Preparing to Sell Your Business

BDO CAPITAL ADVISORS, LLC

"Trusted Investment Bankers for the Middle Market"

The idea of selling a business can be daunting. Finding a buyer and managing the time-intensive process while continuing to run the business may cause owners to avoid the subject until they need to sell. There are, however, steps an owner can take to alleviate the stress and uncertainty of selling, and to help achieve the best value for the business. These steps and recommendations can be completed over time and will help position the company for a smoother sale process, whether selling to an internal buyer, a financial buyer or a strategic buyer.

When working with owners preparing to sell, our advisors at BDO Capital Advisors, LLC (BDO Capital) start with a comprehensive readiness assessment. This article highlights common points we would address as part of that evaluation.

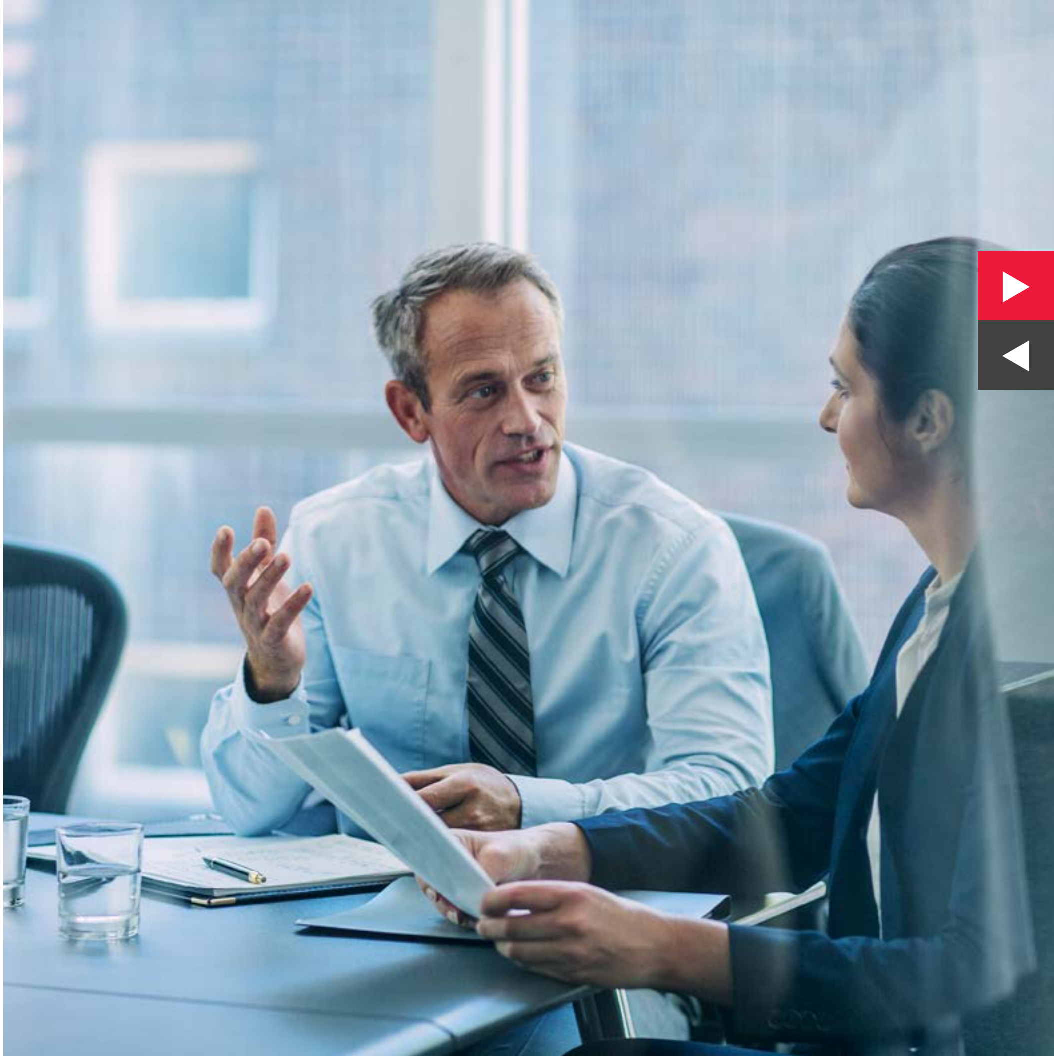
Readiness Assessment

GOALS

The most important step in any assessment or discussion with a business owner is to intimately understand the personal and financial goals of the sale. We understand that selling a business is a deeply personal process. Any potential sale will impact employees as well as management, and the owner's future role in the company can be dramatically different depending on the buyer. An experienced advisor will start this conversation to begin crafting the most appropriate transaction to achieve the shareholder's overall goals. From this conversation, the advisor can begin to model strategic alternatives that will hopefully achieve all parties' goals in a transaction.

SUCCESSION PLAN

Another important step in the assessment is to undertake a succession or talent management review that supports the exiting shareholder's goals. If the seller's goal is to step away from the business immediately, then the executive team should be both capable and informed of the overall succession plan. If the owner(s) have already stepped back from day-to-day management, then this aspect of the assessment becomes less important, assuming the management team has been successful in running the business without the owner's/owners' presence. Nonetheless, many owners have deep client relationships and institutional knowledge of all aspects of their business that may be lost if they were to step away suddenly. Any buyer would identify these issues and attempt to address possible solutions in structuring the transaction.



FINANCIALS & CONTROLS

Assessing a company's financials, internal systems and controls is another important component of a pre-sale assessment. Valuation heavily weighs the business's discounted future free cash flows and any inadequacies a potential buyer perceives will result in discounts applied to the projected free cash flows. The quality of the seller's financials will be closely scrutinized in any sale to ensure that the cash flows are accurate. If a company does not have reviewed or audited financials, it may be prudent to start that process before engaging an advisor to sell the business.

While reviewed or audited financials may not be required for smaller companies, they become more important as business size increases. If a company has only internal or compiled financials, a quality of earnings report could provide a buyer limited assurance. A quality of earnings report is a detailed study of how a company generates revenues, income and cash flows. A company's quality of earnings is determined by identifying, analyzing and/or eliminating financial anomalies as well as nonrecurring and out-of-period activities to arrive at metrics essential to the deal process.

The seller also should conduct a review of the business's internal systems and controls. A company will need to be able to provide timely monthly financial statements, work-in-progress reports, accounts receivable/accounts payable and days sales outstanding records and similar reports. If these records are all kept in Excel, a financial ERP system upgrade can be considered. Finally, the knowledge and experience of the seller's accounting and finance executives are key. A controller or CFO with a strong accounting background will be an asset moving forward.

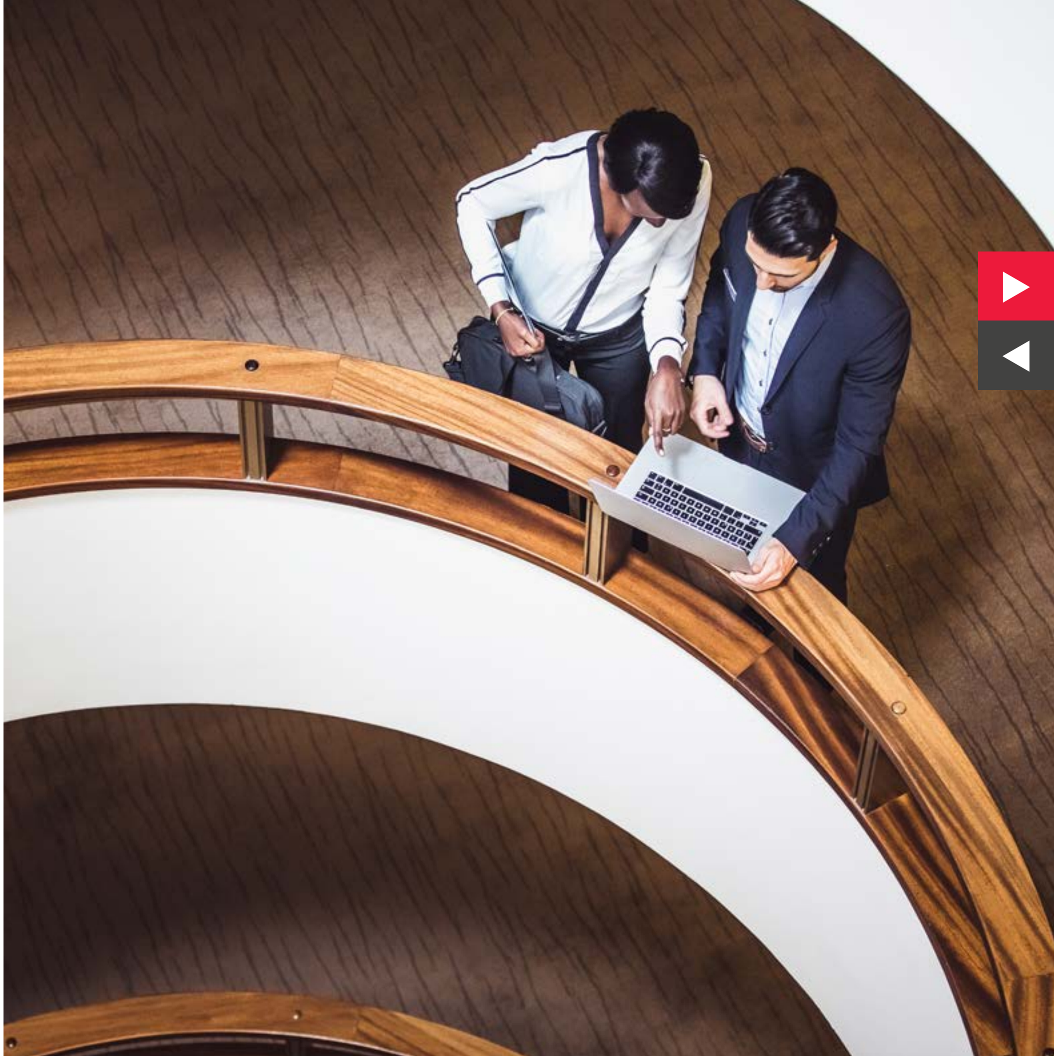
REAL ESTATE

Many closely held businesses will utilize real estate owned by the business's shareholders or related entities. There may be a need to examine that relationship and whether the real estate should or should not be included in any sale, whether to a third party or to an ESOP. In addition, the buyer may require a fair market value (FMV) rent study to ensure that any leases are at market rent. If the FMV rent is below market, there is a tradeoff between future rental income to the property owners and the valuation of the operating business. If the rent is higher than the market value, an adjustment would be needed to bring the rent down to market levels.

As a landlord, the business owner will have income-generating opportunities well into the future, even if the core operating business is sold. This may be an attractive option for many business owners. Separate financials and decision-making processes for the real estate entities and the operating business should be established before a sale for a smooth transition if the owner(s) want to exclude the real estate from the sale. Also, if property owned by the business that is being sold is excluded from the sale, an analysis should be conducted to distribute the property in a tax-efficient manner.

CLIENT & VENDOR RELATIONSHIPS

A company's relationships with its service providers and clients are essential for the ongoing health of the business. Banks, insurance providers and bonding companies will need to be brought into the loop as early as possible to ensure that there is no disruption to daily operations as a result of the sale. These providers and some customers may have a change in ownership clause, minimum net working capital or minimum net worth covenants that should be addressed well before a sale closes.



VALUATION

In a sales process, the most important questions an owner will ask are how much is my company worth, and how can I extract that value in the most tax-efficient manner? There are various ways to position a company for a favorable valuation prior to a sale. First, revenues and customer concentration should be reviewed, as buyers will look favorably at a business with recurring revenues and a diverse customer base. In some industries, recurring revenue is not a part of the business model, but any way to build in recurring revenues to the business will be very helpful to a buyer: financial, strategic or ESOP.

Valuation will typically be expressed as a multiple of earnings or cash flow. The metric that most valuations will base their multiple on is EBITDA (earnings before interest, taxes, depreciation and amortization). EBITDA is a useful metric because it measures a business's core operating cash flows. Capital expenditures and changes in new working capital will impact the free cash flows that a buyer would receive. A business owner should approach these two items with a "business as usual" attitude: The business should continue to operate as it normally would but should consider holding off on any major capital expenditures that may negatively impact value or are not necessary to achieve the financial projections.

In some instances, there may be non-recurring costs such as a lawsuit, a large one-time asset write-off or the costs of a third-party consultant that can be added back to EBITDA to help smooth out true operating cash flows. In others, an owner may be running certain personal expenses through the company. In preparation for a sale, it may be a good idea to cease some of these practices, because a buyer may be skeptical if a large portion of EBITDA is adjusted. A buyer knows that habits are hard to break.

LICENSING

In a few regulated industries, such as engineering, architecture, accounting, law, financial institutions and medicine, states may have financial or professional licensure ownership requirements. These ownership requirements should be considered for every state where a company currently operates and where it expects to operate in the future. Restructuring the company in a way that allows it to keep its state licenses while selling all or a portion of the business may be necessary. Tax and legal professionals should be involved early in the decision-making process.

COMPENSATION CONSULTATION

Taking a fresh look at the management team's compensation should be done before a transaction. A compensation study based on the company's size, industry and geography, as well as on each team member's job title, responsibilities, experience, and tenure should be completed to determine appropriate salary levels and short- and long-term compensation strategies. If salaries are above market and adjusted to market levels, this can be an addback to EBITDA. Conversely, if salaries are below market and are adjusted, this could reduce the business's sale price. Buyers would want to ensure a properly motivated workforce will be in place once the transaction closes.

Conclusion

Preparing for a sale in a deliberate manner over time may help ease the financial and time burdens of selling a business. It will also help get the house in order before a third party comes in and starts reviewing all aspects of a business. When the transaction is forced due to unforeseen yet predictable circumstances, the outcome for the selling shareholders may be less than ideal. Early conversations with advisors may improve the likelihood of better outcomes once a process is launched. The Boy Scout motto – "Be Prepared" – is apt, as being prepared for a potential sale can help bring about a successful transaction.

It is not unusual for a company to explore succession planning options with an advisor and then decide to hold off on the project for various reasons, including receiving a lower valuation than expected. In those cases, BDO Capital would suggest key action items for a more favorable outcome, regardless of what future succession plans look like. BDO Capital professionals are experienced in helping guide and position companies to optimize value in a transaction.

The decision whether to sell a business to a third party, a private equity group, the owner's children or an ESOP is multilayered and complex, and BDO Capital is well equipped to guide you through any of these strategic liquidity options. BDO Capital works closely with BDO USA professionals who have a deep understanding of the tax implications of the various options and can guide you through every step of selling your business. Each path will have benefits and disadvantages, and BDO and BDO Capital work together to walk you through each alternative.

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