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Why You Should Be Prepared to Sell

Whether or not you plan to sell your business in the future, being prepared to sell now translates into greater value and success for your company.

by William S. Hanneman

Is your business ready for sale? Does it matter, if you have no intention of selling or if that event is years away?

Having advised business owners and managed the sales of many companies over the past 20 years, we can say without qualification that being well-prepared to sell makes a significant difference in both the success and value of a business. Whether the plan is ultimately to sell the business or pass it on to the next generation, the attributes of a company that is prepared for a sale translate into greater value for the owners. Preparation positively affects the price received and reduces the time needed to consummate a transaction and the amount of risk retained by a seller after closing.

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The discipline associated with planning for a sale forces an owner (seller) to adopt the perspective of a new investor (buyer) and invariably leads to an effort to clean up loose ends that were easily put off in the past. We have often found that interest in selling can shift rapidly, based upon changes in personal circumstances or the development of a compelling opportunity that emerges when least expected. Much of the planning that can have a real impact on value must be done years in advance; therefore, we are convinced that it makes sense to always be prepared for that possibility. Doing so pays big dividends, even if the business is not for sale.

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Always being ready to sell proved to be quite valuable for Bill Cotter and Greg Davenport, the owners of DaVinci Gourmet, which was recently sold to the Irish food conglomerate, The Kerry Group. Without solicitation, Bill received an inquiry from Kerry about his interest in selling. Conversations led to the conclusion that Kerry's current strategic interest represented a unique value proposition. Although Bill and Greg had no current plans to sell the business, they had always operated the business so as to be prepared to do so. Their planning efforts were largely responsible for completing the sale within 30 days from the agreement on the price.

"Greg and I always knew that we were going to sell, we just weren't sure when.We routinely received inquiries from parties wanting to buy the business and I always wanted to be in a position to respond intelligently. That paid off handsomely when Kerry called."

REDUCE PERCEIVED RISKS

Value is enhanced to the extent that the future is predictable. Actions that foster stability and reduce risks that could negatively affect the business create value for owners, whether continuing or new. A couple of areas of risk that commonly plague deals include customer and supplier concentrations, and management depth and stability.

A diversified customer base is among the most valuable attributes of a business. Businesses that serve only a small number of customers generally suffer greatly from the loss of one. Reliance on a handful of customers directly impacts business value. The same issue arises when a company becomes overly reliant on a single supplier.

Just as a major customer's departure can diminish value, so can the loss of key employees. Building management benchstrength that can perpetuate the business creates value for the owners. To the extent that a buyer perceives that the business has the management depth to move forward successfully without the continuing involvement of the owner/seller, a major element of risk is alleviated. Management depth is a prudent long-term investment, not a short-term cost.

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When it is all said and done, a buyer wants to acquire all the ingredients for future success. At the top of that list is a competent management team. Therefore, tying the managers' interests to the company is important. Employment contracts, stock/options, deferred bonus plans and other mechanisms should be used to cement management stability through a change of control. Likewise, all employees should execute confidentiality and non-compete agreements.

SEGREGATE REAL PROPERTY

If the business operates from real property

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that is commonly owned, an effort should be made to segregate it from the operating assets. Real property does not have the same value attributes of an operating business. This is particularly true for property that has alternative uses.

Real estate investment is distinctly different from business investment and, therefore, most buyers of businesses choose to rent real estate and own businesses. Owners (as well as buyers) often have difficulty properly allocating value between real property and an operating business. The appropriate value of each can only be established when the business pays rent to the property owner at a market rate. The strategy of subsidizing the company with below-market rents until a transaction closes, and then increasing the rents to fair market value, rarely pays off. The buyer realizes the business is not as profitable as it seems and adjusts the value accordingly. Providing the buyer the flexibility to separate the ownership of the business from the ownership of the real property removes a challenging sale obstacle.

QUALITY NUMBERS

Buyers expect that sellers will stand behind the accuracy of the historical financial performance and current financial position. Independent assessments of accuracy reduce the potential for future adjustments for both buyer and seller. A full-scale audit may not always be necessary. However, if inventory is a significant asset, it is advisable for outside accountants to periodically observe physical counts and valuations. Independent verification of inventory balances will allow confirmation of gross margins and historical performance.

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Aggressive expense policies are the norm in closely held businesses. It is also beneficial to maintain a detailed tally of all one-time or non-business-related costs (particularly those that relate to ownership) when it comes time to sell.

FLEXIBILITY IN BUSINESS STRUCTURE

Tax laws offer an incentive for buyers to structure the acquisition of operating businesses as a purchase of assets rather than stock. If a premium over the book value of net assets is to be paid, a buyer can potentially allocate that premium to the value of the assets. This allocation, up to fair market value, can be depreciated over the useful life of the assets to create an additional tax shield, essentially lowering the effective purchase price. A buyer of stock is not accorded the same benefit and, therefore, may be willing to pay less for the same business. In order to provide a buyer with the benefits of an asset purchase without adverse tax consequences to the seller, the business must be operated as a pass-through entity (e.g. S-Corp, LLC, or partnership) for tax purposes. A sale of assets in a non-pass-through entity is the worst of all worlds, being taxed both at the corporate level and at the personal level, when proceeds are distributed to the owners. Remember it is not the price paid, but what is kept after taxes that matters.

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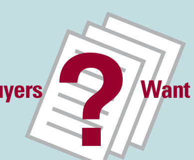
Preparing Your Company For Sale

What Buyers  Want to Know

Perceived Risks
Is the future predictable?

Real Property vs. Operating Assets
Segregate real property from operating assets.

Quality Numbers
Accuracy of past and current financial numbers.

Flexibility In Business Structure
Tax structure affords incentives for buyers.

Transferability of Rights
Does your company own all assets and are they transferable?

Contracts and Business Agreements
Are contracts and agreements valid, enforceable and not in default?

Contingent Risks
Clear policies and processes for managing and mitigating risk.

TRANSFERABILITY OF RIGHTS

Again, a buyer wants to acquire all of the rights and assets necessary to operate the business successfully, including contracts, leasehold interests and intellectual property (e.g. trademarks, patents, and licenses). There are two essential issues: does the company actually own these assets and are they transferable? It is often time-consuming and expensive to nail these issues down at the time of a sale.

Buyers always insist on reviewing all contracts and business agreements and require that the seller warrant that all such agreements are valid, enforceable and not in default.

ORGANIZATION COUNTS

It is not unusual to conduct business with important customers or key suppliers on a handshake or long after a contract has technically expired. Nevertheless, buyers always insist on reviewing all contracts and business agreements and require that the seller warrant that all such agreements are valid, enforceable and not in default. Typically, this is not a problem when agreements are well documented, organized and up-to-date. The same is true for licenses and permits.

How the business manages risk, in terms of product warranties, lawsuits, environmental concerns, pension plans, and regulatory compliance, says a lot about the quality of its management and the potential for future problems.

Accordingly, being prepared to sell means having ready access to all commitments and obligations of the business in a single location and ensuring that they accurately reflect the terms and conditions under which the business is currently conducted.

CONTINGENT RISKS

Risk is an unavoidable element of business. Prospective buyers always expect the worst.

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How the business manages risk, in terms of product warranties, lawsuits, environmental concerns, pension plans, and regulatory compliance, says a lot about the quality of its management and the potential for future problems. For that reason, it is important to have in place clear policies and processes for managing and mitigating risk. Where possible, such issues should be dealt with head-on, rather than being allowed to drag on. In all cases, they should be thoroughly documented. Don't leave these matters to the imagination of the buyer.

This, of course, is not meant to be a definitive checklist of all issues and concerns that must be dealt with in the process of preparing for, and closing, a business sale. However, these issues almost always have a material impact on value and generally are difficult to change in the short run. It is never too early to lay a systemic foundation for a sale, even if you believe it is far beyond the horizon. It has been our experience that attention to these tasks results both in a better-run business, as well as one that is poised to attain the highest value in a sale. A good way to get going is to call in your trusted legal and financial advisors and ask them conduct an audit of your current practices and make recommendations. Do it now; it does make a difference. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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