Setting Clear Guidelines for the Sale of a Business

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Changing the plan requires a plan in the first place.

Groucho Marx is credited with the following quotation: *"I'd never join an organization that would admit me as a member."* That same line of logic can sometimes be found among entrepreneurial owners of businesses. Their version would be: *"I'd never sell to someone who would buy my business."* The latter stages of a transaction are emotionally exhausting, and buyers and sellers alike can let their judgement start to cloud.

Every investment banker has their own story of the client who moved the goalposts as a deal was close to completion because of an emotional decision. Perhaps as proposals from buyers were received, the seller adjusted upwards the threshold of an acceptable price; or perhaps there was a client who, upon being presented with documents to finalize the sale of his business, just flat changed his mind and didn't sell.

Human minds are programmed to overweight incumbency, so this can be a tough one to wrap a mind around, but: both selling and not selling are investment decisions. Said differently: not selling at an offered price and structure is, economically speaking, identical to buying at that same price and structure. Changing a decision to sell without an economic reason can result in a loss of value, and we would argue is a poor decision. A couple of examples will illustrate.

Company #1

A consumer products company was marketed for sale. The key investment consideration was that this was a growth company, based on early returns from capitalizing on a consumer preference trend. The sale was being considered for two reasons: first, the existing owners didn't think they were knowledgeable enough to take advantage of the unique market situation, and second, funding the projected growth was out of their comfort zone.

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When the company was marketed, the number of proposals was far higher than was expected and the value ascribed to future growth was astounding—with values implying a very high multiple of current performance—equaling more than double what the sellers had originally and rationally aligned on as an initial target value. When a buyer was chosen, it found several issues in due diligence that made them lower their proposed purchase price by a marginal amount. But by this point in the process, the sellers had recalibrated their expectations to the very highest end of the proposals received.

Since the owners were unwilling to accept a penny less than they had decided their business should be worth, they disengaged from the selected buyer; when other bidders were presented with the new set of facts from due diligence, they backed off also. The owners were offended and decided not to sell, despite there still being multiple buyers willing to offer prices far above the original target. Unfortunately, the consumer trend that drove this targeted interest in the business proved to be short-term. The business faltered to the point of defaulting on its credit facility, never recovering anything close to the original value target. That emotional mid-deal recalibration cost the sellers a tremendous amount of money.

Company #2

Another company was owned by founders and a private equity fund. The private equity investor had been involved for several years and wanted to get liquidity for its fund. The business had done very well and found a welcoming market. During the sales process, the business had breakthroughs on several strategic initiatives that meaningfully increased its future earnings profile.

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Due diligence with a buyer took a long time and during that time, profits began to climb. Owners disagreed on a course of action: the founders wanted to disengage and allow enough data to be captured from the new initiatives to show their profitability, after which a process could restart with a fundamentally different earnings trajectory; but the private equity firm, having control of the decision and having already realized that it could show a very good return on its investment, decided that a bird in hand was worth two in the bush.

Besides, the private equity firm was in need of a win to showcase in a time-sensitive fundraising process. The sale went through. Within less than two years, the company had doubled in size and tripled in profits. The inability to rationally recalibrate mid-deal cost the sellers a tremendous amount of money.

Company #3

A third business was owned by a third-generation group of family members. The business was a cyclical business that was thriving but needed to retain most of its profits to fund the company's growth. Owners decided that a sale was appropriate as very few family members were involved with the company and had competing ideas of how to deploy capital. A sale process commenced, but did not result in bids for some time because of a variety of reasons, during which the profits grew, as was expected given the current stage of the cycle.

The sale of an operating business requires the joint effort of a team over many months to achieve a successful result. It is an expensive and time-consuming endeavor and should not be pursued without a clear set of expectations and commitment to action should those expectations be met.

Bids considered the expected cyclical pattern to profits, but some of the owners noticed that these bids implied a lower multiple of EBITDA as time went on (as one would expect from a cyclical business).

Although the shareholders wanted liquidity, they felt the business was worth more (using the logic that a fixed multiple would imply a higher value) and convinced other family members to not move forward with a sale. The company experienced good profits and then saw them decrease as the business moved through the cycle. Owners who had been promised that by holding off would get to sell at a higher price, didn't. After a few years, no owner has received any liquidity. The lack of understanding of how a buyer would view the inherent value of the business—and the resulting mid-deal recalibration—cost the sellers a tremendous amount of money.

Know Your Why

The sale of an operating business requires the joint effort of a team over many months to achieve a successful result. It is an expensive and time-consuming endeavor and should not be pursued without a clear set of expectations and commitment to action should those expectations be met. Because of the size and scope of the investment, the standards and conditions for action should be established before embarking on a sale process. Without doing so, a problem can emerge late in a process where the purpose of the sale and the standards for action change, resulting in a suboptimal decision.

Our advice, first, is to know the reason for selling and keep that reason in mind. Examples include:

- The industry is changing such that the business can no longer be competitive as a standalone entity.

- To remain competitive, the business requires additional capital beyond its means or at a leverage level that is uncomfortable for owners.
- The investment horizon for owners has been reached and they are uncomfortable hiring replacement management where they lose direct control.
- The investment horizon of investors has been reached and there is an opportunity to achieve an acceptable return on investment.
- A family-owned business has become widely held over generations and there are many competing uses of capital that can only be met through a sale, or
- Through some set of external circumstances, an opportunity to sell the business exists at a price that can't otherwise be achieved based on its standalone potential.

Second, establish what a reasonable price is for the business and the reason for that value. Value is not determined by a formula. Rather, it is a price at which there is economic logic related to earning an appropriate return by not selling.

While it is true that a sales process can take a long time, and conditions can change during the process, not all changing conditions deserve a revisitation of expectations of success.

For example: it is natural to revisit valuation expectations if a business's profitability changes over the course of the sale process. But this in and of itself is not a reason to move the goalposts. If profitability is changing as is customary as the business moves through periodic cycles, it shouldn't affect the seller's long-term view of the business's value, and shouldn't change the outlook on acceptable terms of a transaction.

On the other hand, if a change in profitability occurs because of a shift in the long-term trajectory of the business—a truly rare occurrence—then revisiting the original conditions is certainly warranted.

Gaining liquidity for a privately held asset is not as easy as it might seem. The purpose for pursuing a sale is critical to establishing guidelines for a successful outcome, as is staying the course along those guidelines. As the case studies mentioned above illustrate, the penalty for abandoning this approach in the midst of a transaction can be substantial.

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