Zachary Scott
INVESTMENT BANKERS

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Preparing for a Successful Transaction—Beyond the Diligence Checklist

Prepare now to sell your company, even if selling isn't in your short or long-term plans.

by Jay Schembs and Mark D. Working

Laying the preparatory groundwork for a potential business sale yields better business decisions, practices and value. Nothing reveals more weaknesses than undergoing the preparation and the type of due diligence investigation involved with the sale of a business. Whether or not there is intent to carry out a transaction now or down the road, business owners can meaningfully impact business performance and value by periodically evaluating their business as an investor would and by taking actions to address identified deficiencies.

In our experience, the vagaries of life, health, industry dynamics, and opportunity defy prediction. Changes in any of these factors may quickly swing the pendulum towards a pressing need for liquidity or a desire to take advantage of an unexpected opportunity, when the consequences for being unprepared may be significant. In many cases, there exists a unique point in time when the market accords a business its optimum value. Delaying preparation work is the equivalent of deferred maintenance and, if timing becomes urgent, there is little time to address the nagging issues that constrain or undermine value.

WHAT DOES "BEING PREPARED" REALLY MEAN?

Preparation comes in two forms. One category can be thought of as "housekeeping" and its value becomes crystal clear when a buyer presents its due diligence list and the clock is running. Housekeeping matters, as we've commented numerous times in IN$IGHT. Undertaking the cleanup in advance avoids showstoppers such as disagreements among owners, managers, and third parties whose consent is required to complete a transaction. Organized documentation indicates management's grasp of the business and all of its vagaries. A well-disciplined and organized process gives the seller leverage throughout the transaction and assures that information is revealed in the appropriate sequence and timing to move the process forward efficiently towards the end zone. Shareholder value can quickly diminish when due diligence findings by the buyer surprise the seller. Disruption of the process can extract a cost and potentially put the endeavor at risk. As every transaction advisor knows, time is the enemy of a transaction.

The second category of preparedness goes beyond the due diligence checklist and addresses the fundamental economic proposition of the business. A clear and concise articulation of the fundamental mechanics, economics and risks attendant to the business and the industry generates rational confidence and enthusiasm, while the absence of such an explanation should trigger questions and skepticism from the company's bankers, potential investors or buyers, as well as from the current ownership.

> **A well-prepared business plan that results from a deep introspective assessment demonstrates the company's value proposition to its customers, suppliers, and employees, addresses risks, provides evidence of the ability to adapt and innovate, and is supplemented by appropriate supporting documentation.**

THINK LIKE AN INVESTOR

Every business exists somewhere in the value chain between the supply of basic resources and the ultimate end user. Suppliers push from behind, customers pull from the front, and competitors, both direct and indirect, confront and squeeze from all directions. An investor searches for an understanding of the dynamics of those relationships and an explanation of how the target business competes to earn its existence. The investor wants to know the forces that threaten the company's market position and the strategy, infrastructure, and talent the business employs to defend and expand its position. The view on this framework forms the basis of interest and terms of a potential investment.

Owners need to be able to articulate the material variables or drivers that underlie operating results and demonstrate tangible insight into the interaction of these drivers. Owners and managers of businesses instinctively think of their business in these terms but often don't challenge the basic premises and quantify the metrics of the business model. Taking this next step of examination and documentation reveals conclusions about how the business can be improved, leading to a stronger business, and when and if the time comes, being in sync with an investor or buyer.

THE VALUE PROPOSITION

"First you need a customer." Understanding how the company competes for and succeeds in satisfying its customers with products or services, quality, pricing, and delivery as compared to other competitors is critical. Beyond the company's direct customers, all customers in the value chain need consideration. For example, if a manufacturer sells to distributors, how that distributor sells through to the ultimate end user can be just as important as the initial sale. The end user can be served through alternate channels. The relative effectiveness of the different delivery or sales channels can have as much effect on financial performance as how the company competes with its direct competitors. Wal-Mart obtains product directly from manufacturers in Asia, domestic product companies that subcontract manufacturing, as well as distributors that buy from various manufacturers. These various channels offer different costs and levels of service. As product demand changes at the retail level, different channels become more or less important. Having a level of knowledge of the dynamics of the industry, volumes of product or services, and comparative business models for satisfying end user needs provides a framework for evaluating

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competitiveness (stability), growth prospects, and potential risks.

There is an "equation" that explains the economics of each business. Understanding it allows a prediction of performance under different levels of demand for products and services, pricing, input costs, and operational infrastructure levels. Once this is embedded in a "model," sensitivities to the variable business drivers can be known and evaluated, possibly leading to changes in strategies to make the business more successful.

Each business also has an infrastructure of tangible and intangible assets, people, and systems that conduct daily operations and provide the basis for competing in the marketplace. Factors that can threaten operational success include manager and key employee depth or succession, common organizational knowledge, vendor and customer concentrations, and market or other external event risk.

Collectively, these attributes reflect an investment hypothesis that, of course, remains vulnerable to a host of risks and uncertainties. Management's ability to identify and outline measures to mitigate those risks heightens credibility in the ability to achieve future plans.

MEASURING PERFORMANCE

Every business needs a scorecard. Knowing the point system and measuring continuously allows the business owner and potential investor to calibrate the effectiveness of the business model and strategy employed. A business employs capital to create and maintain a business infrastructure and, as a result, it generates cash flow from operations. How well it does this task contributes greatly to how an investor views the value of the business. When systems to collect the data necessary to perpetually evaluate the business' return on the capital employed, owners can measure the effectiveness of strategic decisions. Conclusions drawn from analyses of business performance create the framework for the preparation of a plan to improve the business. Addressing weaknesses and building on strengths can make the business stronger and more successful.

A well-prepared business plan that results from a deep introspective assessment demonstrates the company's value proposition to its customers, suppliers, and employees, addresses risks, provides evidence of the ability to adapt and innovate, and is supplemented by appropriate supporting documentation. Collectively, these measures improve business practices, profitability, and value, which the business owner will reap whether or not they pursue a transaction. ❖

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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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