



VIEWPOINT

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PREPARING A BUSINESS FOR SALE: INCREASE YOUR VALUE BY STARTING NOW

By Elliot Williams and Peter Alternative

You receive a call from the largest player in your industry. They want to "preemptively" acquire you and begin asking for detailed information about your finances, your operations and your people. As you look through their information requests, one thing becomes very apparent: As a small, entrepreneurial business, your processes, policies, controls and reporting are adequate but through the eyes of a large acquirer, there are a lot of unanswered questions and "holes" in the information.

WHY THIS MATTERS:

- *Preparing a business for a sale that maximizes value cannot be done overnight. Knowing what needs to be put in place and how long such preparation will take is essential.*
- *Being well prepared for a sale in advance improves the odds of a smoother transaction at a higher price.*
- *The issues you tackle to prepare your company for sale are the same things you should focus on every day to build a valuable business.*

As we discussed in our [March](#) and [April](#) Viewpoints, value is driven by maximizing perceived opportunity and minimizing perceived risk in a buyer's eyes. In today's growing obsession with compliance, the risk side of this equation has taken on increased weight with buyers.

Large acquirers have a lot to lose, potentially. First, large companies and their "deep pockets" are attractive targets for litigation. As an example, we represented a software design company several years ago that was possibly infringing on a major company's patent. There was little concern about our client being sued given their size and resources but large acquirers were obviously much more sensitive to the possibility of a patent infringement lawsuit. Additionally, the credibility and value of the buyer's business could be threatened by acquiring a business that impairs their ability to comply with state, federal or industry compliance standards; complicates their tax and/or accounting practices; or in any way threatens their future operating/financial practices. This all means "clean" companies present lower risk and therefore are worth more.

Preparing your business for sale in a proactive manner gives you time to identify the critical areas of risk and opportunity in your business and then put in place methods to fix, track, and report on any major issues you find. Forcing buyers to wait while you fix issues in the throes of a transaction sends the wrong message. Slow responses to due diligence requests will lead buyers to conjecture about the reasons for delay -- and possibly to a broader set of questions.

"Any time it takes longer to do a transaction, there's a higher risk that it won't happen or you won't get the price you want," says Steve Ingram, partner and New England Venture Capital Practice Leader at Deloitte & Touche's Tech-Venture Center in Waltham, MA. "I have seen deals go sideways for six months and then ultimately never happen or happen at a lower price than was expected."

"I regularly talk with clients about the exit process," says Fred Grein, a partner in the Business Department at the Boston office of Nixon Peabody LLP, a national law firm. "I recommend they start preparing five years before the earliest time they would like to sell the business. I want them to at least think about what the circumstances would be under which they would consider selling the business."

The reason for this timing is that some issues such as estate planning can take years to implement. If you decide to implement an estate plan involving the equity value in your business, many of the tools for tax mitigation won't be available to you as you get closer to doing a transaction. This is critical since what should really matter to owners are the net proceeds after tax, not the total purchase price. Some of these strategies take months or even years to put into place.

SOX IMPACTS YOUR VALUE

Enactment of the Sarbanes-Oxley Act of 2002 has added another compelling reason to plan for an exit sooner rather than later. "The first year SOX came out, no one was sure what its impact would be," says Ingram. "But in the past three years, things have really tightened up. The bigger the company doing the buy, the more rigorous and detail-oriented they are."

John Hession, a corporate partner in the Boston office of McDermott Will & Emery LLP, an international law firm, agrees. "In the post-SOX acquisition environment, buyers are acutely sensitive to any accounting irregularities, unconventional accounting policies or weaknesses in internal controls, systems and procedures of target candidates. Acquirers have always inherited these internal weaknesses of target companies, but now, CEOs and CFOs must certify the combined financial

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— John Hession, McDermott Will & Emery

statements of the acquirer and the target, and must assess the internal controls over financial reporting of the target company if the target is a 'material' acquisition. Private companies are wise to start putting in place policies and practices that are consonant with SOX while not being fully compliant."

(For Mirus' perspective on the impact of SOX on private companies, see the [November 2005 Mirus Viewpoint](#).)

DUE DILIGENCE

The general categories that we see most often for due diligence include company history, corporate governance, employee matters, financial information, products, R&D, operational controls, IT infrastructure, strategy and competition, customer matters, legal, governmental, environmental, tax considerations and others. *[A future Viewpoint on due diligence will give you a detailed look at the type of information buyers collect along with access to a sample due diligence request list. So for the current Viewpoint, we won't dive into many specific due diligence items but rather focus on the nature of the information and how to be prepared to collect it.]*

The bottom line is that buyers want to see that you have all the systems, procedures, and documentation in place that indicates operational excellence. This covers everything from well-documented compensation policies and up-to-date employee manuals to strong budgeting systems and controls. All of these make a buyer feel more comfortable because they expect the same in their own companies. The use of benchmarking, metrics, and well-controlled budget planning and tracking are all critical elements in presenting a picture of a well-oiled machine.

John Hession emphasizes the importance of being well prepared and organized with regard to all legal matters. "It's important to come to a sale transaction with your house in order," he says. "Have important information such as non-compete and non-disclosure agreements, client contracts, and stock records carefully organized. When a company provides the appearance that it is internally well organized, that is very powerful. It provides the buyer with a high level of comfort."

THE NATURE OF DUE DILIGENCE INFORMATION

The nature of the information requested by buyers ranges widely. We think about this information in three categories: *static information, periodic information and dynamic business information.*

- **Static Information** includes by-laws, articles of incorporation, employee handbooks and company policies

that are easy to manage since they change infrequently. The key is to make sure this information is complete, organized, accurate, and accessible. Make sure you have maintained all necessary corporate and government documents with regards to your business.

- **Periodic information** includes customer surveys, board meeting minutes, and operational/accounting audits. Create processes for collecting, indexing and storing this information at the frequency it occurs for future review. One good example of this type of information is customer contracts. Put in place a system for storing and indexing your contracts to cull out which will require assignment consent upon a sale and which will not. Without this measure, you will have to sort through all of your contracts before sending them to a buyer.
- **Dynamic business** information includes sales pipeline information and key operating metrics (utilization rates, quality measures, return rates, productivity measures, etc.) that tend to change rapidly. This type of information is critical for buyers to both assess short-term operating performance and longer-term prospects, based on how tightly your business is run. Our experience working with middle market companies is that this type of business information is often not tracked, and, even more often, it is not saved and indexed over time.

The best way to prepare your business for sale is to start thinking through what business information a buyer is likely to request and why this information matters to them. Restructure your information systems, controls, and internal reporting requirements to better align with the obvious (and not so obvious) questions buyers will ask.

Easy to say, right? This is hard work that will most likely require changing attitudes internally about reporting and data collection. Will it really make a difference in value? In Mirus' experience, it can make a big difference in value.

Valuation, however, isn't the only reason to embrace new, more comprehensive controls and systems. There are three additional benefits to doing this in advance of a transaction.

- (1) You are creating "standard procedures" in your company for collecting valuable customer, financial and operating data that can be mined and used in your business for ongoing improvements.
- (2) You will lessen the chance that you get so distracted

by the demands of due diligence that you take your eye off running the company, which can lead to disastrous results in terms of the final value you realize. As Fred Grein points out, "Most smaller companies don't have a deep management team in place that can both continue to run the business and respond to due diligence questions."

- (3) One of the major concerns we see from clients is that when due diligence requests pour in, they create the need for unusual requests for internal data. Perceptive employees may assume these unusual requests are being driven by a possible sale, causing them to take their eye off the operational ball because of worries about the impact of a sale on their individual jobs. However, if your routine mode of operations involves collecting many kinds of information, employees are much less likely to be suspicious of data requests when you enter a sale process.

HIRE HELP...

Making it through this forest is not something that most mid-market companies can do on their own. "It's important to understand the need to build a team and to build a team early," advises Grein. "Bringing in an appropriate investment bank and getting lawyers and accountants involved early on is important. If you have a strong team of advisors from the start, they play a vital role in being the go-between with potential buyers and helping to keep the process from disrupting your day-to-day operations. These are relationships that should be in place well before you enter the market."

We recommend working with M&A experts well before selling your business to better understand what buyers will look for and what policies you can put in place to avoid typical "trouble spots."

A FEW TROUBLE SPOTS TO THINK ABOUT

At a high level we see several "trouble spots" that appear more frequently than others with middle market businesses. Samples of issues that have the power to impact transactions mid-stream include:

Assignment of invention agreements – it is important to have clear ownership of your intellectual property and to have confidentiality agreements in place with your employees to protect intellectual property.

Audited financial statements are increasingly

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— Fred Grein, Nixon Peabody LLP

important for buyers. "We see companies that have four years of incomplete audits," says Ingram. "This happens for a lot of reasons, but whatever the reason, it causes a problem when they decide to sell. They may find it difficult to get a large audit firm like ours to complete an audit under these circumstances." Revenue recognition (especially with software companies) can be a common problem. Acquirers will take keen interest in your accounting practices generally, but this is an area where some entrepreneurial companies are weak.

Customer and vendor contracts are almost always a trouble spot during M&A. Which customer contracts require approval for assignment to the buyer? Will they approve? Is their contract up for renewal and therefore your request could give them additional pricing leverage? Similarly, partner license agreements can also be tricky. John Hession warns that, "Many license agreements are not structured properly to allow the company to have flexibility when it is being bought. Such contracts allow the consent of the customer upon any change of control of the company. This is often viewed as just boilerplate and some people don't pay attention to it until they find out their customers have the right to terminate the agreement if the licensing company is sold. This gives customers leverage over you during a sale."

State sales taxes are an area of common concern. "A lot of companies don't get expert advice regarding state taxes and they only file in their home state," said Ingram. "But if you do business in other states, it can be subject to sales tax and if you missed that, there can be significant penalties and interest on top of the taxes due."

The depth of your bench is another priority for buyers. You will need to convince buyers that you are dispensable to the on-going operations and success of your business. The cultivation of strong lieutenants will not only let buyers get comfortable with your answers to their series of "what if" questions, but also, and more importantly, will reduce the buyer's leverage in negotiating a significant earn-out.

THE DIFFERENCE PREPARATION MAKES WHEN YOU SELL

Being able to provide comprehensive information about your organization that meets the expectations of buyers makes a world of difference during a sale. You are sending a clear message that you have built a smooth running, well-led organization that will require minimal changes once the sale has taken place. The more "turnkey" your organization appears, the more valuable it will appear.

Also, with Sarbanes-Oxley and other compliance issues taking significant importance, any doubts you create in a buyer's mind is more apt to be reflected in the final price than ever before. "Larger companies do not want to take on any risk of being embarrassed by any impropriety at a company they acquire," stresses Ingram. "The tone at the top is very tight; they are very aware of the public relations aspect of making an acquisition."

When sellers delay transactions to resolve internal issues that should have been taken care of months or years before, the seller's credibility takes a hit and the buyer starts to wonder about what risks and liabilities might be waiting to bite them post-closing.

Another consequence resulting from the perception of a loosely run organization is that buyers conclude that the acquisition or integration will demand a prohibitive amount of their bandwidth. This concern cannot only make the seller less attractive but also ultimately might put the deal at risk. Other deal implications can include more aggressive demands for earn-out payments and escrows for buyers.

With the M&A market currently so active, you don't want to handicap yourself before you start the sale process by not addressing the types of issues we've discussed here. Having your house in good order before a buyer comes calling is always the prudent course.

(Watch for the August Viewpoint on positioning your business for sale.)

Elliot Williams is president of Mirus Capital Advisors, Inc., and Peter Alternative is a partner. Mirus is a middle-market investment bank that specializes in advising companies in strategic mergers and acquisitions. By combining a proven process, industry and transactional expertise, creative thought, and personalized service, Mirus has completed hundreds of transactions for both public and private companies. Mirus is a registered broker-dealer and NASD/SIPC Member. For more information, visit www.merger.com.

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