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WHITE PAPER

BEGIN WITH THE END IN MIND: SELL YOUR BUSINESS THE RIGHT WAY

by Verne Harnish and Steven Sansom

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When you started or acquired your business, you probably had some distant thoughts about one day selling it and reaping the rewards of all of your hard work. However, in those early days, your focus should rightly have been on building a great company. Great companies get *bought*, while mediocre companies get *sold* or fade out of existence. If you want to maximize the value of your company, then you will need to invest the time and energy to sell it the right way. You want to be as intentional in planning your exit as you were in building your business. Here is some advice to help you prepare. We believe a focus on ***People, Strategy, Execution,*** and ***Cash*** is not only the best way to *grow* your business but also the best way to *sell* your business.

PEOPLE

In 1992, the United States Olympic basketball team for the first time included active NBA players. This group, known as the "Dream Team," included legends such as Michael Jordan, Karl Malone, Magic Johnson, Larry Bird, and Patrick Ewing. These incredible players went on to defeat their opponents by an average of almost 44 points en route to a gold medal against Croatia. You will need a similar Dream Team helping you complete the journey of selling your business, whether you're a serial entrepreneur or expect this to be a once-in-a-lifetime event.

KEY PLAYERS FOR YOUR DREAM TEAM SHOULD INCLUDE:

External:

- *Accountant:* A potential buyer is always going to approach your numbers with a skeptical eye. Buyers will want to satisfy themselves that your company was well run financially and has transparent and accurate accounting. While using a Big Four firm is always a safe bet, it can also be quite expensive. If you opt for an alternative, choose someone who is highly respected in the field and who exudes trustworthiness and competence. Through the selling process, your accountant may need to provide information and meet buyers. Make sure he or she has the time available to meet these demands. You don't want a rookie accountant showing up to defend your numbers. Your accountant should also know how to help you to analyze your purchase price options and consider the tax consequences of the structure of the transaction.
- *Investment Banker:* Unless you have used an investment banker to help you raise funds, you may not have ever had the need to engage one. Investment banking firms range from very large "bulge bracket" firms such as Bank of America, Merrill Lynch, Citigroup, or Credit Suisse to one-person boutique shops. In between are a number of middle market- focused firms as well. Your banker is a reflection of you, so the firm and

individuals representing you should be of unquestioned character and integrity. A good investment banker will help you understand the potential value of your company, market it in an optimal manner, and advise you strategically through a negotiation and sale process.

"Choose a banker who understands the nuances of the style of the transaction and make sure to check his or her track record," advises John Ratliff, a Gazelles company entrepreneur who just sold his business, Appletree Answers.

Rob Follows, founding CEO of STS Capital Partners (STS stands for Success to Significance™), notes, "Everything is negotiable in this process. That includes terms of your representatives and thresholds of success fees tied to escalating transaction close targets," he says. Follows explains that after advising on more than 300 transactions, he has found that the three key qualities to seek in an investment banker are: (a) an ability to identify strategic investors; (b) a willingness to take you directly to strategic investors and not to financial investors; and (c) an ability to take you to international investors and willingness to run an auction between many strategic investors.

Investment banker Mike Ward, co-founder of 79 Capital Securities, adds that entrepreneurs should pay close attention to the length of the term of an agreement and any "lock-up" or "tail" periods after the engagement that obligate the entrepreneur to pay a fee if a sale occurs. "Ultimately, you want to select an advisor who has your best interest at hand: if you are successful, they are successful," Ward says. "In other words, look for advisors who have incentives to drive prices up."

If you are doing business in the United States, your investment banker must be a registered representative with an SEC-licensed broker dealer. This is important because some entrepreneurs have experienced significant problems in the United States because they were represented by unlicensed individuals in stock transactions. Potential liabilities include reimbursing investors for the investment (or damages if the investment already has been sold), interest, costs and attorneys' fees.

- *Lawyer:* Look for attorneys who are "deal doers" and not "deal killers." They should have substantial experience completing transactions for business sales. Your attorney should know how to help you with the structure of the transaction and weigh potential tax consequences. When a business is sold, you must consider the risk allocation between the buyer and the seller. Your attorney will help you navigate these potentially challenging issues to protect you after the sale.

- *Wealth Manager:* Don't wait until the money hits your bank account at closing to begin thinking about how to manage your money. Seek referrals and interview independent wealth management firms until you find an advisor who listens well and knows how to match your personal aspirations with your financial strategic plan. Focus on selecting a firm familiar with managing assets for entrepreneurs after the sale of their business. Sophisticated wealth managers know how to help you plan for your exit and post-exit financial strategies. They can help you plan for the next phase of life and consider issues like investment management, tax efficiency, estate planning, and charitable giving.

Internal:

One of the real challenges in selling a company is keeping your management team focused on the day-to-day operations of the business. Too often, discussions about selling the business can cause everyone to step off the "gas" right when you need momentum the most. You want to keep your team focused on meeting their quarterly numbers. That is *crucial* to a sale process. You want to run your business like it is never going to sell, Ratliff notes. "You have to run your business like you normally would and try to change as little as possible," he says.

"It is important to emotionally disconnect yourself from the sale," he adds. "When you emotionally commit, you have already discounted the valuation of the company."

Buyers will usually want some access to your executive management team and key employees. "Take a firm stance with the buyer on which employees it will have access to – the fewer the better," Ratliff advises. Your CFO (or an executive in a similar position) will have a major role in the sale process, as the company will need to produce historical and projected financials. In addition, your legal counsel (internal or external) will likely be involved in the due diligence process. This is an area where it pays to plan ahead. You don't want to be scrambling to find documents at the last minute. The Board of your company can also often play an important role in helping to manage the sale process.

STRATEGY

Great businesses operate strategically. They *make* their plans and then *work* their plans. Unfortunately, many business owners don't realize that strategic planning is just as important when considering an exit. Strategic thinking involves analyzing some very important questions.

Some initial ones to consider include:

- Do you want to sell or would you like to generationally transfer the business?
- If you want to sell, is your business sellable?
- Who are likely buyers? (Consider employees, management, strategic and financial buyers)
- What is your personal time horizon to sell?
- Are there any external or internal forces that will impact your decision or timeline?
- What is the optimal size of your business to sell?
- What is your business worth?
- What improvements need to be made to your business to make it ideal for sale?
- Do you want to stay on and work in the business post sale or move on?
- Do you care if the business continues post sale?
- Do you care if your employees retain their jobs?
- What time, people, and financial resources will be needed to exit the company?

We encourage entrepreneurs to take time out from working "in their business," and focus on working "on their business." As you take time out from the tactical day-to-day, you can consider these types of big-picture questions. Get away from the office and just think. Take time out to consider the end game and what you are trying to achieve. Talk to other business owners who have crossed the finish line on selling their companies and learn from their experiences. "Everyone has to exit at some point," Ratliff notes. "Better to exit when you are on top." Ward recommends that entrepreneurs monitor their industry, competitors, and similar purchases to evaluate when the right time to sell is.

Write your goals down. What would a "best case" scenario exit look like for you? Even if you are not ready to sell your company right now, it is important to "pre-think" about these issues. You never know when a suitor is going to come knocking on your door. You want to be ready to consider offers and evaluate them against your goals. In addition, planning your exit well in advance will allow you to get your business in a position to be "sale ready."

Most owners don't want to stick a FOR SALE sign in their window. That is no way to maximize value. So, once you decide that you are going to sell, you need to consider *how* you are going to sell. Are you going to use an investment banker (or business broker)? Are you going to quietly approach a few potential buyers or run an auction process? If this is handled incorrectly, your employees and customers may run for the door. Therefore, consider carefully how to market your company.

To optimize the value of your company, you will want to seek out the best strategic buyer. Typically, this type of purchaser will pay more than a financial buyer. A financial buyer is usually a private equity firm that wants to grow and then ultimately sell the company to a strategic buyer or take it public. Financial buyers focus primarily on the EBITDA of the company and usually offer some multiple of that (e.g. 3-7 times EBITDA). Take a step back and think about your business as a product. You may sell it to a middleman (a financial buyer), who will buy it, flip it and sell it later to the end user (a strategic buyer). Or you may sell it directly to that end user.

Follows suggests considering the strategic enablers for a buyer that drive value in your business, such as your balance sheet, distribution, management and intellectual property. He suggests considering how your business would be valued to a buyer *inside* its business. Follows recommends considering what cost savings would exist and what revenue opportunities the buyer would have with your business inside of its organization. He also suggests considering both domestic and global strategic buyers.

EXECUTION

As Larry the Cable guy says, there comes a time to "Git R Done!" Translated, this means that selling a business ultimately boils down to executing on your plan. Symantec founder Gordon Eubanks addressed the relationship between strategy and execution when he said, "Strategy gets you on the playing field, but execution pays the bills."

Follows emphasizes that there should be a written work plan which should start off with the main objective of the process and also include preferred outcomes, allocation of responsibilities, and a list of potential acquirers. Once you have your plan for exiting your business, you will need to operate with focus and precision, including getting your business ready for sale. We encourage owners to review a standard due diligence list and make sure they have the necessary information at their fingertips in electronic format. "It is important to always have your due diligence information up to date and have the discipline to keep it updated, regardless of whether you are considering selling or a sale is imminent," Ratliff says. Sample items you will need to have ready include:

- Corporate records and minute books
- Last three years' profit-and-loss statements
- Last three years' balance sheets
- Year-to-date profit-and-loss statement
- Current balance sheet
- Last three years' full tax returns
- List of furniture, fixtures and equipment
- List of inventories
- Commercial property appraisal or lease agreement
- Contracts with customers, vendors, and partners
- Insurance policies

Once you embark on selling your business it is important to consider the process.

The first phase is Preparation. In this phase you will typically:

- Choose your team
- Assess the value of your company
- Establish goals
- Develop marketing materials
- Gather due diligence materials
- Identify potential buyers

The second phase is the Marketing. In this phase you will typically:

- Contact potential buyers
- Have prospective buyers sign confidentiality agreements
- Provide initial information on the company
- Hold management visits with prospects
- Receive letters of intent

The third phase is the Closing. In this phase you will typically:

- Review letters of intent
- Proceed to negotiate a term sheet
- Coordinate due diligence
- Finalize a definitive agreement and related documents
- Close!

"Process is very, very important in successful marketing of businesses," says Follows. "It requires great discipline." Your investment banker should have the ability to control the process and manage it through to the conclusion, so that you can continue to run your business.

At a solid company, a well-run process should always result in a sale. If not, then the process can be an invaluable learning experience for you to better understand your business, its value, and the company's potential for exit in the future. Follows also stresses that this process should start early: identifying potential strategic investors at the outset can help you better position your company for sale.

CASH

HOW MUCH IS MY BUSINESS WORTH?

You can run all types of analyses and comparisons to derive the answer that question. Experts can look to publicly traded comparable companies, transaction histories, and valuation models like discounted cash flow. However, your company is ultimately worth what someone will pay for it – just like any other asset. The market will ultimately set the value of your company. For many owners this can be a rude awakening. It is important to keep an objective viewpoint.

Usually, the best price for a company is obtained in a competitive environment. Whenever you can get more than one potential buyer, your chances of driving up value increases. "You want to create a sense of urgency on the side of the buyer that the deal will not go through for them, and you must always be willing to walk away," Ratliff says. He also wisely suggests understanding the vision of the acquirer so that you can understand why you and your business are strategic to it.

Follows reinforces the importance of understanding how strategic investors would value your business. "Think of it this way: What would your business be worth to a potential strategic buyer, if it was inside/part of their business?" You can end up with valuations of 200%–300% more than a private equity or financial buyer might offer you--if you set aside enough time. It is crucial to work with a professional investment banker who will take you not to just local competitors but to international buyers that have an interest in your firm and your market, and who will also have a much lower chance of disrupting your local business, he adds. Follows suggests going well beyond thinking about just selling to local competitors and broadening your approach to target strategic international competitors and buyers.

WHAT IS THE BEST DEAL STRUCTURE?

Obviously, this requires a case by case analysis. However, there are some important general considerations. Most sellers want to sell their stock and receive more favorable capital gains treatment, and most buyers want to buy the assets so they don't inherit liabilities and to optimize their tax structure. The structure can impact the pricing because of the impact of taxes. "If selling shares is in your interest financially, you'll be asked to give many reps and warranties that there are no liabilities in the business," Follows says. As noted above, your accounting and legal team need to keep you well informed on the tax implications and potential risk allocation of a proposed deal structure.

SHOULD I FINANCE THE TRANSACTION?

Most owners want their check at closing. However, closing a deal sometimes requires owner financing. At that point, you are like a bank. You will want to do your own due diligence on the creditworthiness of the buyer and the buyer's ability to make timely payments. If you go this route, you can usually put a price premium on the transaction as well. Ratliff aptly notes, "Anything that isn't cash is at risk." Carefully consider your position on financing before the negotiation process begins.

SHOULD I AGREE TO AN EARN-OUT?

Similar to owner financing, this is a deal point that is often brought out to close a valuation gap. In this scenario, the owner accepts some post-closing payments based on the company's meeting of certain agreed upon milestones. Earn-outs add a layer of complexity to the transaction and can lead to potential disputes. For the seller, they can provide a nice "kicker," but they can also lead to frustration and headache.

Follows points out, "Earn-outs can come out in all different forms and are always contingent on performance." Look at it this way, he suggests: "If you get everything you need in the up-front payment (i.e. your required outcomes are covered), you can also sign up for an earn-out, which is 'icing on the cake.'" If you do sign up for an earn-out, focus on the top line, not the bottom line, because you no longer control the bottom line after the sale, he says.

SHOULD I AGREE TO AN ESCROW OF THE PURCHASE PRICE?

Most buyers will want to escrow some of the purchase price to protect them in the event of a post-closing claim relating to warranties or indemnities. This amount can be as high as 15% or more. The length of the escrow could be from a few months to a few years. An important consideration is under what circumstances the buyer will have access to your escrowed funds. Your advisors will want to minimize your exposure to post closing risks and buyer access to your purchase price payment held in escrow.

CONCLUSION

By focusing on the People, Strategy, Execution, and Cash, you can be proactive in planning the exit for your company. This framework will you give the ability to begin with the end in mind and know that you are controlling the process to ensure the greatest chance of success. For more information on how to best position your business for exit, please contact:

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