Private Company Services

Private company exit strategies: preparing the business for sale*

three in a series

*connectedthinking

PricewaterhouseCoopers

A series for privately held business owners.

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Introduction: getting both arms around the challenge

Laying the groundwork for the successful sale of a business represents one of the most significant challenges in the life cycle of any company and, often simultaneously, for its owners. Much of the difficulty lies in balancing two competing priorities, each of which demands careful attention. On one hand, a seller wants to realize the highest value it can in the transaction and must commit significant effort to steer the process carefully. On the other, day-to-day operations must remain sharp and managers focused. When that balance suffers, transactions can falter on anything from failures of awareness to subtle tactical missteps.

One information technology (IT) services firm involved in a divesture process provides a good case in point in its preparation to sell a small yet profitable software unit—a business yielding good returns every year and enjoying the benefits of a legacy customer base and scale but potentially capable of much more in the hands of a buyer able to devote to it a keener focus and more resources.

The initial step at first seemed a pleasant surprise: a financial buyer offered a very high purchase price—significantly more than the seller expected. Since the seller had anticipated only strategic-buyer interest in the unit, to complement its own, the seller had failed to prepare for a buyer with purely financial objectives. Further, the IT firm had inadvertently discouraged strategic buyers by stating its intention to complete a deal before the year-end holidays (less than three months away), thereby demanding too tight a time frame for strategic buyers to become acquainted with the management team and the ins and outs of the business.

For the financial buyer, however, the operational details represented a somewhat secondary priority. This changed when the buyer realized—already months into the deal—that it was purchasing a software product without the global distribution network that had helped make it successful. The buyer sought additional information, requiring more time. Rather than reassess the deal and cut its losses, the seller agreed to lengthen the exclusivity period. The buyer then demanded a lower price and further extensions of the negotiation period. By this time, the holidays had long passed and other potential suitors had fallen by the wayside.

Given the uncertainty, many employees lost motivation or exited the company, service suffered, and competitors took advantage of the slip. As value eroded, so did the relationship between the buyer and seller, who by now had lost heart in continuing negotiations.

The transaction disintegrated not so much because of one big oversight, but because the interplay of a series of misjudgments in the complex preparations for sale and the allure of a high price that clouded rational thoughts about the risks associated with actually closing the deal.

But how could the results have been different? While no one-size-fits-all answer exists to help owners manage the challenge of simultaneously running a successful business and managing a sales process, careful preparation is key.




About *Private Company Exit Strategies*

As the third in our series called *Realizing Shareholder Value: Private Company Exit Strategies*, this installment—*Preparing the Business for Sale*—suggests tactics to consider as well as mistakes to avoid in helping to prepare for the sale of a private business.

The second installment in the series, *Finding the Right Buyer,* focused on seeing the business through the eyes of potential buyers and buyer types and on understanding how their various objectives and value drivers fit with the seller's personal and financial goals.

The first installment, *Making the Decision to Sell*, discussed why enhancement of value upon the seller's exit begins with the process of identifying its own business and personal goals and objectives—and how these to a large extent determine the best exit strategy and right type of buyer.

To view all published installments in the series, please visit www.pwc.com/pcs/exitstrategies.

While no one-size-fits-all answer exists to help owners manage the challenge of simultaneously running a successful business and managing a sales process, careful preparation is key.

Adjusting your thinking well in advance

To achieve a successful sale, owners should start preparing early in order to minimize the risk of a failed transaction and to optimize the value shareholders receive.

Such preparation begins by simply recognizing that divestiture is a natural part of a business's life cycle. Success also requires understanding that a sale is a process like any other. It builds from a constructive mind-set and extends through a series of disciplined steps.

Early preparation is required so as to optimize value. A host of external and internal factors must be anticipated, coordinated, and managed; and an approach to mitigate those that come up and aren't anticipated needs to be defined. Both market conditions and business conditions must be considered. Even after a strong year of profits and growth, if market conditions are deteriorating it may not be the optimal time to divest. The reverse can be true as well, as all of the salient variables must be taken into consideration. Value is influenced by the market, by the situational influences of the principals in the transaction, and by the unique aspects of the particular business being sold. In any circumstance, value maximization will not be achieved without efficient information management and effective communications.

Awareness shifts to action when owners recognize that information must be used to set perceptions about the business that are both factually correct and strategically on target. The right information—interpreted and presented correctly and directed strategically—unlocks the basis for value and builds confidence in projected performance. For instance, a seller needs to take steps to create a sense of scarcity on the part of buyers—that is, convincing suitors that the investment opportunity for the business being sold is unique in some regard. A tone of controlled urgency must also be maintained among the buyer's own people, stressing the options of the seller and the opportunity at hand for the buyer. All in all, the objective is to keep value high and avoid the deal fatigue that results from a drawn-out process. In addition, value cannot be maximized in a vacuum: a seller has to understand the courting party's agenda, value drivers, and deal-making and deal-breaking issues. (See *Private Company Exit Strategies: Finding the Right Buye*r for a full discussion of these factors.)

Credibility and control

Unpleasant surprises can quickly derail buyer-seller momentum and deflate perceptions of worth. Therefore, once the decision has been made to sell a company, management should begin planning for the sale process and preparing the company for sale. Self-review and ample preparation time enables the seller to maintain control of the process and minimize disruption to ongoing operations. Effective planning and preparation also enable a seller to better anticipate, understand, and actively manage unforeseen events and keep the sale process on track.

All of the players on a seller's team—both internal managers and external advisors—must pull in the same direction and reinforce the same messages. Conflicting signals compromise credibility and effectiveness by creating confusion and doubt.

Trust is critical throughout the process to build relationships with suitors and avoid the risk of not closing. A seller should therefore provide key factual information for a potential buyer, positioned appropriately. Trust and momentum also depend on the seller's anticipating questions and preparing appropriate responses. A seller must paint a clear picture of market growth and opportunity and relate it to the company's projection. And a seller should articulate underlying assumptions and value drivers and outline how these opportunities will be captured. Key concerns, potential deal breakers, and price adjustment issues should be pushed to the head of the process and addressed early to avoid problems later.

Finally, a seller must stand at the nexus throughout the process—keeping the company focused, creating the correct management incentives and support, managing the advisory corps, and navigating the course between running an effective business and steering it toward a successful sale.

Success in preparing a company for sale depends on 10 critical steps

1. Align organizational objectives
   Share one direction and one message
2. Develop a divestiture plan
   Address the tactical priorities early on so that resources, funding, and timing all fall into place
3. Assemble a team of trusted advisors and deal specialists
   Complement company strengths with functional experts
4. Get financial results organized
   Highlight key financial metrics and management tools, and demonstrate their relevance
5. Develop sound financial projections, and back them up with a picture of strong potential
   Tell a credible and compelling story of future growth and profitability
6. Understand subjective value, and see the business through the eyes of a potential buyer
   View the business—and its value—from a buyer's perspective
7. Initiate a buyer identification and assessment process
   Understand the likely buyers and consider them in the planning
8. Evaluate potential structuring alternatives
   Identify various structuring options and related trade-offs
9. Revisit specific transaction objectives and priorities
   Review the company's changing goals—and refine their direction
10. Determine—and execute—a specific sale timeline
    Act with precision once the decision to proceed has been made


Align organizational objectives: share one direction and one message.

Issues in evaluating and valuing the business

Subjectivity: the picture beyond the numbers

It has been said that beauty lies in the eye of the beholder, and often, financial worth does as well. Value depends to a great degree on who's doing the purchasing: either strategic buyers interested in the company's operations or financial buyers more focused on near-term returns. By better understanding a buyer's philosophy and attitude toward value, a seller can begin to understand how this outlook applies to the attributes of the business and its emerging valuation. An external market perspective also prepares owners to present the most credible and most compelling picture of future growth and profitability.

(For a full discussion of buyer categories, advantages, and disadvantages, see the previous installments in this series: *Private Company Exit Strategies: Finding the Right Buyer and Making the Decision to Sell*, the latter being the series introduction.)

Who's doing the buying—and how that affects value and strategy

Strategic buyers often emerge from the same industry and seek a good fit with some aspect of the seller's business. For instance, this may include accessing new markets, increasing market share, and acquiring expertise, patents, or know-how. When the synergies are significant, the strategic buyer is often willing to pay more. A seller will want to anticipate those synergies in order to capture its share of the potential value.

Financial buyers typically hunt for investment opportunities in which they can use the benefit of significant financial leverage to improve returns, provide financial support for the business as it pays down debt and grows, and then exit their investment for a profit in the short to medium term. For this type of buyer, the most marketable businesses tend to be those with solid cash flows, strong management teams, growing markets, a defendable market position, and lower capital expenditure requirements. Typically, financial buyers are highly sophisticated in terms of deal structure and diligence and often are flexible on industry preference. The willingness of the credit markets to extend loans to private equity and the terms of those loans dictate the strength of private equity buyers, and in some cases private equity buyers can actually become stronger buyers than strategic buyers are, as occurred for several years prior to the credit market realignment during the summer of 2007.

On one hand, if the expected buyer is strategic, then adoption of the right mind-set often means understanding the benefits and costs of integration, including the potential opportunities, inherent sales and distribution channel synergies, purchasing power increases, production and administrative efficiencies, and working capital improvements.

On the other hand, if the likely purchaser is financial, the focus may be on the need for improvements in the financial reporting systems or opportunities that could be accelerated and captured by a new infusion of capital, such as add-on or tuck-in acquisitions or new product launches.

Valuation: getting down to the number

For the seller, all of this qualitative framing finally turns toward simple quantitative questions: What does my business translate to in dollars and cents? How can I even think about selling without knowing the worth beforehand? Should I just get a valuation and ask buyers to pay based on that price?

Of course, the answers aren't as straightforward as the questions. And, market valuation benchmarks can sometimes set false expectations on both the high and low sides.

Setting appropriate expectations begins by understanding the concept of fair market value—the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the facts. At its simplest, a business is worth its discounted present value of future cash flows. That being said, some people say valuation is as much an art as it is a science, and a number of variables goes into a buyer's perception of value.

In addition to discounted cash flow analysis, major alternative valuation methodologies include comparisons to similar, recent transactions; the public market pricing of like companies; and the value that could potentially be derived in a leveraged buyout. However, all of these are heavily reliant on the assumptions applied.

Other variables figuring prominently in the overall picture of worth include the management team's depth and strength and diversity of customer relationships. Evaluations can also crystallize around the company's stage in its life cycle, comparable growth rates and pretax margins, overall opportunities and risks in the company's industry, and the current financing and mergers and acquisitions environments.

A company's historical and projected financial results as well as anticipated future events—good or bad—also affect value perceptions. Finally, psychological factors play a big part, ranging from the sense of scarcity to the presence of rival bidders and the urgency of a seller's motivation.

Given the number of variables and the importance of information, valuation and financial due diligence should be viewed as complementary, interrelated, and iterative tasks. The valuation should provide context for financial due diligence and should guide management toward key focus points for due diligence. And the results of due diligence should shape the final valuation and structure.

A seller must be prepared for several iterations of valuation, because financial valuations respond to the value that different buyers ascribe to the business. At all times in the evolving sales process, the seller must build strong yet credible messages around quality of earnings and develop a dynamic due diligence process that best prepares it for buyers' possible skepticism, rigorous analyses, and intense negotiations.

Value depends to a great degree on who's doing the purchasing.

Getting the house in order

As thinking turns to action, owners can focus their considerations on the right time to sell—with two thoughts in mind: (1) it is always best to avoid letting events dictate when you must sell and (2) the best way to avoid dictation by events is to maintain readiness and agility if an excellent opportunity arises.

The actual events triggering a sale can be a combination of market and personal conditions, such as a highly favorable offer or a generational change in the business. But at the end of the day, owners should always regard the possibility of a sale as one of their alternatives and be prepared by making sure everything they do generates and creates shareholder value whether they are selling or not.

Presale checkup

Early preparation for sale begins with a presale checkup—sometimes referred to as *sell-side due diligence*—followed by corrective actions.

The checkup itself is a diagnostic overview undertaken a few years before the sale and that pinpoints the areas to prepare for sale. For instance: Are information systems robust enough? How strong is the management team—and how capable is it of running the business without the president? What's the status of company assets? What's the situation regarding relationships with customers? and What improvements can be made today that a new buyer will appreciate and want to pay a premium for?

This diagnostic sets the stage for sale on a broad level by taking initial actions and adopting a market-ready mind-set. Later, closer to the time of sale, due diligence drives this foundational thinking into the details that both the buyer and seller will need to know to complete an effective transaction.

Corrective actions

Corrective actions to take in the two- to three-year approach to a sale can run the gamut, including making sure audited financial statements are in hand; shoring up accounting systems; improving the quality of financial reporting; paying attention to contracts with customers, suppliers, and employees; and securing and/or protecting the rights to the company's intellectual property. But particular complexity, hidden opportunities, and risks surround human resources issues, tax considerations, and Sarbanes-Oxley preparedness.

Human resources issues

People-related considerations stand out among the reasons cited most often that mergers and acquisitions fail to meet expectations. Issues range from the talents of the executive team and how the executives fit into a new owner's plans to the financial implications of compensation and benefits packages. Understanding these components and advanced planning can increase the odds for success.

Once the full human resources financial picture is understood, refinements can begin to anticipate potential buyers' concerns and to address weak points. Planning should begin with an inventory of the company's compensation and benefit programs, including those programs' financial implications. That would include variable and incentive compensation programs, severance terms, retirement and health and welfare plans, equity compensation programs, and any benefits or special arrangements for or with executives. The executive team is especially important in light of a sale: in terms not only of its talent and the likelihood that key people can be retained (or others separated) through the deal but also of the financial implications of either severing or continuing the relationship.

All buyers will want to know about retention and severance terms, obligations to keep executives for certain periods of time, payments to executives and employees triggered by the transaction, potentially lost tax deductions on deemed parachute payments imposed by Internal Revenue Code Section 280G, collective bargaining agreements, and defined pension benefit plans as well as any other unfunded retirement obligations. The equation can grow more complex if business units are carved out and sold apart from the whole, when human resources and benefit costs allocated to these units may not reflect expected costs on a stand-alone basis.

Beyond the inventorying of human resources programs and costs, owners need to assess how the total human resources picture and associated compensation and benefits programs will affect different types of buyers throughout the transaction lifecycle, extending even after closing. A strategic buyer in the same industry may want to retain a business's head of sales or operations but not the chief financial officer or CEO and may want to integrate the seller's employees into its own benefit programs. Further, a strategic buyer is more inclined to look for synergies and opportunities for further cost savings. A financial buyer, which often seeks a plug-and-play deal (that is, a minimal need for business or management changes postclose) will want to lock in and incentivize an executive team to ensure continuity. Planning also varies by deal and industry: underfunded pension plans that will need large cash contributions in the short term may take priority in one case, while the costs of settling existing equity compensation and stock options loom large in another—for, say, a fast-growth IT start-up.

Owners can go a long way toward smoothing their path to sale by understanding their own human resources environment early on and taking any needed steps to properly communicate their program's historical and future costs and, when possible, to realign elements that would facilitate the deal.




Tax considerations

While tax structuring grows from a seller's goals and a buyer's goals, from the legal form of business, and from evolving tax laws, the success of the approach depends on anticipating the transaction, establishing objectives, and evaluating the economic and tax risks. Given that there are many variables and potential outcomes, owners should enter negotiations with an understanding of the tax consequences of a transaction, including the different implications of an asset-based or share-based transaction.

In general, a seller should first recognize that buyers typically prefer asset-based transactions for an appreciated business, so that the assets will receive a fair market value basis for tax purposes that can be recovered through future depreciation and/or amortization deductions.

Beyond that, tax approaches vary with the form of business, can often be complex, and require planning. If the business to be sold is owned by a C corporation, an asset-based transaction may result in taxation of both the corporation and the shareholders. As a result, owners typically prefer to sell shares in the C corporation and incur only one level of tax.

If the business is held by a flow-through entity—such as an S corporation, partnership, or limited liability company (LLC) taxed as a partnership—gains generally are taxed only once: at the owner level. The owner's tax liability generally depends on the character of the assets sold, which often drives complex tax considerations.

For instance, shareholders of an S corporation can avoid an increased effective tax rate simply by selling their S corporation shares and recognizing capital gain that is taxed at a 15 percent federal income tax rate, assuming the shares qualify for the long-term capital gains tax rate. However, the buyer will not receive the desired asset basis step up on a share-based sale and may insist on an asset-based sale. Often, buyers agree to an increase in purchase price so as to take into account the incremental tax liability associated with an asset sale over taxes that would be incurred on a *share* sale.

If the buyer and seller agree to an asset sale but find that a legal transfer of the assets is too costly or administratively burdensome, the buyer and seller of an S corporation can achieve the federal income tax consequences of an asset-based sale and the resulting step up to the buyer by making a section 338(h)(10) election on a legal sale of S corporation shares.




Sarbanes-Oxley preparedness

Another area that can be addressed early is Sarbanes-Oxley readiness. Any private company today contemplating either acquisition by a public company or an initial public offering must take into account the demands of this corporate governance and financial disclosure law and prevent them from becoming obstacles to a smooth sale. At the same time, many of the actions taken for Sarbanes-Oxley preparedness, if adjusted to the needs and scale of the company, can pay dividends in better business management.

But most important, embracing the rules may decrease the risks associated with closing the deal and completing a filing with the U.S. Securities and Exchange Commission, if required by the buyer. Sarbanes-Oxley readiness may also have a significant impact on valuation because buyers, investors and underwriters do not want to assume the added risks of non-compliance, nor the initial cost of compliance in terms of professional fees and lost productivity.

Owners can also benefit from these preparatory actions by (1) assessing their internal controls, governance policies, and systems and (2) taking steps to correct deficiencies and install better business operating processes in advance. These steps will not only pave the way for a smoother sale but also help make for a stronger, more competitive company with more-accurate information and greater management understanding.

(To download our white paper entitled *Private Companies: are your internal controls supporting your business strategy?* please visit www.pwc.com/pcs/internalcontrols.)

Building the best package

Sell-side due diligence

Sell-side due diligence (1) helps identify areas that have deal and value implications and (2) prepares and coaches management to appropriately address the issues with potential buyers. Concise, knowledgeable responses are required to answer key buyer questions; anything less can detract from value and from the overall transaction's likelihood of success. Areas of focus typically include understanding the quality of historical earnings, the components of both historical and projected business trends, key customer and supplier relationships, working capital and capital expenditure requirements, strength of the management team, potential synergies, and technology and intellectual property issues, among others.

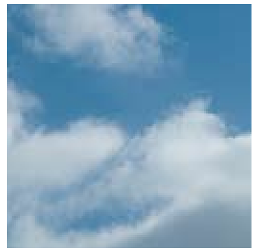
Many of these areas can be addressed initially by a high-level management presentation or, occasionally, a Confidential Information Memorandum (the document that provides a detailed description of the business, future opportunities, and historical and projected performance) to educate acquirers on the benefits of owning the business. Ultimately, however, owners will need to assemble information—usually referred to as a *data room*—that fully supports the story of historical and projected performance.

Thorough sell-side due diligence can help avoid a range of problems, including sellers' being blindsided by unanticipated issues, potential postclosing disputes, and simply failing to close the deal. Sell-side due diligence can also help realize a faster sale process by addressing issues early and avoiding both lengthy negotiations and disputes after closing. Ultimately, the appropriate positioning of the information gathered during the sell-side due diligence process often helps owners gain a higher sale price.

The data room

The data room typically brings together comprehensive information covering financial results, key business drivers, legal affairs, organizational structure, contracts, information systems, insurance coverage, environmental matters, and human resources issues such as employment agreements and benefit and pension plans. Information should start being pulled together as soon as the Confidential Information Memorandum has been drafted for distribution to prospective buyers because ultimately, the data room supports much of that document.

The extent of information and level of detail in the data room should be balanced, providing enough information to enable buyers to determine a fair value but also limiting the amount of sensitive or competitive information disclosed to anyone other than the ultimate purchaser. Often, striking the right balance requires discussions between sellers and their advisors.

A comprehensive, well-thought-out data room demonstrates to buyers that a company has the tools, resources, systems, and abilities to analyze the business and track the information needed to grow and safeguard profits. Conversely, a poorly assembled data room with significant information gaps signals potential buyers that there may be operational or other data weaknesses that could dampen their views on value.

Today, data rooms are, increasingly, online information hubs (rather than actual rooms in attorneys' offices) that present the key information a buyer needs in order to begin judging value and underlying interest. Generally, online data rooms speed the process, lower costs, and better manage information flow by, among other things, differentiating access restrictions by buyer categories to block strategic ones from sensitive competitive information while opening the same information to financial buyers.

Forming the team

Your internal team

During divestiture, owners face one of their most sensitive and critical tasks: determining their so-called circle of knowledge, or those key individuals at the company who need to know about the transaction.

For owners, the art lies in forming the right internal team. The correct people must be identified to gather information and interact with buyers. At the same time, the group must be narrow enough to control the consistency of the seller's message and minimize overall distraction from day-to-day operations. Generally, it's best to keep the group as small as possible—typically, 5 to 10 individuals. But the circle may expand as the process progresses and as more and more internal leaders are needed to meet with buyers and demonstrate the depth of management.

Your external advisors

Given the limited bandwidth of a typical seller's resources, the nuances of the process, and the fact that the sale often represents both a life-changing and once-in-a-lifetime event for owners, experienced external advisors—lawyers, accountants, and investment bankers—can be critical. Good advisors can smooth and accelerate the process while helping accurately recognize value and provide insight and guidance in complex areas. Finally, the objectivity that advisors provide can be crucial to owners faced with many emotional, highly subjective decisions.

The art lies in forming the right internal team.

Looking ahead

The fourth installment in this series, *The Deal Process*, will cover negotiating, getting to closing, and avoiding pitfalls. The final installment, *Life after the Deal*, will discuss estate and tax planning considerations, how to deal with personal wealth issues effectively after the sale, and how to handle the effects of various exit strategies.

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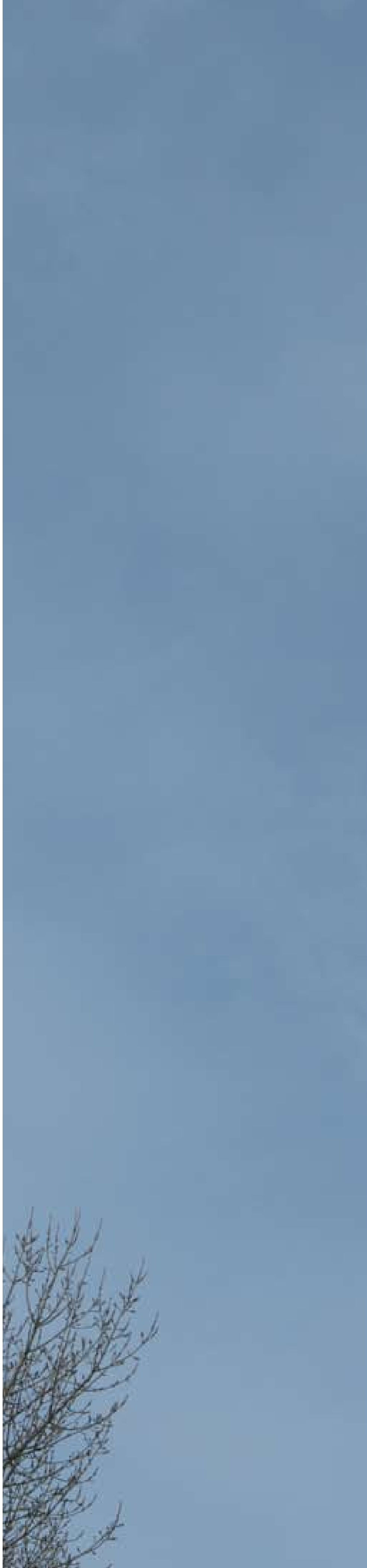

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