growth of 3% and use a discount rate of 6% we get a value of $34,333. If we expect growth of 4% and use a discount rate of 5% we get a value of $103,000. Some small changes in our growth and discount rates estimates cause the DCF value to triple.

Stage 4: Marketing Materials Presentation

Many successful businesses spend tens or hundreds of thousands of dollars each year developing marketing collateral and programs to promote their products and services. And yet, when they decide to sell their most important asset — the company itself — they completely skimp on building professional and comprehensive marketing material. This can be some of the most penny wise and pound foolish thinking you can make as a business owner.

The benefits of having a professional CIM outweigh the costs associated with having them prepared. Just as you would not put together professional marketing materials for your business without the help of a marketing professional, don't make the mistake of thinking you can prepare a high-quality CIM for your company without some sort of help.

Having a robust set of investment marketing materials will have a substantial impact on the success of the M&A process in three primary areas:

- The speed of the process
- The efficiency of the process
- Overall buyer perception (which contributes to their valuation considerations)

SPEED

The more questions you answer in your marketing material, the fewer questions you must answer piecemeal to get the buyers familiar with the business, its dynamics, position, etc. During a sales process, your goal is to get potential acquirers to make a decision quickly and providing the information they need helps speed up the process. The longer your business is on the market, the easier it is to lose momentum.

EFFICIENCY

The more information you provide to buyers, the more quickly they can "self-select" to determine their true level of interest in the opportunity. No business owner wants to waste time educating a potential buyer on their business only for the buyer to indicate they weren't interested, so the sooner you can help some of them screen themselves out, the better. Use the marketing material to help you decide which buyers to spend time with; ignore the tire-kickers.

OVERALL BUYER PERCEPTION

Human beings are heavily influenced by the appearance of things. If you go to a trade show and there are lots of service providers there, the booth with outstanding marketing brochures and demo stations will always outperform the booth with the better product that is poorly marketed.

Invest in presenting your business as professionally and attractively as possible. The ROI is substantial for well prepared materials.

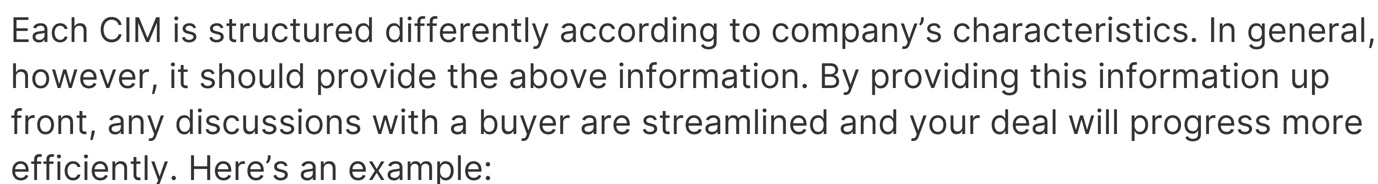
The Pitch Book

Investment-related marketing materials are often referred to as confidential information memoranda, or “The CIM.” The CIM is also referred to as the “offering memorandum,” or, in more informal industry parlance, the “pitch book”, or simply, the “book.”

Let’s say a buyer approaches you to purchase your business and they have already signed your NDA. What should you do next? In an ideal situation you should have a prepared CIM to share with a prospective buyer. The purpose of the CIM is to help a buyer understand your business and the unique strategic investment opportunity it presents.

Well-prepared CIMs tend to have the following:

- Executive Summary
- Company History
- Sales Process and/or Manufacturing Capabilities
- Management Team Structure
- Growth Opportunities
- Competitive Landscape or Industry Outlook
- Intellectual Property Overview and/or Company Assets
- High-Level Financials (preferably five years of historical data and projections, if available)



Each CIM is structured differently according to company's characteristics. In general, however, it should provide the above information. By providing this information up front, any discussions with a buyer are streamlined and your deal will progress more efficiently. Here's an example:

Assume you haven't invested in building a CIM and you decide to approach twenty carefully targeted potential buyers to evaluate your company as an M&A target, and ten of them express a preliminary level interest in your company based on your outreach. Each of them asks you for more information. To answer their questions, you do ten separate conference calls with each buyer and answer some of the exact same questions over and over again. It will take you three conference calls to see what a massive time-suck the process is, especially without a well-prepared pitch book. Instead of running your business while the buyers digest well-packaged information, you're on the phone and responding to emails one by one all the time. This is a terrible use of your time.

WHY HAVE A CIM?

Once a buyer has reviewed your CIM, they can quickly determine if they want to move to the next stage in the deal process, which typically is a conference call with you. The materials will reduce the number of conference calls you are on, but they won't be eliminated entirely. First, since many buyers will pass on your company after reviewing the CIM, you'll be able to focus only on calls with interested buyers. Second, a conference call after a buyer has reviewed your CIM is typically a more in-depth conversation covering topics like your personal goals, valuation and desired deal structure–not basic questions about your company.

The CIM will only take your company so far in an M&A sell-side process. During any potential sales process buyers will want to speak with you over the phone, visit your company in-person, meet your team and tour your facilities, etc., to get as clear a picture as possible of your business. But a CIM can and should set the tone for all discussions and set expectations in a transaction. Sharing a CIM with qualified buyers is the most productive and efficient way to determine a buyer's level of interest.

Stage 5: Building the Buyer List

While large multi-billion dollar companies often have only a handful of relevant and sufficiently capitalized potential acquirers, lower middle market companies (this generally refers to businesses whose value ranges generally between $10M and $250M) often have an enormous number of potential buyers. Some of these potential buyers are known to the business owner and some might be known by the advisor, but no one's Rolodex is usually broad enough to know every potential buyer.

This means that the banker and the business owner must have tools and resources to research and access the largest and most qualified data set of relevant buyers. Databases and tools of varying qualities exist out there, but there is no silver bullet. This research process should be exhaustive, not rushed. The banker should review competitors, customers, strategic buyers, private equity firms with relevant expertise, and other sources of highly suitable capital and partnership. This is one of the most time-intensive elements of the process but it often determines the overall success of the sale process. If you don't approach the best buyers, how can you get the best outcome?

Your M&A advisor will take the lead in compiling a prospective buyer list. The key is to find an advisor with the transaction experience and industry expertise necessary to build a diverse buyer list that not only helps maximize your potential valuation, but also enables you to achieve your non-valuation transactional goals.

Advisors will rely on their existing network of financial and strategic buyers, tools like Axial, and your own knowledge of potential acquirers to compile the list. Building the ultimate buyer list is part art and part science, and a qualified advisor can help you identify the most likely buyers for your business from among the thousands that may potentially be interested.

As the list is being finalized, you and your advisor will review it to ensure you are comfortable with all of the buyers on the list and prioritize the list in tiers that the advisor uses to stagger their outreach. Some advisors may also recommend "pre-marketing the transaction at this point, where they may contact a handful of buyer contacts at the top of your list with whom they have long-standing relationships.

Exploring the Sale Process

Once you have researched and built the Buyer List, a key decision is to determine how many buyers you will approach and whether you will employ a sequenced or parallel process. There are three general techniques:

- **Serial Approach/Negotiated Sale:** You identify and contact the most logical potential buyer(s). You approach one buyer at a time and negotiate exclusively with that buyer. If unsuccessful, you approach the next party and continue to work your way down your list until you find a buyer.

- **Targeted Auction:** With this M&A process, you discretely contact a limited number of potential buyers. Typically, you will approach between 5 and 20 buyers, solicit indications of interest, and then negotiate with the most appropriate and interested buyers.

- **Full Auction:** You identify and contact a broad universe of potential buyers. Strategic buyers will include firms that are your competitors, suppliers and customers. It will also include "creative" strategic buyers that are not currently operating in your industry. In terms of financial buyers, you will go out to a sizable number of investment firms and executives with the financial wherewithal to buy your company.

Find an advisor who can build a diverse buyer list that maximizes valuation and enables you to achieve your other transactional goals.

Each approach has strengths and weaknesses. The strengths of the “Serial Approach/Negotiated Sale” or “Targeted Auction” include reducing disruption to your business and limiting the chances of confidential information leaking out.

However, we have observed that those sellers who initially identify and approach a more thorough universe of qualified buyers are more likely to have a successful sale process. While certain circumstances can uniquely call for the limited approaches, they are very risky for business owners. The reality is that there are a tremendous number of considerations that a buyer is making when deciding whether or not to make an offer for your business. Many of these considerations can have nothing to do with your actual business. For example, perhaps you approach the ideal financial buyer only to realize that they are raising capital for their next fund and cannot get the deal done, or you approach the perfect strategic buyer but their CEO is focused elsewhere or still integrating a recent transaction.

What is the right number of buyers to have on your buyer list? It depends on your situation. Usually, it’s wise to err on the side of too many buyers versus too few. In the end, it is not about knowing the perfect buyer when the process begins. It is about finding the right party that will structure a transaction to fit your particular needs and ensure your business is positioned to thrive in its next phase.

Qualification of Potential Buyers

Some people that express interest in your business will be tire-kickers, i.e., firms that are not qualified to purchase the company. A good banker will know the right questions and have enough market intelligence and expertise to smoke these buyers out and pre-qualify the right potential acquirers before the tire-kickers impact the CEO or management team’s time and attention. This isn’t a particularly complex or time-intensive step, but if it isn’t done, the CEO will waste a lot of time and effort speaking with unqualified buyers and increasing the confidentiality risk of the entire process.

One preparation method to stave off tire-kickers is building a list of qualifying questions to ask interested buyers. The questions allow you to ensure that conversations are focused and productive. If initial meetings are unsubstantive and the buyer seems half-hearted in their intent, chances are they may be a tire-kickers. In addition to question lists, documents such as in-depth financials, marketing materials, and overall business metrics allow you to quickly determine the strength of buyers’ interest level and weed out unqualified acquirers.

Stage 6: Negotiation

Mastering negotiation takes time, talent, homework and practice. However, there are a few key negotiating techniques and resources that are crucial for success when closing a business investment, growth capital, or M&A transaction.

Since buyers seek to buy companies at the lowest possible price and most favorable terms, and business owners and entrepreneurs are looking to realize the fruits of their labor by maximizing price and favorable seller terms, negotiation skill is critical to completing any significant financial transaction. Despite the tension, there is always one critical goal that buyers and sellers share: getting a deal closed that benefits them and their stakeholders.

To that end, here are six helpful negotiation tips and techniques.

1. REMEMBER PRICE ISN'T EVERYTHING

When it comes to the sale or purchase of a company, it’s very easy to fixate on the price. It’s a key piece of the negotiations, but hardly the one one. The terms matter too. Does the buyer get the first refusal for future transactions? Does the sale agreement provide the buyer with any recourse against the seller if costly problems arise immediately after the transaction? Is there any seller financing? By creating many terms beyond just price, buyers and sellers can find out what are the top priorities for the other side, and this allows both sides to ultimately make concessions to the other to keep the deal moving forward. Perhaps the seller is comfortable with an earn-out provided the buyer is willing to pay a higher price. If you don’t put an earn-out term on the table, the deal might be off.

2. MAKE CONCESSIONS STRATEGIC

“Concessions are often necessary in negotiation,” says Harvard Business School professor Deepak Malhotra. “But they often go unappreciated and unreciprocated.” Malhotra offers four strategies to make sure your concessions are returned in kind.

- First, make sure that your counterpart is aware that you have given up something of value.
- Second, define how your counterpart can return the favor. Then demand it.
- Third, if you don’t trust your counterpart to reciprocate, make a contingent concession. In other words, offer to yield on something only if the other side meets a certain condition.
- Fourth, make concessions in installments. Malhotra points out that people are happier to find two $10 bills on consecutive days than one $20 bill. We like our good news spread out, including in negotiations.

3. KNOW YOUR “WALK-AWAY” NUMBER

Enter negotiations with an understanding of the reasonable range in potential sale prices for your company. Just as important, know their “walk-away number”; this number is youR final threshold for consummating the deal. Knowing your walk-away number going in takes research and preparation, and sticking to it will help you stay disciplined.

4. KNOW YOUR OPPOSITION

In order to get the other party to agree to a deal, you need to intimately know what their interests are. **Getting To Yes**, one of the “Bible” books on negotiations technique, recounts that the 1978 Camp David negotiations started with Israel and Egypt positing irreconcilable claims to the same piece of land. It was only when the sides recognized the other’s real interest–Egypt’s wanted its previous borders and Israel wanted its security–they were able to realize an agreement both sides could accept. Egypt got the land but promised to demilitarize it. Also remember that there’s a distinction between your negotiating counterpart and the organization they represent. His or her compensation structure and career goals could be playing a role in their decision-making. Understand what’s driving him or her helps you increase your bargaining power.

5. DON'T FEAR SUNK COSTS

As negotiations progress, it’s easy to get tunnel vision. So much time has been spent and effort has been exerted, how can you walk away empty-handed? Sometimes you have to because that’s the best option. As was already pointed out above, it’s important to know your alternatives and walk-away number before you enter the negotiations.

6. SHAKE HANDS, THEN SECOND GUESS

After the deal is done, second-guessing can be helpful. Research has shown asking yourself what more could you have done following negotiations can make you more effective. A study from professors at Haas, Kellogg, and Ohio University found that the second guessers learn more and perform more effectively in the future. Not all self-reflection is equal though. The experiments found it’s better to think about what else you should have done rather than what you did but should have avoided. “Particularly effective negotiators learn from experience by mentally adding rather than subtracting from reality,” wrote the researchers.

Stage 7: Structuring the Transaction

The sale of a business has many financial and professional considerations for the management team / owner. The purchase price is only one component of the overall result. Other decisions and considerations include: stock sale versus asset sale; earnout; terms and interest rate on financing; liabilities assumed by the acquirer; employment contracts; non-compete agreements; current assets retained by the seller; stock ownership and equity options packages; relocation; employee preservation versus redundancy layoffs, etc.

10 Key Factors Other Than Purchase Price

1. THE CONSIDERATION

How will you be paid? In cash? In stock of the acquirer? Seller financing or some combination? If stock is a significant portion of the consideration, the value of the deal becomes linked to the future performance of the acquirer, which is probably out of your control. Also, the stock may not be freely tradeable or liquid. If there is a seller note, the terms (interest rate, repayment terms, etc.) are very important.

2. ADJUSTMENTS TO PURCHASE PRICE

Will the purchase price be subject to adjustments based on performance between now and the closing date? Typically, adjustments are based on trailing revenue or EBITDA at close and/or changes in working capital or net assets. A key consideration is the limitations to the adjustments.

3. EARN-OUTS

An earn-out is a payment at a future date contingent on certain performance criteria. While relatively simple in theory and seemingly useful to bridge a valuation gap, they can create a contentious relationship due to the misalignment of goals and the wide range of interpretations. In fact, earn-outs are a frequent source of litigation after closing. It is important to consider the protections you have as a seller during the earn-out period. The best way to eliminate an earn-out scenario is by making your business' revenue and profits more predictable.

4. TAXES

Depending on the structure, the after-tax impact on the seller can vary dramatically.

5. ESCROW

Escrow is the amount that will be held back at closing to fulfill some contingencies. Key considerations are how much of the total purchase price is being held and for how long.

6. INDEMNITY LIMITS

Indemnification is a form of protection against certain risks in the transaction. They are some of the most complex and heavily negotiated provisions. The provision can cover a wide range of subjects: breach of contract terms, breach of representations and warranties, fraud, excluded liabilities, taxes and environmental issues. As a seller, you will want to limit the indemnification liability both in terms of dollar amount and duration.

7. EMPLOYMENT ISSUES

There may be non-compete agreements and/or employment agreements with the seller(s) and key employees. On the other hand, there may be employee terminations. A key consideration is who incurs the severance costs.

8. APPROVALS

Are third-party approvals needed? Approvals can be required from Board of Directors, stockholders or lenders. It might also involve regulatory approvals from the DOJ/FTC, SEC, or FCC.

9. FEES

Who is responsible for the legal, accounting and due diligence costs? These can add up, and must be netted out. Especially in smaller transactions, these can have a big impact on net proceeds.

10. DEAL PROTECTION MEASURES

Many times, the buyer will require deal-protection measures such as break-up fees, voting agreements, material adverse changes or no-shops. These protections are usually in favor of the buyer.

Stage 8: Due Diligence

Typically, buyers express interest in a company at three stages through three documents: the IOI, LOI and Purchase Agreement. The IOI is non-binding and provides the proposed terms, valuation and structure for a transaction. The owner will review this with their banker and make a determination as to whether or not to invite the buyer to learn more about the company and become more serious. LOIs (letters of intent) are a more serious signal of interest by the buyer; once they are jointly executed, the seller is typically under exclusivity with that buyer, such that they are not able to meet with other buyers during a stated period of time.

Meanwhile, that buyer is beginning to conduct heavy due diligence on the business with the intent of acquiring it. During the exclusivity period, the buyer must move quickly to determine if they want to proceed. If so, the purchase agreement must be drafted to define all the details of the transaction: legal, financial, representations, warranties, etc. The purchase agreement is the definitive document outlining the terms of the sale.

What to Expect from the Due Diligence Process

by James Darnell, KLH Capital

Read the original article here.

As with many things in life, expectations are key to having a successful outcome to the diligence phase of selling your business. The more you understand of the due diligence process — and match your expectations accordingly — the more you can prepare, the easier the process will be, and the most likely you will be to achieve the best outcome.

One of the most critical parts to preparing for the due diligence process is to understand the perspective of the buyer. Since investors are responsible for being wise stewards of their capital, they need to learn about every facet of your business and leave no stone unturned. They are trusted with the money of larger LP investors and they cannot be frivolous with that responsibility.

As a result, it is important to remember that the due diligence process is not personal. Investors are simply trying to best understand your business and, since you have run your business for years and accumulated years of knowledge and understanding, you are the best resource for them.

Generally, given the many stages that have already passed in the deal process, the investors will likely know a lot about the financials of your company, its performance, its history, and its structure. The diligence process will help confirm that information. If serious information discrepancies emerge, it can be a deal killer.

However, the deal professionals will also use the diligence time to learn new information. This will likely include more information on how to grow your business, possible new products and services, the landscape for potential acquisitions or add-ons, etc.

The diligence process, which can take anywhere from 3 – 6 months, will be led by the investor and supported in large part by a variety of experts employed on behalf of the investors — namely lawyers, accountants, consultants, and other service providers. They will be looking into five major parts of your company: overall business, accounting, legal, IT, and environmental.

FOCUS A: BUSINESS DUE DILIGENCE
In this phase of the due diligence process, investors want to understand i) the sustainability of the company's revenue and cash flow and ii) the prospects of growing your business. To uncover these data, the diligence team will request a number of meetings and phone calls with you to extract all the wisdom you have built over the years of running the company. You should expect questions on nearly every aspect of your business, including: products & services, pricing, supplier relationships, operations, accounting, HR, IT systems, etc.

Once investors have a better understanding of your business, they will likely begin investigating the broader industry. The PE firm will likely hire third-party researchers to perform studies on your industry and customers to understand the most important market dynamics. Understanding this broader market picture helps investors understand the growth potential of the business and the landscape of products, services, and competition already present in the space.

The last major part of the business due diligence will focus on your customers. It is very common for investors to request calls or meetings with your top customers so that they can make sure the customer is comfortable with the transaction, better understand how the customer views your products/services, and make sure the customer will still want to do business with you after the deal closes.

FOCUS B: ACCOUNTING DUE DILIGENCE

After analyzing your business and broader industry, investors will begin reviewing your financial performance. This step is mostly confirmatory due diligence — making sure what you told them is the truth.

The review will not be as detailed or as in-depth as an audit, but is typically referred to as a “Quality of Earnings” report. In this report, accountants will help the investors understand your primary accounting policies, your compliance with GAAP, and any modifications to the financials that need to be made to become GAAP-compliant. You should expect the investors to be very involved in this phase of the process. They will want to understand the economics of your business works — how delivering your products/services gets translated into EBITDA and cash flow.

Practically speaking, this stage of the process will require a great deal of data collection. To make the process as easy as possible, you should be prepared for your CFO/controller/CPA to be significantly involved in these discussions so they can help collect and prepare the requested information. Once the data is collected, accountants will likely be on site for about a week to review the information and ask questions. Although this may seem like a while, this is one of the most critical parts of the diligence process.

FOCUS C: LEGAL DUE DILIGENCE

In addition to the financial review of your company, investors will need to take a look into the legal side of the business. A group of lawyers will review all material contracts (i.e. suppliers, customers, service providers) to understand any terms or conditions that would result in liability going forward or any material change in the business.

Additionally, they will review leases to make sure the company will continue to have access to the needed facilities and confirm the terms of the lease are “market.” Other items to be reviewed include any current or prior litigation, the corporate books to make sure that there is clear title to the stock/assets of the company and all paperwork is in order.

FOCUS D: IT DUE DILIGENCE

The fourth key area of due diligence is information technology (IT). Like most of the other phases, the investor will bring in third-party consultants to review the posture of your current IT networks.

These consultants will help the investor understand the importance of technology to the running of your business, your historical spending on technology, the future expectations for IT budget, and any risks in IT infrastructure that could prove harmful for the business (i.e. cyber risks, disaster recovery, down time, etc.).

FOCUS E: ENVIRONMENTAL DUE DILIGENCE

The last major area of due diligence is a review of the environmental risks associated with your business. While the importance and rigor of this diligence will vary based on your industry, consultants will review all publicly available information in Phase I of the transaction.

The goal of the review is to understand any environmental liability that may be associated with the business or potential for liability in the future. To uncover these issues, the consultants will perform detailed onsite inspections and will review any prior claims and/or issues.

These are the five core areas of the due diligence process to expect from every buyer in a transaction. There is no way around it. The due diligence process is hard work and will require extra effort on part of team that already has a business to run.

The best strategy to ensure success is to know what to expect, have the right attitude, and bring the right people onto your transaction team. If you do that, you'll have a successful transaction that accomplishes the goals and objectives that you originally set out to achieve.

Stage 9: Ensuring a Successful Transition

There are three common scenarios for a company's management after a deal closes:

1. Management plans to stay on with the company and is looking for a partner who can help them improve/grow the business.
2. Management plans to transition the business to new management over a 12-24 month period, after which they intend to depart.
3. Management does not intend to stay on and will depart after the closing of the transaction.

Of course, this is something to keep in mind as you evaluate buyers. Some buyers pursue strategies in which they intend to insert their own management team. Strategic investors often employ this strategy because the acquisition will be folded into a division of the corporate parent and there's an existing manager who already runs that division. Other buyers don't want to invest or acquire any private company where the management team in place does not intend to remain with the firm with a significant ownership stake rolled into the newly acquired entity. Their preference is to partner with existing management and help them run the company even more effectively.

Generally speaking, your involvement in your business does not conclude immediately after the sale is complete. More often than not, the buyer will offer a lucrative contract to you and key executives to help stay on and transition the business. Depending on the terms of the agreement, incentive payments (earnouts) may be included, which are contingent on the performance of the business.

Scott Bushkie of Cornerstone Business Services says one popular transition model is the yearlong phase out. "For the first three months, the seller commits full-time-plus attention to the business as he or she teaches you the business and helps run regular operations.

For the next three months, the seller works a standard workweek, stepping back into a support role. At this stage, for example, the previous owner is still going along on sales calls, but the new owner is the one driving conversations.

In the third quarter, the seller moves into a part-time role. Perhaps this is an opportunity for the seasoned leader to mentor a younger professional, or maybe there's some special project to complete before they leave.

And finally, the seller goes home but remains available for phone calls and consultations. They no longer work in the business, but they're still there as a lifeline if you need one."

Upon fully exiting the company, entrepreneurs can expect to have the mixed emotions of excitement and achievement, coupled with sadness and loss. The emotional fallout associated with the sale of a company is legitimate. Similarly to raising children, entrepreneurs pour their heart, soul, and energy into growing a business that can succeed on its own. Once the business is fully under new ownership, the most important thing left of its former owner is his or her legacy. At that point take a few months off to rest and relax — at which point you'll probably be ready to hit the ground running for your the next venture!