# PREPPING THE PRINCESS FOR THE PARTY


## Is your business ready to sell?

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## Introduction

What makes a business attractive to a buyer?

It's an inquiry we field often, and it's one that almost always comes with a series of follow-up questions. What steps can be taken inside of a business to make it more attractive for a sale? And, "how do I know that my business is ready for the transaction dance?"

It's never too soon to consider the answers to these questions. In 2016, our first edition book was inspired by the popularity of a podcast discussion from 2015 between Trusted Counsel and Focus Investment Banking. This year we present our third edition book. For this podcast series, Trusted Counsel has united with GrowthPoint Technology Partners, Aprio, and Wilmington Trust to present Prepping the Princess for the Party: Is Your Business Ready to Sell? Trusted Counsel has curated a brand-new podcast series of six episodes each on preparing your business for sale.

The following conversations were recorded over the course of the summer and fall as a series on the show: *In Process: Conversations About Business in the 21st Century,** a monthly podcast show hosted by Evelyn Ashley and John Monahon of Trusted Counsel. Together, with this third edition book, they are designed to give the enterprising business owner an idea of how to prepare for an exit, even if that transition is years away from fruition.

If you would like to listen to the podcast conversations in their entirety, you may do so a few ways:

1. From your podcast app, find our show as In Process Podcast. Be sure to subscribe to the show so that you don't miss a single episode!

2. Visit our dedicated website: www.PreppingThePrincess.com.

All of the episodes that are featured in this book have been added to the website.

3. Visit Trusted Counsel's website at www.trusted-counsel.com. Click on the tab In Process Podcast to view and listen to our show podcasts there.

* *In Process: Conversations about Business in the 21st Century* is a monthly podcast that is recorded and produced in Atlanta, GA. The program was developed to educate listeners through the conversations on the many topics that are helpful in the daily operation of their businesses. Featuring guest experts from around the world, each episode is formatted like a living room conversation – one that might leave you with new ideas, tools, or techniques to help your business grow and succeed today. The show is hosted by Evelyn Ashley and John Monahon of Trusted Counsel.

## Knowledge and Preparation is Everything in the Sale of a Business

A Conversation with
Vijay Rawat
of GrowthPoint Technology Partners

*Recorded in June 2019*
*(Part one)*

***"At GrowthPoint, our job is to ensure that we know as much about the company as possible, to understand their business model, understand its competitive position and the areas of differentiation. We ensure that we understand their financial history and future prospects, understand what transactions are taking place in the sector, and who would potentially acquire the company at a premium valuation."***

Selling a business comes with a lot of uncertainty, but while a would-be seller can't always control which parties are interested in buying, the seller does control the way the business is prepared to sell – and the way they use their leverage in negotiations. Managing Director, Vijay Rawat discusses the current mergers and acquisitions market, what makes a company ready for sale, types of buyers, and examples of difficult transactions he's been involved in.

### About GrowthPoint Technology Partners

GrowthPoint Technology Partners is an Investment Bank that provides M&A and financial advisory services to technology companies around the world. GrowthPoint (for short) has the depth of expertise acquired from hundreds of completed transactions and they recognize that what matters is getting the client the best deal, not just getting the transaction completed. As former CEOs, founders, inventors, venture capitalists and advisors, GrowthPoint brings a wealth of strategic and financial experience to their clients with the sole objective of helping them achieve success. GrowthPoint recently celebrated its fourteenth anniversary and is located in the heart of Silicon Valley in Menlo Park, California. For more information, visit https://gptpartners.com/.

### The Current Selling Climate

(Host)
Evelyn: Talk to us about the market, Vijay. Many of our clients and business owners are a little freaked out right now because they're not sure if they should be selling their business. Or maybe they're thinking, "If I don't sell now, I'm going to miss an opportunity." We do know that there seems to be a lot of money looking for a home still.

Vijay: Absolutely. I think this is a fantastic time to consider “a sale” for most types of companies. There are several factors that are driving technology M&A:

First of all, private equity firms have raised a record amount of money, and they need to put that money to use.

Secondly, despite trade tensions that exist between the United States and Mexico/China, the stock market is at or near all-time high.

Lastly, large companies have never had more cash on their balance sheets, which currently earns them a very low return. Consequently, more and more companies are looking to put that cash to use either through an M&A transaction, organic investments, or in many cases, buying back their stock.

When you consider the broader drivers of the M&A activity, todays market is as good of a time as any to sell a technology business, except for technology subsectors and companies that are more directly impacted by the tariffs and trade concerns related to China. For example, companies in the semiconductor sector with significant exposure to China are less likely to engage in M&A or pursue a sale at this time. So overall, I believe this is a fantastic time for technology companies to consider a sale.

Evelyn: Let's talk a little bit about private equity buyers. Typically, PE funds haven't looked at smaller businesses for acquisition. What are you seeing there? Are they? And what is the range that you're seeing from a revenue and profit base? Lastly, do you believe they've kind of gone lower in the way that they might look at companies that are not quite as large as they typically and historically have been?

Vijay: Broadly, PE firms have raised a lot of money. As a result, many have very large funds and they need to put that money to use. But they can't spread their investments across 30, 40, or 50 companies because they don't have the ability to manage that many companies. So broadly again, they've moved up the market and they're doing bigger deals. But that's not always the case.

Some PEs have established what they call "heritage funds," which are primarily focused on middle or lower-middle market transactions. They are targeting fast growing companies with perhaps $10 to $20 million dollars that typically are not yet profitable. In these cases, PEs typically look for certain business characteristics when investing, such as recurring revenue and more resilient business models. If a PE likes the company, the growth rate and believes it to be in the right market, they are generally more than willing to consider a smaller acquisition. GrowthPoint has noticed that large firms such as Accel-KKR, which is known for their successful billion-dollar plus fund, have created smaller funds called heritage funds that primarily focus on middle to lower-middle market investments in order to capitalize on a large market opportunity.

**Factors to Prepare a Business for Sale**

Evelyn: What do you believe makes a company ready for sale?

Vijay: I get asked this question quite often. There are many factors that make a company ready for sale, though it’s important to note that what applies to one company in one sector will differ from what applies to another company in another sector. For example, if a company is a software company, the business will need to focus on their KPIs (key performance indicators), which are extremely important to their long-term success and valuation. Some of the key KPIs for a software business include market size, revenue growth rate, ARPU (average revenue per user), customer retention rate, net expansion rate, lifetime customer revenue, customer acquisition cost, and the time to break-even, etc.… Acquirors use these KPIs to assess the health of the business and the potential for future profitability. Broadly speaking, there are several questions that apply to most companies within the technology sector. They are the following:

Is it an attractive sector?

Is the sector growing?

What is the company’s market position?

Does the company have market leadership?

How differentiated is the technology platform or solution?

What type of customer base does the company have?

Is there a customer concentration?

What does the financial profile look like?

Is this a business that has high gross margins (which speaks to the quality of products or services they are offering), or does the business have low gross margins?

Eventually as the business evolves and grows, what sort of profitability can one expect in future?

As you can see, there are many factors that go into evaluating a business, but it really depends on the type of the company. For services companies, it's more about what type of customers they have? Have the customers been with them for a long time? Does the business have significant customer concentration? So, there are many factors that you need to look at in order to evaluate if the business is ready for a sale, and these factors will vary from business to business. Of course, I am only speaking from commercial and strategic aspects. The companies also need to get their legal house in order in terms of employment agreements, customer agreements, supplier agreements, IP protection, commercial dispute resolution, tax issues, etc. And have a leadership team where the success of the business is not reliant on only one or two individuals.

## Company Profiles that GrowthPoint Technology Partners Works With

Evelyn: Is there a profile company that GrowthPoint seeks to work with?

Vijay: We classify our clients into three buckets. The first bucket consists of high risk, high reward companies. These are companies that have built some special/ differentiated technology that acquirers are willing to pay a lot of money for. In these cases, the technology itself is highly valuable, and thus we can achieve high valuations despite low revenues. An example of this type of company would be Wise.io, a company that had developed a unique and compelling technology stack in machine learning that drove its strategic valuation despite limited revenues. GrowthPoint has worked with many companies that had under $5M in revenue but have been sold for $50 to $100 million because of the strength of their technology platform.

The second bucket is what we call “the middle of the road” type of company. A company that has $10 to $20 million in revenue, particularly software, that is growing at 20-40%. While the company may not have achieved profitability, it has all the indicators that it'll become profitable in near future. These types of transactions define the bulk of the companies we work with.

The third bucket includes large companies that have more than $20 to $50 million in revenue. They’re generally profitable, more mature in their offerings, but they're not growing as fast.

A majority of companies we work with are somewhere around the $10 to $50 million in revenue, growing at 20-100% and they're mainly software focused. Sometimes these companies could be services or hardware focused.

**Types of Buyers**

Valerie: What's the difference between a financial buyer and a strategic buyer?

Vijay: Strategic buyers often have many objectives when they are looking for an acquisition such as:

1) Seeking to consolidate the market

2) Trying to add certain adjacent capabilities to expand their market opportunity

3) Enter new markets, or

4) Acquire a certain technology or a team

Strategic buyers tend to take more time in evaluating a company for a potential acquisition in comparison to a financial buyer. For the strategic buyers, the entire management team may or may not be that important, particularly if the buyers already have a management team in place which can help run the business. Typically, strategics acquire 100% of the target.

Private equity buyers on the other hand are looking to answer the following questions: How do I increase the value of the acquired business by 2x to 5x over the next 3 to 5 years? For them, it's important that the management stays with the business and continues to run the business. It's likely that many PE firms may acquire only a majority stake, perhaps 60% to 80%. Generally speaking, PE firm’s main goal when acquiring businesses is to minimize their overall risk while maximizing their return on the investment. The way a PE firm achieves this is primarily through the structure of the transaction. For example, they could seek to invest in preferred shares, which have a variety of benefits associated with it, whereas the management or founders will be likely invested in common shares.

There are a variety of differences between a strategic and private equity transaction, including the deal construct and the strategic/financial rationale behind the transaction. However, it is important to note that there are many cases where a PE firm will do a complete buyout of a company and seek 100% ownership, thus altering the requirements of the deal. For example, if the firm already owns an asset that is similar to, or complementary of, another company in the market, they may look to merge these two companies into a single entity. In that case, the PE may not want or need the current management team as they already have a team in place capable of integrating and running both businesses. Once again, it's situation specific, and it's hard to provide a single, comprehensive answer that applies to all cases. It really depends on the company and its situation.

Evelyn: Can you make any generalization on the kind of values offered by PEs and strategics?

Vijay: In the past, it was more common to expect higher valuations from strategic acquirer’s vs PEs. However, given the incredible amount of money raised by PE firms today, we have seen more and more transactions where PE firms offer a strategic acquiror’s type of valuation and in some cases – even higher valuation. If you look at some of the recent large software M&A transactions, you will notice that PEs are paying seven- or eight-times revenue multiple (not EBITDA), which is a huge shift from the past.

Ultimately, valuation depends on what the company does, what sector it’s in, and its business model. For example, a services company that's growing at perhaps 15-20% and is profitable, is more likely to achieve a valuation that is 8 to 12x EBITDA than a software company that’s growing at the same rate with recurring revenue, which might achieve 3x to 5x revenue multiple or 15 to 20x EBITDA multiple. Again, I'm generalizing here, but ultimately valuation is very specific to the company’s situation.

At GrowthPoint, our job is to ensure that we know as much about the company as possible, to understand their business model, understand its competitive position and the areas of differentiation. We ensure that we understand their financial history and future prospects, understand what transactions are taking place in the sector, and who would potentially acquire the company at a premium valuation. Based on these and other factors, we prepare a valuation range that GrowthPoint can firmly stand behind. GrowthPoint tends to be quite conservative in its valuation range to make sure that we are overachieving on valuation expectations. We try to not only meet, but often exceed our promises to our clients.

**Seller Preparation**

Valerie: From an educational perspective, what makes a really good seller, in your opinion?

Vijay: It's all about preparation in my view. I would advise a company to allocate one or more years to really prepare for an M&A process as they'll need to complete various tasks to ensure a successful outcome. The first step for many of these companies is to reach out and have conversations with investment banks such as GrowthPoint. We are more than happy to take the time to have a conversation with a potential client or prospect, research information and to provide feedback in terms of what the business needs to do in order to effectively prepare for the M&A process. Questions that sellers should consider prior to beginning an M&A process include the following:

Does the business have employment agreements with all of the employees?

Are all customer agreements in place?

If agreements have lapsed and the business continues to provide services to these clients, you'll need to address these issues prior to starting a M&A process.

Does the business have contracts with all the suppliers?

If a business does business in multiple states, does the business pay a sales tax in the relevant states when required?

Does the business have employees in many different states, does the business pay the employer related payroll taxes?

Is the IP protected?

Is the management team in place to execute on the business plan?

Does the business have a robust business plan?

Vijay: These are the potential due diligence issues that come up quite often. It's also important prior to beginning the process to take a deep look into the business. The prospective seller will need to understand what the business trends are. Does the seller have any customer concentration issues that they'll need to address? Does the business have high customer retention rates that are moving in the right direction? If the business has a SaaS business model, a software as a service business model, which many people listening would have, you need to ask yourself, are my KPIs moving in the right direction? For example, is my customer retention rate moving in the right direction? What's the lifetime revenue? How much does it cost to acquire a customer? How long does it take to break even? So again, there are many different aspects of the business that you'll need to look at. And how GrowthPoint helps with this process is that we role play and act like your prospective buyer. If GrowthPoint were to be the buyer of your business, what questions would we ask? Essentially the seller needs to have an answer for any potential questions that a buyer may ask – if you don't, you are not sufficiently prepared.

Evelyn: So basically, create a strategic plan of how to actually execute the operation for purposes of getting the business ready for sale. It sounds to me that that's kind of GrowthPoint providing that kind of guidance, and then the business owner goes and implements those elements.

Vijay: Oh, absolutely. This is what we would discuss in a meeting with a potential client. GrowthPoint would seek to learn about the business and provide its perspective on various aspects of the business – creating a plan regarding what the seller should focus on before going to the market. As I mentioned, the amount of time we spend preparing the business for a sale pays a huge dividend when the business ultimately goes to market. Effective preparation can drastically reduce the time it takes to complete a process, as we are able to answer a buyer's questions in a timelier manner. It leads to a more efficient process and subsequently, a more successful transaction in the end.

## The Importance of the Management Team

Evelyn: You mentioned the management team earlier. Is it important to have a management team that is in place that *really* knows the business?

Vijay: The management team, in most cases, is extremely important. There may be some cases where the buyer is already active in the market, meaning that the buyer understands the business and has a deep bench that they can pull from. And so, in that case, some members of the target management team become a little bit less relevant to the M&A process. But in most cases, it's almost always critical to a transaction's success that the management team and even the founders themselves, stay on with the business in order to continue to grow the business. If the founders and the management team plan to leave the sold business post transaction, many buyers will be concerned. The loss of critical members could suggest a high degree of risk associated with the transaction. Consequently, if you don't have the management team in place, it could be possible that the seller receives a lower valuation from a potential acquirer. In many cases, some acquirers purposefully don’t buy 100% of the business for this specific reason, hence they worry that the business could go down if the management team or the founders aren’t still in the sold business. So once again, it's situation specific, but in broad terms, the management team is incredibly important and should be seen as a risk from both a buyer’s perspective as well as a seller’s perspective.

Evelyn: So, it’s important that there are agreements in place that will keep the management team, or the founders employed in the sold business after the transaction.

Vijay: Yes, but sometimes it’s more important, than employment agreements or non-compete clauses, to retain key employees through incentives which reward the management team that supports the closing of a successful transaction. In fact, in most cases, sellers put some financial incentives in place to keep the management incentivized. These incentives could be in the form of higher bonuses to maintain or enhance financial performance or sharing a part of the M&A proceeds. Alternatively, a buyer could do the same as part of a transaction. Most buyers want to make sure that the target management team/employees are committed for the long-term and so buyers will put in place long-term incentives to make sure target employees’ interests are aligned with the buyer’s interest. Particularly if there is a private equity buyer, the buyer will put in an incentive plan, which will allow the management team and employees to participate in the value creation. This can be hugely lucrative for the management team to stay on, particularly when a company gets sold over many times from one PE firm to another.

**The Valuation**

Evelyn: I know that you get asked this question often, but it is a regular point of information sought by all sellers. How do you respond to a seller that just wants to know, "How much is my business worth?"

Vijay: We get asked that question all the time and we will really work with you (the seller) to give you the right advice. The valuation depends on the business model and on what the company does. If the seller is a software company, there could be many variations in the business model. We will ask questions such as what sector do you (the seller) focus on? Is that sector growing? How is your business growing relative to that sector? Again, we talked about KPIs for SaaS businesses. For companies that are not SaaS within the software, the multiples tend to de-crease if you're doing license and maintenance type of revenue. If the business is a services company, the valuation is more driven by how profitable the business is. Perhaps, in some cases, if you're dealing with something like the cloud, the multiples tend to be more like software multiples. GrowthPoint spends a lot of time trying to understand the business, analyze where other transactions are taking place, where the public competitors are trading at and what sort of valuation market is being assigned. Based on these, as well as other factors, we triangulate and come up with a range of values that we think will be reasonable for the business.

Let’s take an easy valuation example. If you have a company with $10 million in revenue that is growing at 100% per year. The following year the revenues will be at $20 million. Now if you take another company with $10 million in revenue that is growing at 20% only, its next year revenues will only be $12 million. Clearly, with all other things being equal, the company that reaches $20 million in revenue next year is much more valuable than the company that is expected to grow to only $12 million.

Similarly, let's say that two companies are expected to grow at 100% next year and reach $20 million in revenue next year, and the only difference between the two companies would be that 100% of the first company’s revenue is recurring while the second company derives its revenues from project-based deals. The company with a recurring revenue or SaaS model would typically have a higher valuation in comparison to the project-based company. In this regard, we do a lot of work to educate our clients and communicate with them how we arrive at the valuation, what the concerns associated with their business should be, and what they can do to enhance their valuation. Therefore, as mentioned earlier, the preparation process is extremely important. If we are going to market in several months, a business may not have a lot of time to make many changes to its organization or to the business model. But, if a company takes time and goes to market a year from now, then it may be able to change its business profile and positively impact its valuation.

Evelyn: Trusted Counsel works with your profile client, but we also work with smaller businesses that cannot afford to hire a banker as an intermediary. I know that you're seeing this, so suddenly there’s lots of cold calling going on from potential buyers where a seller will take a call and suddenly they are in negotiations to sell their business in an environment that they've never been in before, and in that kind of scenario, what would you recommendation they should actually do to determine what a reasonable price is for their business?

Vijay: There are several things small businesses can do to better understand their valuation range. First, they should do their homework to see who is acquiring their competitors and at what valuation multiples. Perhaps, they should pick up the phone and talk to some of their friendly competitors that have been acquired. Second, they should learn about the public companies in their sector and study their public market valuation. Of course, there will be a small company discount to the public market valuations for smaller companies. Small companies' valuations are more likely to be linked to profitability than to revenue. It is less likely that small businesses receive a very high revenue multiple. So, it's more about educating oneself and talking to people like me as there's no cost of talking to us. I'm more than happy to spend 15, 20 or 30 minutes just to learn about your business and to provide my perspective on a valuation range. Most importantly, you the seller will need to educate yourself, and if you're not educated, then you will not be sure what the appropriate valuation range is for your company.

There is a saying in the Investment Banking industry, "You choose the price, let me pick the terms." What that really means is that the headline price may not be what it is made out to be, and that the actual realized price may be significantly lower due to several factors. For example, the "headline price" may include a combination of an earn out or some other deferred payments. It could be that there's a large escrow or the required net working capital is too high, resulting in a lower price for the sellers. In summary, there are many ways in which a buyer can extract value through deal terms. A business needs to protect itself from that perspective, which is where having a financial and legal advisor is helpful. I understand that smaller companies sometimes can't afford a financial advisor, but certainly try to get some help or seek out advice, particularly from a legal perspective so you are protected. Lawyers can be extremely helpful when negotiating business or legal terms as they do many deals.

**The Process**

Evelyn: Let’s say a business has hired you to sell their business. You’ve had preliminary conversations, maybe you've given the business some direction as to what they could be executing. Time goes by, they’ve done those things, they’re ready to go. What is the process then, Vijay?

Vijay: Typically, the initial phase consists of preparing a management presentation and a financial model of the business. Depending on the company, this could take anywhere between two to three months, sometimes a little bit less or a little bit longer depending on how prepared the company is. We call this the preparation phase. We want to make sure that when creating these materials, we do so with the right story in mind and how we want to position the company to potential acquirers. We must consider how to structure the company overview and what we highlight within it - what markets the company plays in, what differentiates the company story, what are its technology strengths, who are the customers, what does the competitive landscape look like, who are the key competitors, why customers stay with the company, how does the go-to-market model works, what does the historical financials as well as the forecast looks like, etc.. That's what a typical management presentation tends to include.

Along with the management presentation, we also prepare what we call a teaser, which is what we send to buyers on a no name basis. At the same time, we identify a list of prospective buyers - it could be a list of 40-50 buyers, or it could be a list of more than 100 potential buyers. If we are going to include private equity firms, then the list could consist of hundreds of potential acquirers. Then, we start the marketing phase. Those buyers that express an interest in moving forward in the process after reviewing the teaser are asked to sign an NDA (non-disclosure agreement). Once we have an NDA in place, then we share the management presentation and the financial model with the buyers. The goal at that point is to get them interested enough to set up a call or to have a meeting with the seller.

Once we have developed sufficient interest, we then set a deadline to receive what is called an LOI or the letter of intent. That process takes somewhere between two to four months, depending on the company and process. Considering the process discussed so far, ~2 months to prepare, 2 to 4 months for the marketing phase, we are about 4 to 6 months into the process at this point. Once we have received LOIs from buyers, we then proceed with negotiations before settling on one offer and entering exclusivity.

The exclusivity period may last between 30 to 60 days. During this time due diligence is conducted by the buyer in areas such as legal, accounting, HR, and tax, as relevant. The process typically takes about six to nine months in total. Sometimes the process can be shorter if a company is well prepared or if there’s already a buyer on the table. In that case, then it’s our job to merely check the market for other potential interest rather than approaching a wide range of buyers. The length of the process is incredibly situation specific.

At GrowthPoint, we have had situations where we've had a single meeting between the seller and various acquirers, and then we have four or five offers within a week due to high interest. However, we have also had clients who have had to have multiple meetings with the same potential buyer over a span of several months, but don't receive any offers due to the existence of hesitations and concerns. In those cases, the process can drag on. Thus, the amount of time you spend up front in terms of preparation will really help us on the backend when we start marketing the company.

Evelyn: Are you seeing deals close faster than in past years? Or are they typically on the same kind of timeline?

Vijay: I would say most deals happen in a similar timeline. I don't think the deal timelines have accelerated, though, again, it's company specific. Last year, we closed two deals within four months from the time we got engaged. In contrast, I have also worked on deals where we have a limited set of buyers and they choose to move slowly through the process resulting in a 12-month timeline. However, for a vast majority of our transactions, it takes somewhere between 6 to 9 months and ~ 80% of our transactions are completed within a 6 to 12-month timeframe.

Evelyn: Tell us, why GrowthPoint should be hired by a potential seller?

Vijay: I believe a potential client should hire GrowthPoint because they like us (and me) and because they think that we can do a fantastic job for them. I would encourage anyone who is looking to engage an investment banker to look for someone who not only understands your story, your company and your technology, but also someone who is going to spend the required time and energy evaluating your business and giving you the right advice, and someone who's experienced. There are many bankers out there who will say, "Hey, choose us and I will work with you every step of the process," and then, unfortunately a month later, they will pass the project down to a junior team and let them execute on it. That happens all the time. At GrowthPoint we don't do that. We strongly believe that the time that you have committed in building your company and business should not be taken lightly. You may have spent the last 10, 15, or 20 years building your business and perhaps all your wealth is tied into it. I believe it's my responsibility to ensure that we do what is best for you and help you achieve your strategic goals.

I also suggest that you seek out references when choosing an investment banker. Talk to their former clients of various investment bankers and ask them the important questions. What did they say? Did the investment bank deliver for its clients? Did they under promise and over deliver? Were they there when the client needed them? Were they listening to the client concerns and addressing them? These types of conversations with people who have been in your position will provide you (the seller) with a good idea in terms of who you will want to work with. Every single transaction at GrowthPoint is led or supervised by a managing director. One of our unique and most compelling advantages over competitors is that I, and our other managing directors, are involved in the process end to end and we are there for you every step of the way. There's nothing more important to me than to have a successful transaction where we have another client that would serve as our reference. We want to make sure that we achieve an optimum result for you, and you are someone who becomes an advocate for us going forward because that's the only way we can build our business.

In summary, when you are thinking about engaging investment bankers, look for experienced bankers, do reference checks, and you'll get an idea about whether this is someone who is really motivated to work hard for you.

Evelyn: GrowthPoint is a relationship partner with Trusted Counsel.

Vijay: Oh, absolutely. This business is all about relationships. We work hard to earn our clients' trust by going above and beyond what is required, and we deliver outstanding results. GrowthPoint exists only because of our clients. Our clients are our #1 priority and we are here to serve them.

### Challenging Transactions

After the podcast, Trusted Counsel had a few more questions for Vijay. So, we called him up by phone.

Valerie: Vijay, tell us about your most difficult transaction. What is it about a transaction that really challenges you and tests your skills?

Vijay: That's a great question. One thing I'll tell you, that may come as no surprise to you, is that all transactions are different. I've never seen two transactions handled in the same way. From my past experiences, one of the more stressful transactions I have completed closed in the last two years. A week prior to closing, the CFO of the company we were selling informed me that they were running out of cash! In an unanticipated series of events, the company had burnt through more cash than they had. To save the deal, and ultimately the company, we successfully arranged a short-term financing prior to losing and completed the M&A transaction within the next two weeks after the financing.

Another interesting situation where we were not successful at selling the company and rightly so, was a case where the buyer discovered some financial irregularities during the diligence process. Our client, an international company located in a high-tax country, decided to take certain payments through a tax haven in another country, effectively eliminating the need to pay certain taxes altogether. As you can imagine, once the buyer found out, they chose not to move forward with the transaction. As an investment banker, we at GrowthPoint would never intentionally want to be associated with such a situation and subsequently terminated our engagement as soon as possible. Yes, that's a true story!

Lastly, we recently dealt with a buyer that two weeks prior to closing, upon hearing that our client had financial performance below expectations in the last quarter, decided to reduce the price by 30%. As they were the only buyers on the table, we had to work with them in order to demonstrate that the numbers were simply an anomaly and that the next quarter's performance would be significantly more favorable. We ended up delaying the process by a month in order to show the improved financial performance, resulting in the completion of the transaction at the original terms, including the price.

So, to answer your question, every transaction has its own difficulties and it's never a straight path. However, we at GrowthPoint work with both the sellers and the buyers to ensure everyone understands the situation and to find the best way forward.

**Lessons Learned**

1. As the seller, be prepared. Growth Point advises a company to allocate one or more years to really prepare for an M&A process as they'll need to

complete various tasks to ensure a successful outcome.

2. Have a strategic plan of how to actually execute the operation for purposes of getting the business ready for sale.

3. Have your management team set-up.

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# Anatomy of the Sale Process; How to Sell Your Business

## A First Time Seller

A Conversation with
Trey James, CEO and co-founder
of XCentric sold to Right Networks, LLC
*Recorded in March 2019*
*(Part two)*

***"We were prepared to not take the best financial offer because we really value culture and we cared about keeping our culture intact."***

Trey James co-founded Xcentric, a business focused on managed IT solutions for accounting firms in 2002. In 2017, Xcentric was acquired by Right Networks, a leading provider of cloud-based accounting business solutions for CPA firms, accounting professionals, and small-businesses. The Xcentric team was seeking a buyer that not only shared its mission and market focus, but also would offer more value to its customers. James discusses the strategy for and implementation of the sale, how the sale came to fruition, and the 20/20 hindsight that comes after closing a deal.

### The Background

(Host)
John: Today, we're talking about a sale of a business. With us today is Trey James, co-founder of Xcentric, which sold to Right Networks in 2017.

(Host)

Evelyn: This conversation is directed to those listeners who have never been through the "exit process." *While Trey had not been through a process like this before, you'll soon find out he was a diligent and sophisticated planner, completely process-oriented, learning what he needed to know about making the company attractive to a buyer, how to facilitate a sale and thinking through in detail what success would be well in advance.*

Trey let's start at the beginning. Tell us about forming the company, your focus in the company and how you actually developed the business focus of managed IT solutions.

Trey: My brother and I founded the business out of my basement. We were roommates and had really just a huge opportunity to step into running a business that we took over from our prior employer. We left that employer, they went out of business shortly thereafter, and then we bought the business from them. Basically, the owner of that previous business decided to move in a different direction, and we benefited from that greatly. After four months of running the business out of the basement, we got legitimate with some space, so very humble beginnings.

Evelyn: What year was that?

Trey: 2002. There is so much credit that's due to the relationship that my brother and I have. We get along famously. We're similar in a lot of ways, but different in good ways. It just was a phenomenal kickoff to a new business. Xcentric was a bit of a rocket ship as we grew about 30% a year every year from that kickoff.

Evelyn: Was the company always focused on the accounting profession as its client base even before you took it over?

Trey: It was. I was in a sales role and my brother Christian was in a technical role. We were prepared to go out and do something different, and a different vertical altogether. What we did recognize was that there is value in having a vertical expertise and being focused, so you really hone your trade around a specific set of problems, a specific community. You know what kind of customer you're going after and what specific solutions to provide there.

So really from day one we just maintained that same CPA focus. We also got counsel through the groups that you and I have been involved in. This is a side note here. You've got to get people around you, whether it's some kind of community group, or CEO round table to help shed light on things that you might not have experienced. Through that, every year, we would ask the question, should we focus on CPAs, or go after law firms, or healthcare? Every year, it was pretty clear that the accounting marketplace was underdeveloped. We had so much opportunity there that we stayed focused there, and even to this day have stayed focused there.

John: When you started the new business Xcentric, did you have any plans or any end goals in mind?

Trey: No. We had an opportunity that we just went after. We did know that from the prior business that we worked at, the idea of an eat what you kill mentality was certain death to the business. You might be able to make it work financially, but you'll run out of gas physically trying to do something that's cyclical in nature and doesn't have a recurring revenue stream. So with the new business, we really focused on building products and solutions that would have a recurring nature to it. That was unintentionally brilliant because when we sold the business, that was probably the most important piece that drove value.

**Growing Xcentric**

John: When did Xcentric start offering cloud-based solutions?

Trey: The idea came about in 2003. We actually had T-shirts that said, "We were cloud before cloud was cool." It wasn't called cloud then. It was called a number of things and it was all confusing. It's still confusing today, but we had this idea.

So, going back to your question, we were hired by CPA firms to basically set up technology in a way that one of their offices would be the core, and all the remote offices could log in remotely and would operate from the mothership. Over time, the idea came to us that what if *Xcentric* were to become the mothership with all our clients coming to us for their computing needs? That would surely make it a lot easier on our business in terms of being able to manage the technology, to replace the technology, to support it, and to ensure that it's working well, and more.

What lead Xcentric to kick off our first cloud platform is the following story. A severe hurricane went through one of our client's town and it caused damage to his server racks. I literally got a call at 3:00am about the situation and so we met at a Waffle House to have a breakfast meeting. Afterword's, we transferred his server to my car and I drove it back to Atlanta to get it resolved. That was the kickoff to our first cloud platform. So, back track a bit, we already had the infrastructure built, we just needed to get his data. And we needed someone who was willing or desperate to trust us, and we got that.

Evelyn: To do it. To try it out.

Trey: That was the kickoff. It was awesome, but it was also really hard. Hard for Xcentric, hard for him, because there were so many new things that we were all learning. Today, it's a very mature space. It's still difficult, but it's a very mature space.

Evelyn: How long before you felt like you were a business that was truly focused beyond the day to day - on longevity? Was it from the very beginning that you thought, "This is it. We can execute this and continue to execute it for years to come?" Or did it take a little while to figure out, "Okay, we have our foundation set now. It's just about growth rather than education?"

Trey: You're probably giving me more credit than is due. I really believe that there was more opportunity than we could handle. Our problem was figuring out how to grow without killing ourselves.

I'll answer the question in a slightly different way. What gave us a sense of stability to be able to survive the next challenge, so to speak, is that in the CPA market, accountants basically go dormant to the outside world from January through the end of April because of tax season. There's another “Fall” period where there are extensions. They don't buy during those times. When tax season is over, they go and hibernate because they need to recover and get sleep. That's now or June before they were talking to technology providers.

So for example, the sales season for our business, if you were selling something at one time, like a project worth 100 grand, a network or what have you, we had to sell it between June and October, in order for them to deploy it and have it ready for the next tax season. That was a massive problem. It was the biggest challenge to our predecessor, which was how do I generate enough revenue...

Evelyn: To carry you through those months.

Trey: Then we had to hire and train our staff, which was very technical and very focused. How do you train them fast enough to do the work correctly and then retain them during a period of time for five months where there is no new revenue? *So recurring revenue was the solution to a major, major problem. We knew that in order to have a business that would survive long-term, we had to move to a recurring revenue model. We established early on that everything we did in terms of new services would have a recurring revenue element to it. We started out and converted fixed-fee things into recurring revenue that didn't really make sense completely, but clients signed up for it. There was a lot of trust there.* At one point, we got to where every single bit of revenue we had, ***so at the time of the sale, 98.6% of our revenue was recurring***. Most of that was on five-year contracts, which is unheard of.

Evelyn: It is unheard of.

Trey: People have asked me, "How did you get clients to do that?" We responded, "We didn't give them a chance to go otherwise." Very few people pushed back on a multi-year contract. The mentality of most people (CPAs in our case), was that switching technology was a big enough headache that if we could forego that and push that out another five years, that would be a welcome thing. It worked in our favor that accountants leaned on us and needed it.

Evelyn: Take that problem off their shoulders.

Trey: Yes. That worked in our favor. I'm not sure most technology businesses can do five-year contracts.

Evelyn: I think the other thing that, and I know John will agree with me, is that *we were always so proud and fascinated that Xcentric only contracted with clients on* *your own paper. It was very, very infrequent that you would even negotiate your contracts, that you basically structured it from the beginning with "This is how we're going to do it, this is how we sell it, and this is what the contract's going to look like."* Everyone was charged with that on your team.

Trey: I live by trust. I don't need a contract. That's how I really feel. But the real-world scenario is that you need contracts and they need to be written well. The only question is how much do you lean on them? But they needed to be there.

I learned lessons from you, Evelyn, early on. I didn't want to say difficult things to clients. I think I may have shared this with you a few years ago, but you don't know what you don't know. Trusted Counsel wrote the contract for us, and it has been modified slightly, but not much over the last 15 years. We have used that template hundreds of times.

It wasn't until about five or six years ago that we had a small issue. We had little minor things that we would tweak, but just where does arbitration happen? Is it my state or your state? Those things, but very simple. But we had a client that was frustrated with us. It was very clear that we were never going to be able to serve them well and we wanted them to leave, which was very rare. So this gentleman said, "I don't care what your contract says, I'm not paying the exit fees. I'm not going to perform my contract." We all tried to cordially wrap up the phone call. The next thing we knew is that we received an email from his attorney accidentally copying us on that correspondence saying, "You better pay the fees because this contract, it's rock solid. You don't want to mess with this." I think I sent you that email of correspondence.

Evelyn: Yes. Thank you, Trey. Businesspeople are often more focused on “Can it be a one-page contract?” Rather than *the reality of the contract is, it is important only if things break down completely. That’s when you need a roadmap to get yourself through that mess. That's why you need good contracts.*

Trey: I think initially I underestimated the value of having the contract present.

Evelyn: The other key component in all of this is that you and your team were always very focused on a high level of communication with your customers. If you had challenges put in front of you or unhappy clients, then you were willing to talk it through, and resolve to work with them. It's almost disarming these days. People don't expect you to place the call and to have a one to one conversation with them. I think people, in this day of electronics, forget that we *are* human and that we should be having those conversations. Communication is key.

Trey: It's shocking when you start looking at websites, especially of technology companies. It's very hard to find the bios of the executives. It's not easy to find what their mission and vision statements are online. It's very hard to find who the real people are because so many hide behind the machine of the web presence, or the technology platform or what have you. I would echo your sentiment of being a real human being and having a conversation.

Roy, who ran our sales and marketing for years, did a phenomenal job. He said, "We are not a machine. We're a group of people, group of human beings with spouses, and dysfunctions, and interests and all those things that just happen to be the ones who are all about serving you." He set about to humanize us and to bring a human element to cloud. So, we literally put every employees’ headshot on our website.

*<u>From a trust standpoint, we built our systems in such a way, that when you called in to get help, you would see on the page who you were interfacing with and pictures of the people that were serving you</u>*. It was all a mental shift of saying, "We are real people. Don't send us an email in all caps blasting us, because there's somebody who is going to actually receive it – and you need to depend on us to help you.”

**Realizing that it’s time to Sell**

John: You started Xcentric in 2002, but what eventually led you to start thinking that it was time for a sale?

Trey: We were naïve. I can speak for Christian and myself on that one, because we had never been down this path. We were both very resistant to saying, "We're building this business to sell it." To me, that doesn't have a good cultural stance in terms of creating culture and alignment. It seems more negative than positive.

Clients would hire us and ask, “What's the long-term plan?" Because in those days, everybody was about IPOs, or about equity, and stock and so forth. We’d say, "We're pretty simple. We're not building this business to sell it. We're building it because we believe in the opportunity." What I learned later in the process is that as you grow, your vision must change. And that as we grew up, people eventually retire or people move on. Those people that you want to retain on your team will need something bigger than a vision that’s simply of the mindset "We're just going to keep grinding it out."

*<u>Over time, it became more important to think about an exit in order to manage the team, and create alignment, and really keeping the team focused, to say, "There is something in this for you if at some point we sell."</u>* Trusted Counsel helped us with building a

program to creating incentive for our employees. We didn't give equity out, but rather phantom equity, which at the end of the day, it was a nice cash bonus to them, which was very meaningful.

What I learned later on in the process is that preparing to sell a business can be just as energizing as growing a business because there is actually stuff that happens after selling a business that can be way more interesting than what you're doing in that one business.

Evelyn: That you could really take advantage of.

Trey: In some ways, I felt like I was limiting peoples' future by not creating a bigger space to play in and... in our industry, we basically had to trick non cloud-based software into being delivered over the cloud, over the web. So, at the point in time when those pieces of software are no longer a desktop software and they're all natively delivered over the web, well then our business model is gone.

Here's another example. What if Microsoft Word were no longer installable? And individuals had to log into Microsoft to run Microsoft Word? Just like Google Docs functions today. So in other words, there's no desktop installation of Google Docs. If that were to happen today to 100% of the software that we host and manage for CPA firms, we'd literally have no more business.

The writing was on the wall, about eight years ago, that that structure was going to be a focus for most software vendors. To go cloud. There were vendors out there saying they were going cloud without even really knowing what that meant, but that was the buzz word and they already had a pseudo strategy.

Going back to our humble beginnings, we would install networks, that's all we did. There was no cloud. Then we innovated and we completely changed our business model to a cloud only business. Three years ago, we had to tell a client whom we had supported for a long time, "We will not install another network for you." We still had some laggards that are now on cloud. But the software vendors converting to cloud was the threat. Just the economy of scale where cloud type companies were headed, we thought we were on the front end of that, but it was going to start decreasing over time. And we wanted to be on the upswing, not on the downswing. I've had several people say it's lonely on the backside of a growth curve, an adoption curve.

We were still so early in the adoption cycle when we started thinking about what would those triggers be? - I think we caught it right at the right time. I still think that there is probably 10 more years of doing business as usual because it's just taking way longer to do cloud than everybody expected.

Evelyn: I think that professionals will always rely on other professionals that are really know-ledgeable about their industry to help them make the choices for technology. That might even have more longevity. It might be a different model, but it seems like a knowledge-based person in the industry that knows the technology and how it operates, and everything is always going to have an opportunity.

Trey: There are opportunities. We could have innovated at a couple of different directions and those opportunities still exist. I think part of it too is just the exhaustion factor. When you've been the leading provider in an industry that was undefined, you've helped define the industry, accounting firms are looking to you for direction, which that happens - and you don't realize it. It sneaks up on you and finally you're the expert.

**The Inc. 5000 List**

John: What year did you start thinking about selling, before you actually engaged an investment banker?

Trey: Let me start out with this story. We signed up for the Inc. 5000 list. Everybody thinks that Inc. 5000 reaches out to you and will say, "You're really important. We want to put you on this list." That's not how it works at all. You essentially subscribe, meaning that you don't pay a fee, but you basically submit your revenue amount for the given year and list how many employees work at the company. You'll get placed on the list if you meet the criteria of being in the top 5000.

Every year, we had our CPA firm, or maybe you guys signed off on it, but you have some third party sign off that those are indeed your real figures. And it's just those two figures, annual revenue and headcount. The folks on the receiving end will literally add them into their database and run the list. If you're on the list, you're on the list.

I think this year, 2019, we hit year #13 on the *Inc. 5000*. They don't even know we've sold. *If you're a high growth company, you should put your name on the list.*

Trey: What ended up happening was that *I started getting calls from investment banking firms*. I would get four or five calls a week and just emails all the time. I never, ever responded. For three or four years I didn't respond to a single one.

After a few years, I started seeing signs that the industry was changing. I decided that it was time to educate myself and *so I took some of the calls*. I started those calls out with, "Listen, I'm not doing anything. I'm a neophyte, but I'd really like to learn.

I'm just telling you upfront, you're going to waste the next half hour with me. But if you're willing to do that, I'd be willing to spend the time and it would be worthwhile to me." Inevitably they'd say, "Not a waste of time. This is relationship building," which was smart of them to say. *They educated me on what the process looked like and gave me a chance to get questions answered*.

Soon thereafter, Xcentric had its annual retreat off-site. I think this was probably 2010 maybe, and I said, "I think our focus is changing and I just want to point out some potential threats in the future. We have a decision to make. Either we innovate and pivot as these externalities become real, or we sell and go do something new." We decided that selling was the way to go.

It's interesting, only two guys came after that meeting and said, "Okay, what is in it for me?" Literally, specifically, what is in it for me and can I get that on paper?" That was good. Really, it was a hassle, but it was the right thing for them to do. They told me that they were committed.

*Then there was this sort of an amazing shift between that old logic of, "I don't want to build something to sell it," because that would be a negative, to now a positive of, "We're all coming around this now. How do we build this in a way that will maximize the value, and to all of us?" Very aligning.*

Evelyn: Amazing.

Trey: It was amazing! It is really amazing when you have a goal and you start building a plan to reach the goal, how aligning that is. It's very simple to say, more difficult to do. Obviously, you must have a good plan to align around.

It was a big shift for the team that I was pretty nervous about. I did feel relieved because we had decided that we were changing course and we were now saying "We are going to build this business to sell it now." Christian and I both felt this burden of we know something that the team needs to know. How do we deliver this at the right time and in the right way?

Evelyn: And they embraced it and helped.

Trey: The entire management team was onboard during the sale. They didn't know every single element, but they were called in at different times. If they asked, we were completely transparent. There was a group of about 10 people on the management team, and there were five of us that were on the team that really participated in the overall transaction.

**Choosing the Right Investment Banker**

Evelyn: So, you received all of these inbound requests that you took advantage of for education. *How did you decide, I will go and see if I can choose the banker, as opposed to them choosing me? Was there any shift there or was that something that you just knew that you needed to do?*

Trey: I wanted to be in control of choosing someone versus…

Evelyn: Them choosing you.

Trey: *I think we had a number of things in our favor*. We had and have *a rapidly growing business that is again, 30%, 35% a year which is good; all the metrics of the business, retention, growth, were there. All the things that are important to outsiders were all moving in the right direction, so we had a lot to be proud of which gave us confidence going into those conversations.*

The other thing we had was that we weren't pressured by anything other than our own desires. We weren't in a situation where we *had* to sell to meet some objective or it was purely a we think this might be a good time because of these factors: market timing, software, conversion to cloud and all those things. We had the ability, at any point, which I think is a strong negotiating point to say, "No, this isn't going to work. We're just going to regroup and start over, or do this a different time." Knowing that we were in that position, it was much easier to go out and say, "We're going to find the perfect group for us instead of having to jump on quickly with somebody that we didn't know whether they would make sense or not."

I think we feel like, and I think every business feels like they're different. We certainly felt we were different. I think from a revenue standpoint, from a mechanics of the business standpoint, we are unique. We're like a software company, we're making one thing and we're selling it multiple times for a monthly fee, but we're more like an infrastructure company because that's really what we're buying. We have this weird complexity to the business.

The line of thinking early on was we better find somebody who understands us. *We need to find somebody who is not necessarily selling manufacturing businesses, and then retail and all the different things. Let's find somebody who speaks our language*.

Evelyn: That they know what you're talking about.

Trey: Correct, that they not only do they know what they're talking about, but that they'll correct us when we have those metrics wrong, which happened in our case, thankfully. We were measuring things in a way that was not very efficient. I know for a fact that a couple of different bankers that we could have chosen from, well we would have been teaching them the process the whole time. So, it was important that we hire an investment banker that would understand us. I was a little concerned that if we went to a boutique shop who focused on technology companies specifically with recurring revenue and a SaaS cloud model, that because they would be so focused, that their network wouldn't be broad enough to find a buyer for us.

What ended up happening - and I’m oversimplifying here, but one way that I valued or validated the different bankers out there is that I went to their website. If I had never seen any of the brands because they all have the row of trophies on their website, the different logos of the businesses they have sold or bought, or what have you. I would look at the logos and if they were recognizable, it was like, "Wow, that's interesting." The banker we went with, they had logos from Apple, from Microsoft, brands that we all know. A lot of these other bankers had companies that no one knew. Pretty logo but had never ever heard of them. That was one way of validating.

Then at the end of the day when we had our shot, we met with three of them. The one firm that we thought had vertical expertise in our business, well they crushed their presentation. They totally knew our business. They were teaching us things about our business that it would have been really nice to know years before. That was eye opening and reassuring all at the same time.

## Preparing to Sell

Evelyn: You hired the banker. What happened next?

Trey: I went home and said to my wife, "Okay, I've been told that you need to be okay with me being crazy for the next six months."

Evelyn: How'd that go?

Trey: She was totally with me. We had talked about it enough already that she knew that was going to be high pressure. I think there were probably a couple of 3:00 a.m. mornings calls. You do the work that needs to be done no matter what time of day it is or what vacation you're on. It's important that you keep momentum. Those months were really invigorating. It was so fun because it was an MBA ...

Evelyn: On steroids.

Trey: ... on steroids in six months, just crushing, learning new things, and fixing things. I had such a great team. The team was so awesome. They produced a lot of the heavy lifting. There were some late nights during the middle of the transaction that were really high volume, but for the most part it was just working differently. It was a second job. During the day and I had the luxury of accommodating the second job, without doubling the number of hours I worked. That was purely based on having a company that was mature.

John: Your deal actually was one of the more fun deals to work on.

Trey: It's who you were working with!

Evelyn: Of course, yes!

John: *The team was really good, but one of the things that you did right, which should be essential to anybody who sells their business, is you had a big team kickoff meeting where we all sat in a room and we all got to know each other. Some of us had already worked with each other before, but that just set the tone of the team going forward.* You and Christian were great about what you wanted to accomplish, the things that you were concerned about, you were open about what you didn’t know. You all did a great job of being involved and decisive, and helping that process.

Trey: I would bounce the accolades back to you guys at Trusted Counsel because I do remember feeling a bit inept. Like establishing the right team. “I know I need that attorney, the accountant, but there's three kinds of accountants that need to be here and what are their roles?” Evelyn, I think you said, "Well you need a team and it consists of these people." So, I set out to find that team.

Evelyn: Well, and a team that would work together, since you have a lot of disparate functions. Sometimes people have worked together, but a lot of times they haven't worked together. You can get a lot of fighting going on where people are testing each other and their expertise. It loses the focus of getting to the goal. That whole idea of introducing everybody so they know exactly what the objective is and how we're going to do this forward is a great thing.

Trey: We had a perfect example of that. In our case, we got a meeting together in your office and we had eight, nine people there. In that meeting, we went around and everybody went around the table and said, "This is what I do, and here's how Trey and I know each other. Here's what he's asked me to do." That started collaboration directly between the members of the team. You guys had to sort out where the boundaries were like what pieces are you taking versus which ones are we taking. Again, I was clueless as to how all the overlaps needed to happen. But dumb luck, again, and great suggestions from you guys to get the team together, and figure out roles and responsibilities. And the timeline. It created space for us to talk about the sense of urgency and where we stood.

Evelyn: In the whole transaction, *what went right?*

Trey: Golly, so many things went right! <u>*We found a banker that understood us*</u>. <u>*We had been supported by you guys and by our CPA firm*</u>. So, I think we had <u>*great team alignment*</u>. The process that we went through was really interesting to watch and how that was orchestrated by our banker. They got 10 different companies to fly in from all around the country in the course of 10 days, and we went ... I hadn't worn a suit that many times! Yes, it was really uncomfortable. We went without ties, but I looked forward to getting home each day to get the suit off. But we went back to just pitching who we were. It was just an exposé on who we were and what we were thinking, and it gave us an opportunity to all these potential buyers to come in and look at us. That went right in terms of creating urgency with the buyers, and identifying which buyer we'd be interested in.

I think I mentioned this earlier. <u>*We were prepared to not take the best financial offer because we really value culture and we cared about keeping our culture intact.*</u> We were setting out to find a company, a buyer who wasn't going to try to be destructive. We wanted to find a buyer that would value the business we built, and the culture and the team, and that we would fit in with their organization well. We were successful there. After the transaction took place, we only had two people resign and we asked, "Why are you leaving?" They said, "I don't know. It's just a little scary." So, we took the time to explain what was taking place and they ended up un-resigning. In the last year and a half since the transaction, we've had one guy who has been let go as a result. I think just overlapped between organizations and wasn't going to work. But out of 130 people, that's pretty amazing!

### Important Lessons Learned

Evelyn: It is absolutely amazing.

Trey: The culture is still intact. I think *from a transition standpoint, we found the right buyer who had a very compatible culture and today the two businesses together are killing it.*

Evelyn: Let's talk about the things that maybe you were surprised by or didn't really expect, and maybe wish you knew in 20-20 hindsight what you wish you had known going into it?

Trey: We were a very data driven company, even though some of the definitions of our data, we might call retention or define retention using this formula. The banker defined it and looked at it through a different lens and we redefined that. I think *maybe having a banker look at the business years prior to selling to say, "This is what people care about," would have been awesome.*

Evelyn: Interesting.

Trey: Because what happened, as soon as we secured the banker is we got very aligned on what terms were important. Is growth important? We got very laser focused on very specific metrics that we started reporting on weekly. Are we trending off or on? Are we going to make this or not? It was all done through the lens of the buyer in terms of what was important to them, most likely. We did have a huge mess on running the business in GAAP. I think we confused the banker. He said, "Do you run the business in GAAP?" I said, "Yes. We ... "

Evelyn: "We're moving to GAAP."

Trey: "We're moving to GAAP. We're being audited for the first time." This was two years prior to the sale. "We're going to go through an audit first time and then we'll know what GAAP should look like." We had to convert from cash to GAAP.

The banker ... I think we both get credit for having been not more sophisticated on that one. But not being in GAAP was totally a false start to the process because as soon as we identified the buyer, selected the buyer, we got into the numbers and nothing made sense. All the things we had been saying, this is truth, was true through a cash lens. We were totally legitimate in what we were saying. But when you move that to a GAAP perspective, all those rights change because everything gets moved around.

It was meaningful because one specific example is in GAAP, if you pay your salespeople upfront for commissions, you actually can't take the expense upfront, you have to take the expense over time.

Evelyn: You have to wait.

Trey: Now our profit gets adjusted. That actually helped. The sales thing helped. The revenue that you get upfront doesn't matter if you get it upfront. You have to show it as it's earned. The recognition of revenue ...

Evelyn: Switched to accrual. Yes.

Trey: ... when you move to accrual and GAAP changes everything.

Now there was this sense of goodness, I thought our profit was X and it's not, it's Y. It's Y through the definition of GAAP and it is truly X through cash, but cash didn't matter in the case of this buyer. If the buyer doesn't care about GAAP, if they're just going to swallow you whole and they could care less about GAAP, then it's no big deal. I think, I'll just throw out a probability, 95% of the buyers are going to want you in GAAP.

Evelyn: Absolutely. Particularly anyone, so private equity, any kind of large public company, even large private companies. That's what they can rely on, that you're following those principles.

Trey: I learned a lot in that process. It normalizes all the abnormalities. It totally normalizes how the business functions, and takes the lumpiness out of cash flow and all those things, and just flattens it out. It's really helpful to run in that, but we had run on a cash basis for so long because in the early days it was more about how much cash there was in the bank than it was about are we growing fast or slow. That was huge. Probably the most significant lesson learned is getting our accounting done in the right way.

Again, if your business is not data driven, if you don't have all those statistics, and the key for us ended up being ... You don't generate the report once, and then you hit once and done. You generate it on Tuesday and they say, "Well, can you regenerate that report on Wednesday?" If it's all manual, you now have a full-time job being a data monkey. You've got to build systems, use systems to automate reporting, get your accounting right. There's so many of those things that if we didn't have real-time reporting that we could rely on, it would have just killed the whole deal.

Evelyn: Because you would not have been able to respond.

Trey: No.

Evelyn: They wouldn't put up with that. It's not ...

Trey: It becomes very frustrating to them and it creates a situation where they are wondering if the rest of your business is run that way. We were fortunate that we had our house in order as best we knew how to. The redefinition of our terms and our metrics was relatively easy because it was modifying the formulas that we were using in our reporting to make it match what they are looking for.

Evelyn: I think that's one of the principles that many sellers don't really even understand when you hear you need to dress yourself up, so you look more like your buyer. I think because they haven't been through the process before, it's very hard for them to really understand exactly what that means. Well I don't want to do audits, they're very, very expensive. I don't want to do GAAP; I want to be on cash basis. I don't want to be accrual.

Trey: Yes, well too bad.

Evelyn: Yes, if you want high value for your business then you're going to make these changes. Any other major lessons learned?

Trey: The big ones were GAAP. The fact that we weren't GAAP created a pause in this transaction that was negative in the sense that it was off-putting to everybody. We were just anxious. We were really excited to start working with these guys and we had this whole thing hanging in front of us now. If you're audited, your auditor can't actually do the accounting for independence sake.

Evelyn: Yes, they have a conflict.

Trey: Who's going to help you convert your books? You need somebody who understands GAAP. In the 11th hour, we were trying to find people to help us because our auditor was totally capable, but had a conflict.

Trey: That was a pain. Then in our case, we had, again, this was unintentional wisdom, every year we had employees sign a non-compete. Every year we had in that language in an updated confidentiality and work assignment agreement. There were a number of protections that constitute a contract between us and the employee, so much so that there was no like, "Whoa, wait a minute. You're asking me to sign a non-compete this year." It wasn't every five years. It was every year.

Evelyn: Right, they were just used to it.

Trey: It was part of the handbook.

Part of the sale, the buyer's perspective is risk, and it is how certain is this business to keep performing as it's described? In order for the business to perform, how certain it is that the employees are going to stay and not steal your Intellectual Property (IP) or what have you?

Evelyn: The IP, the ... yes. Go after your customers.

Trey: You've got to have contracts with every single employee in a folder to hand to the buyer, you've got to have every single contract that you have between you and a customer. You just expert your customer database. If they're a current customer, you better have a contract. Or even a customer that was in the past in the window that you're looking at, you've got to actually database every single contract you have.

Evelyn: I think the diligence process is a surprise too.

Trey: It's a lot of work.

Evelyn: Yes. It always is. We're going through a purchase of a company right now and the seller has said to us, "Gosh, I'm learning so much about my business because you're forcing me to look at all of these documents for the first time. It would have made the company more valuable for him to understand them years earlier!"

Trey: But all the contracts between customers, vendors, employees, all the non-competes. I don't have a financial background and I learned a lot, obviously, in 20 years of doing this, but the difference between ... the impact of OPEX and CAPEX on profit, and where it hit me the most was the way...

We're an LLC. The way my brother Christian and I ran the business was that we took up guaranteed payments, effectively a salary. We didn't have bonuses set up for ourselves because we were gracious, and we were just going to get whatever was leftover that we felt comfortable taking out of the business. We didn't establish legitimate bonuses for ourselves.

In the early days, there was no bonus. It was thankful that we got our salary. Then in the later days, it was like, "Wow, should we take this much out? We should leave it in because we should use that money to grow." But the way we took that money out was in distributions.

From a financial standpoint, the distributions, we attributed emotionally as a bonus. But on the books, it's after operating costs, so it's in the profit category. It doesn't impact profit to take a distribution, because the buyer gets to keep that money instead of us.

The challenge with that was, now we've been acquired, we've been hired to help run the business for the next year or what have you. Because the books were written where our salary was operating cost, but the bonuses weren't, there really wasn't room in the model for us to take bonuses.

Evelyn: To get the bonus.

Trey: Because it would throw off profit.

Evelyn: Or an increase in your salary, essentially. Yes.

Trey: Yes. I've shared this with friends. If you are taking a subpar salary and you're going into the sale process, your banker hopefully will lead you to say you need to get right.

Evelyn: Yes, before.

Trey: Do you know our buyer came to us? We bought the building that we operate in out of Montana. We were renting it to ourselves for much better than the market rate. The buyer came to us and said, "We need you to revise the lease on that building and charge us more so that it's market rate, because this is not real." We're like, "Well wait a minute. We're going to pay ourselves more? You're going to force us to charge you more?" Yes, because we want to be real.

If you think about their mindset, they're not thinking about what they're paying. They're thinking about what's real for the next buyer to buy that asset later.

Evelyn: Right, absolutely.

Trey: On the compensation side, here's where it really stung. We paid ourselves a salary. Because we're an LLC and it's all passed through taxes, whatever the tax bill was, we just stroked another check from the company to ourselves to pay the taxes. Well now, and so the net result was the money we took home every month was after tax because when we had to pay the taxes, we just wrote another check. After we became employees of the new company ...

Evelyn: The taxes weren't advanced.

Trey: We got the same salary but now we had to pay taxes out of that salary. Some people would say, "Well yes, but you got a bunch of money for selling the company," which is totally true. There is a judgment call.

Let's just use round numbers. If your company is valued at 10X, 10 times, it's up, the multiple is 10X, and for every dollar that you don't take out of the company, that leaves a 10-fold value. The fact that we didn't take $100,000 out of the company that year actually made that $100,000 worth a million. Add a 10X multiple. It makes sense to do the math. Is it better to leave it in and maybe suffer for the year in terms of not getting compensated? Barely. Said another way, it would take me 10 years and a 10X example to recover. It was an easy decision. Let them keep the money. I'll take the 10 times, you keep the one time.

**Life Post Business Sale**

Evelyn: What are you working on now Trey?

Trey: Christian, my brother, and I are doing real estate. Right now, in this season, it's been a year and a half since we sold the business. We worked for a year in helping make the transition, which was really fun. Conflicting at times like, "Wait a minute, who's the boss. But I think in this season, it's really about a family and giving our wives some space. We have a super blessed life for the whole time we ran the company, great work-life balance, a lot of flexibility, all those things. It's not to say that they were overly burdened, so to speak, but it's been fun and challenging both to be home and helping with the family. Golly, wives deserve so much more credit than we give them. It's so much more difficult than work.

There's a couple of other business that we're considering spinning up. We've already spun on up we're working on in real estate, and then it's so much fun to help other businesses survive and thrive and grow. Really, it's all about telling them all the things you did wrong.

Evelyn: Paying it forward is always great.

Trey: It's incredible. It's very gratifying to help out.

Evelyn: I guess I should ask though. Ultimately, you hired the banker, you went through the process, you made the sale. *You were happy with that transaction?*

Trey: I was very happy. Great culture, great fit. We did turn down the highest offer and so thankful we did. The offers weren't hugely different, but it was in fact the second-best offer on paper. In practice, the priority of keeping the culture and choosing was critical to us. Yes, it was a great financial outcome – but culture retention was key.

Evelyn: I think sometimes though that people are not quite as conscious of what they really want to have happen. That whole idea of “we need to have our culture in alignment or at least mostly in alignment, and trust being such a key factor, these are not generally spoken about by sellers. They may think it, but do not always focus on it.

Trey: Yes, it's really been incredible. There's been times where and candidly, you warned me about all the ugly monsters that could come out in the process, and you've been wrong a number of times on this.

Evelyn: I'm glad.

Trey: To your credit, we were prepared for them. I'm super thankful that they have not matured in the ways that they can.

Evelyn: Me too.

Trey: I think it's been abnormal because I know a lot of people who have sold their businesses and it did not go down this way. In our deal, because we valued our business, and because they wanted to see how certain we were and confident we were in our business, we rolled money back in at the time of sale to buy into the parent company that owns both companies. We're now on the board and very involved there, which is a unique experience, and eye opening, and very different culturally at the management team level, anyway. Once again, it's a huge learning experience and fun, and we'll see how things go in time. But it's fun to be a part of something in an exclusively strategic way, not operational at all.

Evelyn: You don't have to worry about that "day to day" anymore.

Trey: The day to day is gone. It's taken a little while to unwind from, "This is where I'm comfortable to say, "Wow, I'm really glad someone else is doing that." Honestly, I can say this, they are doing it better than we did it. It is incredible to watch how things have gone.

Evelyn: They're doing it different than you did it.

Trey: Yes. I would say just on paper, from an experience standpoint, the people our investment banking firm brought in, are experts. We were hacks that made it work and we were successful, but they are experts. To our credit, I think there are things that can't be replaced in terms of culture, in terms of how we treat people and those kinds of things.

Evelyn: Plus, you clearly built a great team because they are still with the business and they are working it. I've had a little bit of a view into that and I can actually see the professionalism rise, which is really cool. It's great to see how confidence kicks into people when they have a larger platform opportunity - where they can grow and perform beyond their past responsibilities.

Trey: Again, Christian and my big concern was “how are we leaving?” What's the legacy that we're leaving behind as we step away from day to day operations, and are they going to be okay. It all worked out. It worked for all the years we were in power. Now I think there are tradeoffs for sure. But they are getting opportunities now. Even when you get into these deals, it's not a once and done, it's the transaction.

Since we sold, now we own part of the company. We're owners in the company. We've made three or four more acquisitions. You learn even in that, that wow, we could have done that too. Why didn't we do that all these years? It was simply just lack of understanding. We're still learning. It's still so fun.

Evelyn: This has been great, Trey. Thank you so much for spending the time with us.

Trey: Absolutely. I would say thank you to both of you guys. We couldn't have done what we did without Trusted Counsel. It's been awesome knowing that when I call, you're going to say, "I know you're trusting. Just do it the right way and trust me this will work out. But you got to do it the right way." Our house was in order and we benefited greatly from that, so thank you guys.

**Lessons Learned**

1. Have a banker look at the business a few years prior to selling because he or she is going to tell you, “This is what people care about.”

2. The seller must be GAAP compliant when the seller

starts the process – and for a three year look back. Accrual Accounting.

3. Make sure your company is data driven – to be able to handle the financial process of the transaction – make yourself work (process wise) like your buyer.

4. Get your contracts in order: not just customers; employees, contractors & suppliers.

5. Know the impact of a transaction on owners if compensation is involved after the sale.

6. If leasing a building to the buyer, know and understand the change of market rates.

***Trey James*** *is a technology thought leader to the accounting profession. He's a speaker, CEO and now former president of Xcentric. Trey has been recognized as one of the 100 most influential people in the accounting industry by Accounting Today.*

## Selling the Externally Funded Company

A Conversation with
Peter Paglia, former COO and Chief Revenue Officer
of Onboard Security, Inc. sold to Qualcomm.

*Recorded in August 2019*
*(Part three)*

***"…work closely with your investors and Board of Directors to be sure expectations are set up front."***

Peter Paglia was the COO and Chief Revenue Officer of OnBoard Security, Inc., a cyber security solutions provider for automotive and IoT organizations. Peter led OnBoard's sale to Qualcomm Technologies Inc. (QTI) in 2019. He discusses the key factors that led to the decision to sell OnBoard, and a prior company Anritsu as well as the lessons learned from these transactions.

### Career Background

(Host)
John: Peter, before we jump into OnBoard's sale to Qualcomm, let's discuss a prior sale transaction you were involved with at Azimuth Systems. You joined Azimuth Systems in 2004, correct? Can you tell me where that company was at the time you joined them, since you eventually rose to CEO and raised several rounds of financing and then lead the sale of the business.

Peter: Azimuth was a venture backed company in the Boston area, funded by, at the time by two tier one VCs, North Bridge Venture Partners and Kodiak Ventures. We developed products and solutions that validated the performance and interoperability of wireless devices, networks, and services. Back in 2002 when the company was founded, Wi-Fi was really in its early stages of growth. The problem Azimuth was trying to solve was the inconsistent performance of Wi-Fi devices and networks. Similarly, many Wi-Fi devices were hitting the market at that time, and there was no standardized way for OEMs to validate the interoperability between devices.

Azimuth worked with industry leading OEMs such as Intel and Cisco, as well as standard bodies such as the Wi-Fi Alliance to develop solutions that tested the performance and interoperability of Wi-Fi devices, networks, and services. As you would imagine, it was a highly complex set of problems we were trying to solve, and as a result, it was a highly technical and collaborative sales process. I joined Azimuth a couple of years after it was founded and after the early stage investments to help lead the growth strategy for the company and to build out the channel footprint.

John: What was your role at Azimuth?

Peter: I initially joined in a sales role to run part of the international business and to build some of the major accounts. During the first few years of the company we remained focused solely on the Wi-Fi market. The challenge for us at the time was that Wi-Fi was a best effort service. Most of the products at that time were low cost retail devices, and there were only a few companies that cared enough about the performance to invest in the solutions like the ones Azimuth developed. While we had strategic relationships with companies like Intel and Cisco, it wasn't a broad enough market opportunity for us to get to profitability. We actually got to a point in 2006 where the company was losing significant money and wholesale changes were made across the management team.

In 2007, I was promoted to run global sales and strategy, and a new CEO was brought in by one of our investors to assess the business case. The CEO was not from the wireless market so he worked closely with me and the rest of the team to assess our strategy and go-to-market. What we decided to do, John, at that point, *was to pivot the business away from Wi-Fi and towards the cellular market, towards the emerging 4G standard that was being developed.* This was a larger opportunity where the quality and performance of everything we delivered was much more highly valued.

This pivoting of the company launched our growth, and for the next four years my role was to lead commercial operations. I ran sales, business development, the go-to-market strategy, and our partnerships. We grew our cellular business significantly.

In 2013, we were at a point where our venture investors were looking to sell the business because we were in portfolios that were at the end of their life and our venture investors were not raising new funds. We actually were very close to a sale in late 2013, but unfortunately the deal fell through. At that point, the Board of Directors asked me to step in as President and CEO. The former CEO who was planning to retire, stepped down at that point in time and became chairman of the board.

John: Was that something that you contemplated, that you thought that you one day might be the CEO of the company?

Peter: Yes and no. *The CEO and I had a very good working and trusting relationship. We complimented one another very well.* He included me in discussions with the investment banks, with strategic partners, and he also informed me that he was planning to retire in the not-too-distant future. *I therefore knew there was a* *succession plan being contemplated.* What I didn't know was if I was going to be put into that role before the company got acquired. So, at that point when the sale of Azimuth in 2013 did not go through, that was when the decision was made to promote me to the role of CEO.

**Factors to Decide to Sell Azimuth**

John: How were the conversations around selling the company? The funds had decided it was time to sell just due to their natural life cycle, but where was the company at that point? Was it ready to sell?

Peter: There were **three factors**, John, that was **driving the interest in a sale**; *1) Our lead investors were at the end of their funds, and no additional funds were being raised by them.* That was clearly a driving point for the sale. We could've continued the business with new investors, but there were a couple of other factors that we had to contemplate.

*2) We recognized that we were playing in a telecom market that was highly cyclical.* We rode the wave to 2012, 2013 where that market was in a growth phase, but starting really in 2013 and beyond, we were entering a saturation or transition phase of the market cycle. As a result, some of the natural acquirers for our business were actually becoming sellers themselves. Given the long sales cycle in the telecom space, we were faced with a declining number of potential strategic acquirers over the next handful of years. That created an impetus for us to consider a sale.

*3) We also had to take very seriously the fact that there was, quite frankly, a level of fatigue within the business, both at the executive level and at the board level.* Given the amount of capital that was put into the business in its early years, the market opportunity just wasn't large enough to create what I'll call venture level returns, the 10X returns that a venture firm is looking for, and the management team knew that. This created an additional sense of urgency to get a deal done.

John: Once you decided to sell the business, what were some of the things you *as CEO were thinking about with respect to the sale?*

Peter: The focus for me at that point was to *pivot the company once again*, but pivot more towards the next market opportunity that would *attract a strategic exit*. So, the first priority was to get back to our core niche. We had multiple product lines that we had built over the past several years, and by 2014, I decided we were going to *consolidate that product strategy and focus the company on its core brand.* Wireless performance was the core brand for the business, and I wanted to make sure it was recognized throughout the potential universe of buyers that we were going to get back to that brand.

*We focused on leveraging that core competency* and actually expanded it into adjacent markets where we could increase our universe of potential buyers. We were able to quickly tool up a new product line that was focused on IoT. It was a natural leverage point for us, and it helped broaden not only our market opportunity but that attracted a broader set of potential buyers.

We *then optimized our P&L and realigned the company so that we could demonstrate that our business would be accretive to an acquirer.* From there, it was essential that we had timely execution and that we had a pipeline of new business around these new ventures. I constructed some incentive plans for the entire company that incented delivery schedules and incented building the pipeline around those new market opportunities, and that helped us validate our strategy even ahead of a sales process.

At that point, as some of these initiatives were taking place, by 2015 I began the strategic outreach. I started to meet with prospective acquirers, started to discuss operational and the strategic synergies, and by early 2016 I connected with the company that eventually acquired us, Anritsu. We had a working relationship with them, with prior business in Japan, but we really started to engage more strategically with Anritsu in 2016 and generated sufficient interest from other prospective companies. We formally engaged a banker, and launched in the process in the Spring of 2016 that culminated in the sale to Anritsu in September of that year.

John: *You had already known Anritsu (the acquirer) before you engaged a banker.* You had a relationship.

Peter: That's correct. *The real value that our bank provided us at the time was to create that competitive process to engage other companies that we were not speaking to.* For the most part, given the relatively small ecosystem that we had in our business, we were either engaged with or at least knew the prospective buyers. In the case of Anritsu, I had a relationship with them that pre-dated the banker.

John: Was there any pushback on that from the board or maybe Anritsu said "Hey, we don't need to get any bankers involved here. We have a good thing going," or did you know exactly what you wanted to do? That this had to create a competitive market.

Peter: *The board fully supported it and they were in favor of bringing in the bank, primarily for the reason of creating the competitive process.* We were very upfront with Anritsu, for the reasons I mentioned earlier, most notably that the investors needing to end their funds and that we were going to launch a process. This was very much out in the open with Anritsu, and they were accepting of it.

John: You mentioned in 2013 there was a sale that didn't come to fruition. Did you learn anything from that experience?

Peter: Yes, there were a handful of things that we learned along the way. I'd say that the first thing to know is that when considering investments, there's always a question of how much capital a company needs to raise. Raising capital is time consuming, and if done too frequently, it's counterproductive to executing the business. So it's important to balance the capital raise to the market opportunity and to continue to test that market opportunity up against the business model to ensure that you can create increasing enterprise valuation overtime. One of the issues that Azimuth had in the first couple of years of its existence was that a lot of capital was brought in, which created a high level of enterprise valuation expectations. So you have to learn as you're running a business the idea of how do you balance the right amount of capital with the business opportunity. That's number one.

Secondly, it's critical to identify and construct the right strategic customer and partner relationships within an ecosystem. It not only helps you validate the business model, but it also helps to build sustainable value to a potential acquirer. We did this very well at Azimuth. Our partnerships actually created a pull through effect for our technology, and it got to the point where some of the potential strategics understood that the ecosystem Azimuth built was highly strategic and that Azimuth was very much in the middle of this ecosystem.

Thirdly, I'd say to make sure that the leadership team that's in place is able to scale to the opportunity and that the leadership team is aligned with the strategy for the business, particularly if the business has to go through a pivot. At Azimuth, we went through two pivots and they can be very disruptive if you don't have the right leadership team in place. It can hurt an M&A process, let alone hurt the business.

Lastly, it's incumbent upon the CEO to continue to understand and align expectations for the strategy of the company, the valuation of the company, and the timing of the exit with investors, and the board of directors. When I took over in 2014, we had very frequent conversations about valuation, exit timing, and strategy. Not everyone is going to agree, but the expectations need to be understood when you're driving a transaction.

John: You took a year to regroup and figure things out before you actually went to market. Is that correct?

Peter: Correct. From effectively the end of 2013 into the middle of 2015 is when we were focused on the product strategy and expanding some of the core competencies. We launched effectively a couple of product lines over an 18-month period that allowed us to begin to broaden the strategic interest we were going to get from potential buyers, and we did that really into the better part of 2015 when we started to do a strategic outreach. 2014 and 2015 were the years when we pivoted the strategy to focus on the next market opportunity, namely 5G and IoT, and that lead us to the M&A process in 2016.

**Joining OnBoard Security**

John: After the sale of Azimuth, you joined OnBoard Security as a Chief Operations Officer and Chief Revenue

Officer. What was interesting to you about that opportunity?

Peter: I stayed with Azimuth for a year after the acquisition, and after the one-year integration, I was doing some advisory work with companies in the IoT space. I was introduced to OnBoard Security by one of its investors. OnBoard Security was a 25-person company that developed IoT cybersecurity software. The company had built a very strong brand in the connected and autonomous vehicle market. The company was actually spun out of a larger security business before I joined. After some initial meetings with the CEO and the team, I became very impressed with the reputation and the leadership position that such a small company was able to establish with a large set of conservative buyers in the automotive market, and in markets, quite frankly, where safety and privacy were mission critical. The board was looking to bring on an executive that could scale growth across some IoT verticals, lead a series A investment round because they were looking to organically grow post-spin-out, and eventually succeed the current CEO that had plans to retire. So I believed in the opportunity, felt my experience was highly relevant, and I joined in 2018.

John: The CEO and COO positions are somewhat different, but even besides that, I think one of the things is that you went from working at a fairly larger entity to joining a 25-person company. How was that shift for you?

Peter: The problems might be somewhat different, but the speed of the business and what you're trying to accomplish is not so different. Azimuth was slightly larger, but even in the case of a 25-person company, there were a lot of expectations, functional roles within the company that have to be addressed. And so I'd say whether it's the COO or CRO for that matter, what's important from my perspective is to be able to translate strategy to execution. This includes product deliverables, acquiring customers, delivering profit, hitting revenue and profit targets, all of these things. Whether it's a 25-person team or frankly a much larger team, those are still execution deliverables that need to happen. So I've been fortunate with both OnBoard Security and with Azimuth to have a good relationship and rapport with the CEOs. I think it's essential that you have a complimentary relationship between the CEO and the rest of the executives.

When I was at OnBoard, the CEO and I worked very well together. We instantly understood how we complimented each other and how he was looking to me to help drive some of this operational execution. Similarly, at Azimuth, prior to my becoming CEO, I was entrusted to execute the commercial operations for the business, which made the transition for me to CEO much easier. So again, I'd say in both opportunities, my ability to define that strategy and then translate that to an execution plan for the business is what helped me be successful.

John: *OnBoard Security hired investment banker Growth Point Technology Partners* , a referral partner in this podcast series. It looks like you were at OnBoard for a year and you were brought in to raise a series A round. Were you expecting the company to sell so quickly?

Peter: No. When I joined OnBoard Security, we were planning to organically grow. The plan was to use the series A to fund the development and the commercial team. About 60 days into the series A process, we received a term sheet from a strategic investor that planned to lead the round. OnBoard Security went back out to the rest of the investors that were looking to participate, and through those discussions, we actually received some inbound interest from potential investors that wanted to acquire the business. That interest was coming from a wide variety of companies in the IoT space, including companies focused on the automotive market.

We had a board meeting and we discussed the options; do we move ahead with the series A, or do we pivot to a strategic acquisition? At that point, our primary market was automotive, and while our technology was designed into numerous pilots, we understood it can take two to three years to go from pilot to production. That represented a risk to the revenue plan. The board saw this potential risk, and the risk in their mind was that future valuations for the business could be affected if there was a delay in the time it took to get into production. If that happened it would affect subsequent valuations and subsequent investment rounds. At that point, the board decided to pivot from a series A to M&A. So we abandoned the investment route and moved to the acquisition path.

John: I imagine that you received from the strategic that made the numbers work overtime for you.

Peter: It was a compressed process for a couple of reasons. First, an investment process is very distracting. We had some customers that we were on the hook with to deliver solutions critical to our brand, and we didn't want to undermine that with a drawn-out process. Second, while we knew we need to raise capital, the time period was even more compressed than we originally thought. We needed to make some quick decisions around cashflow and we were fortunate that the term sheet resulted in inbound interests and that we were able to bring on investment banker Growth Point Technology Partners to drive the process.

**Hiring the Investment Banking Firm**

John: How did Onboard Security get introduced to Growth Point Technology Partners?

Peter: I was introduced to Growth Point by our board. I discussed with *Growth Point the market opportunity and the security space we were in. My initial feeling was they had a very good grasp of our segment within the overall security market. Security is a very fragmented space, but they had a good understanding of the business we were in.* They also had done transactions in similar spaces, so even prior to hiring them as a banker, we saw that they had relevant expertise.

I also felt that *Growth Point was realistic in terms of the valuation expectation for the business.* Again, going back to one of the earlier points that I mentioned - aligning expectations with the board, I thought that was critically important. Their market expertise combined with their aggressively realistic assessment of valuation are the reasons we moved ahead with them.

John: What were some of the things that you were thinking about with respect to this sale at that point? It seems like it was still somewhat early in OnBoard Security's life cycle.

Peter: When I joined Onboard Security, my first priority was to evaluate a couple of things. I evaluated whether our strategy for the business aligned with the growth projection, and also assessed how well the strategy would hold up even in an investment diligence process, let alone an M&A process. After that quick assessment of the current state of the business, I focused on preparing our investor deck. This included us refining the value proposition and updating our messaging around the market opportunity, the strategy, and the financial outlook so that we were very much becoming a valued commodity.

I also worked with the management team to develop a prioritized roadmap. There were a handful of things that were planned, but what we did was place a lot of effort into prioritizing the roadmap and the pricing strategy that ultimately would drive a larger opportunity for us in some of the IoT verticals we were addressing. Doing this enabled us to develop a five-year business plan and P&L that leveraged this newly defined roadmap.

Doing these things helped prepare us for initially an investment but ultimately for the sale of the business.

John: And what about from the financial perspective? Was the business being run as an early stage company, or because the business had spun out from a larger organization, did the business largely have those financial issues in order?

Peter: That's absolutely the case. One of the things that you look at when you spin out is that you are operating with sufficient capital based upon the operating plan that has potential downside risk. <u>*One of the challenges the business had was that there was certain market dynamics that were pushing out some of the revenue traction. This created tension on our cash that necessitated the acceleration of the investment.*</u>

**Due Diligence**

John: Excluding pricing and having the right financials that you've already discussed, what were some of the points that were key in the diligence process for supporting value?

Peter: Once we were working with Growth Point, we spent about eight weeks from October through November reengaging the earlier stage Series A investors, as well as reaching out to new potential buyers. There was a recognized sense of urgency on behalf of the interested parties created by the Growth Point led process. In fact, one of the differences between the discussions we had around investment versus acquisition is that the acquisition discussions became a lot more time based. That led to an increase in not only interest but it also drove a more competitive process. That was key, and it resulted in our achieving multiple offers that we began evaluating in the December timeframe.

*OnBoard Security wanted to select a company that not only strategically was offering a compelling offer but that was also aligned with the goal of the team. Our board did a very good job of trying to understand what the synergies were both from a talent perspective and from a product perspective, which led ultimately to our selecting Qualcomm.* We were going for the right strategic partner that was critical for success.

John: Did the employees of OnBoard Security know about plans to sell the business?

Peter: The employees knew that we were considering and actively investigating an investment round. Everyone knew that I was there to help lead that. So, when the situation migrated to an acquisition, we were careful as to what we were able to say until we were officially deep into an exclusive process. *The team knew we were raising capital but did not know about the M&A process until we were well into that process.*

John: How did you manage retaining talent and discussion once your team was made aware? That's a big fear right? That the team will find out and that some will be worried about their employment status and of course the idea of keeping a team intact.

Peter: Absolutely. I've been fortunate in both at Azimuth and with OnBoard retaining the talent because you're right, the value is very much focused on the people. I think there's nothing really elegant there that you can do other than being as open as possible, to let people understand that, "Look, there are a lot of opportunities. And the question that we have is not that we don't want to continue to grow the business, but what puts the company in the best shape to capitalize on the opportunity." In some cases, it is through some inorganic integration, and as long as the team trusts that they are integral to an acquisition, which typically in companies the size is the case, then you tend to retain people. <u>*You're always going to get people worried, but that's when you just need to make sure you're staying in close communication with every individual.*</u>

John: When you're going through a sale process, some acquirers focus on different things such as the idea that they're acquiring a company for its IP. Other acquirers focus on the market opportunity and maybe a first mover advantage. And then others, of course, due to the EBIDA and the money that the company generates. In your opinion, what should companies be focusing on before they go-to-market?

Peter: That's a good question. The diligence process was different in both the sales that I led. During the Azimuth transaction, the diligence was much more focused around the sales growth, the pipeline, and the forecast accuracy. Are you going to hit the quarter year end? The worse quarter to miss is the quarter when you're in the process.

John: Right.

Peter: That was a relatively commercially driven transaction. The OnBoard diligence, however, was different. It was more about the synergies that could result in increased revenue, an increased portfolio, or increased IP. You need to understand what the motivations are for the buyer. I don't think the valuation multiple would not have been tremendously affected in the OnBoard transaction if our revenue were slightly larger. It still came down to basing the multiple on the IP, the technology, and the team, whereas in some other transactions, as you said, if it's not instantly accretive, you're going to see that reflected in valuation. It depends on the motivation of the buyer.

John: It's interesting because you had a series A, and then an exit shortly thereafter. How did your team feel about the difference between the intensity of a preferred round versus an M&A, diligence and the transaction? That just seems exhausting, but also was it covering a lot of the same ground, or did they feel like one was significantly harder than the other?

Peter: Oh yes, the M&A diligence was significantly harder. In fact, during the series A, most of the work fell on the CEO and me. And even when it came to the M&A diligence, what we tried to do was initially focus the heavy lifting among the VP of finance, the CEO, and me. The expanded management team was brought in for technical and IP diligence. At that point the full team noticed this is a very time-consuming event.

John: You’re absolutely right, it is very time consuming to be involved in the sale of a business process. It seems like you prefer to keep it known among a few executives until it has to go to the broader management team or others. Has that process worked for you? Is that what you would recommend to others as far as limiting how many resources this takes away?

Peter: I would. Every situation is unique in terms of the level of urgency. We were at a point where we knew we needed to raise capital and we were getting to the point where that was getting critical. The management team was clearly involved in the urgency of the transaction. But in situations where that might not be the case, then to the extent you can limit the distraction, you want to do that.

John: *What are some things, having been through this a couple times, that you wish you would've known at the very beginning?*

Peter: As I look at both processes, I'd probably say three things. *1. First of all, make sure the market opportunity and the business model justifies the investment capital that you bring into the company.* It starts with that, and continuing to stress that business model.

The second thing that I previously mentioned is the *leadership team*. I think that's absolutely critical. Surround yourself with the team that can lead under these kinds of circumstances. For me, *I give a specific shout out to the finance person. I was fortunate to have a CFO at Azimuth and a VP of finance at OnBoard that were really essential. Without them, neither deal would have happened*. You've got to make sure more than any other role in my opinion, that the finance person is prepared to go through the diligence. In a small company, folks wear multiple hats and the finance person touches so much of the company making that role critical.

And then third, I'd say, again, *be sure to work closely with the investors and your board of directors to be sure the expectations are set up front.* We did a good job of that, particularly at OnBoard Security. We got the board involved frequently so that when we got to the stage where we were looking to pivot from investment to an acquisition, it was a relatively easy conversation.

John: Now that you have two solid business sales behind you, home runs, what are you up to?

Peter: I’m doing some advisory work. I've been advising and consulting growth stage companies that are really looking for help around the idea of defining strategy, then translating that strategy to go-to-market that scales. I’m also helping companies that are also looking at strategic investments. I'm seeing a lot of companies that are at the stage where they're trying to scale, and they're trying to find out if their business model will scale. Other questions they are asking include whether they are getting the right level of investment, and also what the strategic ecosystem should look like when they’re starting to think about an exit down the road. So that's what I've been doing really since March. It's been a ton of fun, and at some point I plan to take on a full-time operating role to help in these areas.

John: There's no lack of businesses out there that need that sort of advice. So that's a fortunate thing. Well, Peter, this has been fantastic. I loved hearing about your experience about how you've taken two companies now successfully through, and the things that you've learned to get there. This has been very enjoyable. How can our listeners can get in touch with you?

Peter: Sure. You can connect with me on LinkedIn. Go to: https://www.linkedin.com/in/peterpaglia/

John: Thank you, Peter.

Peter: Thank you, John.

**Lessons Learned**

1. Make sure the market opportunity and the business model justifies the investment capital that you bring into the company.

2. The leadership team is critical; you need a top-notch finance officer.

3. Be sure to work closely with the investors and your board of directors to be sure the expectations are set up front.

***Peter Paglia** is an entrepreneurial executive with a proven track record transforming strategy, building and scaling economy centric, high value business models, and leading strategic M&A at two venture backed organizations. He has a passion for solving complex problems, delivering scalable and sustainable and value securing, lasting partnerships and creating winning team cultures. Over his career, Peter has repeatedly built high performing teams, led organizations through growth and transformational phases, collaborated with business leaders, sold and integrated two venture backed businesses, both of which we'll hear about today. And these experiences have enabled him to appreciate what it takes to create a world-class organization, deliver sustainable value to the market and maximize company valuation.*

## Getting Your Legal House in Order

A Conversation with
Allen Bradley and Valerie Barton
Of Trusted Counsel (Ashley), LLC

*Recorded in July 2019*
*(Part four)*

**"You don't want to sell your business without making sure your house is in order…If you're thinking about selling your business, ask yourself, what is the buyer going to be looking for?"**

We all know the foundational requirements for selling a business for top dollar: consistent revenues, loyal customers, continued market opportunities—but often the legal elements of a strong business are overlooked. Partner, John Monahon, host of In Process: Conversations about Business in the 21st Century, is joined by Partner Allen Bradley, and Attorney Valerie Barton for a conversation about tight contracts, deep diligence, and balancing the legal priorities of buyers and sellers.

### About Trusted Counsel (Ashley), LLC

Trusted Counsel provides seasoned, practical and confidential legal services for businesses. We are a corporate and intellectual property law firm dedicated to serving the unique needs of companies, investors, and legal departments. Our focus is to guide and empower our clients with exceptional legal counsel, knowledge and tools that lead to practical, and informed business decisions. For more information visit trusted-counsel.com.

## Getting Your Legal House in Order

(Host)
John: Hello listeners, welcome to the show! I'm John Monahon. Today, unfortunately, we do not have our normal co-host Evelyn Ashley. But we are fortunate enough to have two other colleagues from our firm, Allen Bradley and Valerie Barton to help guide this conversation today. Welcome to the show you two!

Valerie: Thank you, John.

Allen: Thank you, John.

John: Today we will be discussing the legal side of selling your business. Allen and Valerie let's start talking about how attorneys can help their clients get their businesses ready to sell.

Valerie: From a legal perspective, what we're looking for are contracts that are in writing. It might sound a little bit frivolous to say, but oftentimes the contractual obligations our clients have aren't in writing or they're in a contract that hasn't been signed, or there is a contract with no date on it. For a contract to be enforceable, it's going to have to all those elements in the document. If you're thinking about selling your business, ask yourself, "What is the buyer going to be looking for?" *What the buyer is going to be looking for are enforceable and binding contracts meaning that they are tightly drafted. And it needs to support the seller's recurring revenue without creating long term liability as well.* For example, you would not want to place in your contracts that you're going to warranty everything about your services or your products, or your warranty needs to have a definite timeframe. It can't just last in perpetuity.

John: Recurring revenue is important and often times, businesspeople who don't have legal advisors sometimes overlook the idea. Businesspeople know that it's an important part of building value in a company, but they don't pay enough attention to their contracts. For example, sometimes contracts are year to year. If that's the case, then the deal can be easily terminated**.** *What a buyer really wants to know is, "Hey, there will be a certain amount of revenue contractually for a period of time."* The buyer would love to see is if there's some longer-term commitment. Those are things that buyers look for in diligence.

Valerie: Exactly. I think the problem is that oftentimes if the seller has a long-term relationship with a customer or a vendor, the seller is perfectly comfortable letting the relationship go month to month, and the seller is comfortable because of the relationship. *But when a new buyer comes in, they're going to think, "Wow. I don't have that relationship. They will ask themselves, "How can I sustain this if I don't have a contractual obligation*."

John: It's all about making the new buyer comfortable. The better your contracts are from an enforceability standpoint; it reflects upon your business. If you're doing things right in the legal way and signing customers up the right way and have the right paperwork, that also reflects in how you're probably running the rest of your business.

Valerie: It's kind of like when you're buying a car. If you plan to sell a car, you wouldn't put the car on the market without washing it, cleaning up the engine, vacuuming it and so forth. So similarly, you don't want to sell your business without making sure that your house is in order.

John: One thing that our firm Trusted Counsel reviews all of the time is the idea of intellectual property ownership. For example, whether the seller obtained all of the work assignments needed from their employees and their independent contractors to own the intellectual property. *Unless there is a work assignment to the company for the intellectual property, an independent contractor is often the rightful owner to certain intellectual property it develops—even if the company paid the contractor to create it!*

I think also, Valerie, another item that buyers look for from sellers is restrictive covenants on key employees.

Valerie: Right because the acquirer is buying a company. Oftentimes, I see buyers buy the company and want to keep the staff for continuity. But if the seller has employees or contractors that have been working for them for a long time, the seller may not have bothered to put agreements with competitive protection provisions in place. Again, kind of like the other kinds of contracts, you have relationships but you don't have them documented. When a buyer is coming in to buy a company, the buyer needs to have assuredness of post-acquisition continuity.

John: A classic example is when the seller has some key salespeople who have great relationships with the seller's top customers. If the salespeople are not under a non-solicitation agreement, they could leave after the sale of the business and take customers' business with them. That is why restrictive covenants, non-competes, and non-solicitations are very important to a buyer.

Valerie: One other thing a buyer's concerned about is being able to maintain their employee base. If the seller hasn't done a so-called non-recruitment provision, that employee that you just talked about could also leave and recruit other employees to go with them.

### Tax Aspects

John: Allen, what should a seller look at from a legal and tax perspective when they're getting ready to sell their business?

Allen: *One of the first things, John, is to look at whether the company is structured as a C corporation or a pass-through entity such as an S corporation or an LLC. There's a big tax penalty associated with being a C corporation which is two levels of taxation. One tax is when the C corporation sells the business, the second tax is when the proceeds of the sale are distributed to the shareholders.* That's why in the vast majority of the cases of private companies, nonpublic companies are passed through entities. Either S corporations or LLCs.

Valerie: Allen can you explain to our listeners what a pass-through entity means?

Allen: It means that the income and loss passes through from the entity to the owners of the business. The owners pay tax on the income of the business, but again taxes though to only a single time as opposed to twice when you have the two levels of tax in a C Corporation.

John: So if you're taxed as an S Corporation or let's say as a partnership, you're a pass through, but a C Corporation is not?

Allen: Correct. And most all public companies are C Corporations, and again most all private businesses are pass through entities.

Valerie: What about limited liability companies?

Allen: A limited liability company is a pass-through entity, so there's only one level of tax. At the end of the year, the owners of a limited liability company will receive what’s called a schedule K1 and they pay taxes on income of the business.

Valerie: What if they don't receive any money on the income of the business? What if they don't receive distributions?

Allen: The tax is still owed. It's important to recognize that if the management of the LLC decides to hold back the cash and make no distribution, tax is still owed. Tax passes through them on that schedule K.

Valerie: So businesses need to be careful about the offering agreements that are signed for their new limited liability company?

Allen: Right. And those offering documents need to be in order. We discussed that a little bit earlier about making sure that the paperwork is in order before the business decides to sell. But that's one of the provisions in the offering agreement typically that you see-- a requirement of the company to distribute cash to allow the owners to pay tax.

John: There was a big tax overhaul not so long ago actually. Before that overhaul, the general advice was to form an LLC rather than a C corporation. Does the old advice still hold true?

Allen: I think the old advice still holds true even though the corporate rate was vastly reduced from 35% to 21%. The main target of that benefit was public C corporations. Small companies viewing the two levels of tax still prefer the pass-through entities even though the C corporation tax has been reduced.

John: Right. I think we continue to see at Trusted Counsel that clients still tend to think that the pass throughs are still the right way to go.

Allen: Correct. To harken back on your discussion about employees, oftentimes S Corporation, the principles who are the shareholders are also employees of the S Corporation. And the old game is to pay the employees reasonable compensation and pay employment tax on that, the 3% self-employment tax that goes on forever. Try to reduce that through moving some of the compensation to distributions that are taxes dividends and therefore there's no employment tax on that, what's passed through is the distribution.

**Corporate Agreements**

John: When we go to sell a company, the buyers ask for all the minutes and passed actions of the shareholders and the board. What are they looking for there, Valarie?

Valerie: Usually what I'll hear that will transpire between a buyer to a seller will be the following conversation. "Do you have your board minutes? Do you have your shareholder's minutes?" And the seller will answer something along the lines of "Well, it's just me and my partner Bob running the company." The idea here is that sellers need to understand the importance that the buyer will be looking for the formality of contracts to be enforceable and to be in writing. For example, let's say at the beginning of your company existence you (the future seller) initially have four or five employees working for you. Then over time, these employees move on and decide to leave the organization. If your business does not do the documentation to explain their exit, such as the new chain of title basically to their ownership, you the business owner won't be able to prove to a buyer that you actually own the shares that you say you own. Going back to my earlier point; a buyer will be looking for certainty in what they are buying.

John: We often hear business sellers say comments such as "Oh, no. I wouldn't worry about ex-employee Jim or Sally. They're cool." Well think about it this way, now you, the business owner, are in a position where you are going to be selling your business for a lot of money.

Valerie: Yes, exactly. You just made $10 million, I think Sally might come back over and ask you about it.

John: I think one thing that is sometimes surprising to a seller, is the actual vote required to buy or sell a company, and the seller's ability to affect that sale. Allen, can you tell us what drag along rights are as far as forcing someone to sell?

Allen: *If a buyer is buying the equity interest, whether it be stock or membership interest, can the majority holder who perhaps negotiated the transaction require a minority person to sell his or her shares, and the drag along clause says, "Yes, we can require you to sell if the majority of the people that own equity interest desire to sell."*

Valerie: So if a seller has a minority holder, say for example that somebody owns 10% of the company, and the seller's got a great deal on the table to buy its 90%, the seller doesn't want the person holding 10% to be able to hold the deal hostage. A drag-along provision solves for that scenario.

John: I think that's surprising to a lot of people because they think that just because they have majority control that they also have the ability to do whatever they want, which of course is not always true. The other thing we find sometimes is if that depending on the corporate documents, voting percentages are not always consistent with ownership percentages.

Valerie: It's not just that it's the big guy against the little guy though. <u>*There's something in addition to a drag-along called a tag-along, and what that means is if the majority holder is selling his or her stock to a buyer, then the minority holder can tag along and put their stock in the mix at the same pricing that the majority holder is going to own.*</u> You can do these protections in both directions just for both majority and minority holders.

John: Absolutely. And then of course the final thing that a good shareholders agreement should determine what happens in various scenarios. If someone leaves, and they are supposed to be someone who is active in the business, how do we buy their ownership back? How can we force this person out? What if an owner commits a felony?

Valerie: Yes, life happens and people go through phases in life, they could get a divorce, or begin to receive disability benefits because they are injured on the job. <u>*All sorts of events could occur where especially if you have employee shareholders, you're going to want to be able to transfer the shares either back to the corporation or to the other holders so that you can deal with the gap.*</u>

**Agreements for Management Post-Sale**

John: What can a selling company put in place to ensure that the management team will stay on after a sale or acquisition?

Valerie: Well, one thing people may not realize is if you're selling the stock in your company, chances are that the buyer is going to want you to stay on board so that you can continue running the successful company that you're selling in the first place. But at the same time, the buyer will demand a non-competition from you, something that tells them that you're not just going to set up shop after you've left them and start competing with them again.

Allen: Also, in addition to the restrictions, sometimes buyers want to use golden handcuffs, which is what we call a change of control bonus or accelerate stock options.

Valerie: Can you explain that a little bit?

Allen: That means typically that stock options have a vesting schedule, and we accelerate the vesting so that the key person can exercise that option on the date of the acquisition as opposed to having to wait. But there are tax issues with those golden handcuffs. And one is actually called the golden handcuff excise tax, the tax on what's or parachute payments. There are ways to work around that, but again it must be considered because the excise tax is imposed on the individuals and the company are excessive.

John: I think for the employees that are rank and file, we see the opposite sometimes in that the employee incentives do not accelerate immediately, so that the employees do not immediately upon a change of control get a lot of money. The employees must stick around and work and continue to vest to get that ownership, and then they'll get the benefit from the sale.

**The Selling Process**

John: What are some key points about the sale process that sellers should be educated on that maybe that they're not aware of?

Valerie: Sellers are going to have a second job in addition to their day job. A seller needs to realize that it's going to take a substantial amount of their time to negotiate and actually consummate a purchase or sell of a company.

John: And that's one of the reasons you engage professionals who have a sense of this, who can work the process out on your behalf.

Valerie: Well, by the same token, as a buyer is investigating a seller, the buyer learns a lot about the seller's company. <u>*As the seller, you must be careful about confidentiality and about revealing your own trade secrets or your other intellectual property to potential a competitor.*</u>

John: What's the team of advisors that sellers should have in place?

Allen: Typically, it's accountants, attorneys, and sometimes there's an investment banker involved to help negotiate things like price and finding a buyer. Those are the three key groups. The attorneys, the accountants, and the investment bankers.

John: I know that sellers are sometimes apprehensive to hire bankers, but the good investment bankers that we know justify their fees. Statistically speaking, people are horrible negotiators on their own behalf.

Valerie: Listen to this scenario that often happens in real life. A client will receive an offer for their company out of the blue, say for $10 million. And so I'll get asked, "That's great, isn't it or is it? How much is my company worth?"

John: Right.

Valerie: How much do you want? How much do you need?

How much do you need to do an exit? How much do you think you have invested in your company? And so an investment banker is going to help you talk through all of those issues and come back you with a reasonable number. Investment bankers know the market. They can help sellers to determine what is a reasonable valuation.

John: It's important to rely on professional advisors beforehand so that you have this network of people that can refer you to other people that are familiar with the process. Okay, moving along, what's the timeline as far as the sell?

Valerie: It depends on whether you're starting the process as in 1) getting the legal house in order, and then 2) identifying what you the seller wants to do post sale. By this statement, I mean that some sellers will want to retire. Other sellers will want their children to inherit their business. Another option might be that the seller may want to stay with the business for five years, do a five-year plan, and then slowly but surely work their way out of the business. The business owner must think in advance, "What do I want? what do I truly want out of this?" As the owner, you must think about what your needs and desires are for the future.

The process itself with investment bankers (once they are engaged) can take days, it could take months. It could take a year. It just depends on what industry you're in, how good your business is, and is your house in order? And is the investment banker readily able to identify buyers for the seller? And I think the third part is as Allen said that the accountants must become involved because unfortunately, we often get a deal put on the table, and no one's looked at the tax implications of that transaction.

Allen: A final point on the accounting front is that most small businesses keep their books on the cash basis, and as we've found that many of the larger purchasers want to see the numbers on the accrual basis. And so that gets into your issue, John, of that recurring revenue. Even though a seller got a cash payment this year, the seller may not get to include all that payment as income under the accrual method, particularly if the contract imposes liabilities on the company. It's important to understand how much the seller's revenue is going to decrease if it has to switch to the accrual basis.

John: Everyone knows that due diligence is part of the process. Diligence may support the price, but we also see that price negotiated if the diligence doesn't work out very well.

Valerie: Exactly. Diligence identifies liabilities. *One thing that will reduce your price very quickly is learning that there's a lingering litigation issue out there, there's an employee claim somewhere. Those things will reduce the valuation of your company as well.* And you need to identify all those in advance so that you're not surprised and the buyer is not surprised.

**Phases of a Transaction**

John: Okay, let's talk about the actual nuts and bolts of each stage. Valerie, can you provide us a roadmap to the typical phases of a transaction?

Valerie: A seller may come to us and have a desire to sell, in which case we'll find an investment banker or an advisor to work with them to prepare for sale. Or it may be that the seller already received a letter of intent and we're now in a position to respond to it. A seller needs to ask itself, at the point it has been approached, "Do I want to do an auction? Do I want to open this up to a broader group of potential buyers so that I can get a competitive deal?"

After that, one of the first things the seller needs to be concerned about is confidentiality. We mentioned before that buyers oftentimes want to acquire their competitors. They're going to be looking at the seller's intellectual property. They're going to be looking at the seller's employment agreements, contracts with customers, and a list of customers. They're going to be looking at the seller's financial statements. A nondisclosure agreement before a seller starts the conversation is critical to protecting the business that the seller has.

The nondisclosure agreement is a relatively short two to three-page document that can save you a lot of headaches and a lot of heartache. Before a seller is purchased, the buyer is going to want to do some diligence. A seller does that under the nondisclosure agreement, but <u>*the seller needs to be very careful in limiting as to what information it is going to impart before it signs a letter of intent.*</u>

Doing a letter of intent is critical and having the seller's lawyer involved during a letter of intent stage is also critical. <u>*As attorneys, we have received signed letters of intent (which weren't reviewed), and we've looked at them and thought, "Oh wow. We really could've impacted the deal terms. We could've impacted the process.*</u> They didn't think about taxes." All sorts of things that just come to my mind right now.

A letter of intent is to have parties negotiate and principle the big-ticket items for a buy or a sell.  You're talking about the price, whether employees are going to stay or going to go. Are you going to do an asset or a stock purchase? There's a lot of different elements that a seller could pre-negotiate before drafting definitive agreements.

Valerie: Next, after the seller signs the letter of intent, the buyer is going to do a deep dive into the seller’s company. When Trusted Counsel does due diligence on behalf of a buyer, we review a number of items; the seller contracts, their financial statements, intellectual property, and trademarks if they own them. We follow-up with questions such as are the trademarks registered? Does the seller have licenses that are appropriate for the software that they're using? Does the seller own property? Does the seller lease its property? Are there environmental problems? These are all things that we look at in the deep dive to make sure that the buyer is getting what they are paying for.

John: What happens after diligence?

Valerie: Once through the diligence stage, and everybody's still happy and ready to proceed with the transaction, it’s up to legal to draft definitive agreements that memorialize everything that the seller has been negotiating. It can be one agreement, the purchase agreement, or it can be 10 agreements, depending on how complicated the deal is. So once legal has drafted definitive agreements and everybody's signed them, the deal will close. The next step becomes post-closing integration.

John: Sometimes there's what is called an earn out in a deal. Can you talk a little bit about earn outs? They get a bad rap. Is it deserved?

Valerie: Do they have a bad rap? *I like earn outs. I think are actually great because they let a lot of deals that otherwise couldn't be done get done*. However, you have to be careful how you define them. Where people get into big negotiations about earn outs is how you're going to calculate it. If you're going to calculate it based upon net income, income after expenses, well that new company's going to control expenses. The buyer is going to control allocations of overhead. The buyer is going to control your accounting expenses and whether they keep the seller's staff. Maybe the buyer doesn't keep all your sales staff, and you can't hit the numbers. *You really do need a good lawyer to negotiate a good earn out provision, but a seller can protect itself and achieve a deal that might not otherwise occur.*

Allen: Valerie, I think from the seller's perspective, to keep it as simple as possible is important. Any complicated calculation goes to the benefit of the purchaser to make it very difficult to ascertain whether the amount paid is a correct amount.

John: So, Allen, let's turn to structures now because well, tax is a hard thing. We'll try our best to…

Valerie: Keep up.

John: Yes. But let's start with some of the basics. What's the legal difference between a stock sell and an asset sale?

Allen: *The asset sale is when the buyer buys the business, the assets of the business and the workforce. A stock sale is when the buyer purchases the legal entity, whether it be an LLC or a corporation.*

From a tax perspective, there's a huge difference between the two. *For example, when the buyer purchases the assets of a technology company, the large part of the purchase price goes to what's called goodwill, and as a tax attorney, I'm able to amortize that goodwill and create a deduction that reduces the taxes every year going forward for 15 years. But if the buyer does a stock sale, the buyer doesn't get that* *goodwill asset and the ability to amortize it over 15 years.* So that means that essentially if I work on a stock purchase, unless I make some of the special elections we'll discuss later, I end up using in effect after tax dollars to buy the business while by doing an asset purchase is before tax dollars. So that's a big difference in cost to the purchase.

Valerie: Well, in your experience, does the buyer seek to do one versus the other as opposed to the seller wanting to do one versus the other? Is there a preference?

Allen: Typically, the preference is that the purchaser will want to do an asset purchase, and the seller will want to do a stock sale. From a business standpoint, if the seller sells their assets, the seller then must go to their customers, get their consent to what's called assignment of the contract to the new purchaser. And that's difficult particularly if who they are selling to is a competitor because that means that the seller’s competitors are talking to the seller’s customers before the closing. *Most sellers prefer to sell an entity in which an assignment is not needed, and most buyers want to buy assets because they get the benefit of the tax depreciation. Plus by buying assets, the buyer is not assuming all liabilities. So that's a big issue for small private businesses, the idea is to avoid assuming old liabilities.*

John: If you have a buyer and a seller, and they have different goals from a tax perspective, who gets to dictate the structure?

Allen: Typically, the buyer dictates because the buyer is the one that has the money.

Valerie: Let's talk about an example that came up recently at work. Allen educated me about a 338(h)(10), which is a great way of saying it's a tax code provision that I’m not familiar with. So, what is a 338(h)(10) election mean?

Allen: Again, it's very specific to the transaction as to whether or not it can be used, the 338(h)(10). But, basically if a seller is an S Corporation and the purchaser is an S Corporation, the buyer can buy the stock. But for tax purposes, it's treated as an asset purchase so that the purchaser can amortize the goodwill and depreciate the assets on a new schedule based on the purchase price.

Valerie: And you said that you amortize goodwill over 15 years. That's a huge tax benefit. When we've had that tension between the buyer and the seller and the buyer wants to do the 338(h)(10) election, we've actually had the seller ask to share in some of the tax benefits the buyer's going to enjoy.

Allen: Correct. I've seen this in the past before. And many times the benefit of the tax deductions allow for the purchase price to be in a range that is acceptable to the seller.

John: In addition to the 338(h), there's also 1202. That's a possibility that could be taken advantage of in a stock sell correct?

Allen: Right. The 1202 benefit, for example, has been around for decade, and it applies to a specific situation. Typically a C Corporation. Many of our clients are not able to take advantage of it, but in some cases it does apply. It allows the seller to exclude the gain on the sell.

John: That’s the importance of getting good advice before the letter of intent. “How can we structure this to save tax? Valerie, as you rightly brought up, maybe a deal gets done that wasn't going to get done. We saw that recently when Allen came up with a nice tax structure that helped solve the gap in value between two companies through savings, and the deal was able to get completed.

### The Letter of Intent (LOI)

John: What is a letter of intent?

Valerie: *The letter of intent is going to set forth the terms and conditions of the transaction to buy or sell a company.* It's going to have line items such as the purchase price. It should also have a number of other items in it such as how the purchase price is going to be paid, how much is going to get paid at closing? How much is paid in the form of an earn out down the road? Whether there is any deferred compensation. Will the key employees be retained or will they go? Do you anticipate hiring everybody? Will the executives or the owners of the company have a leadership role in the post-closing entity? And what will their compensation package look like?

If you're selling your company, the big part of what you're going to receive (Allen and I just counseled a client in this respect), is not just the dollar amount that you're going to receive. It could be the dollar amount that you're going to receive plus a certain amount of equity in the newly formed company, but also what your compensation is going to be once you work for them over the longer term. All of those things will be set out but some other things like after you sign the letter of intent. Oftentimes the seller is then locked into negotiating with that buyer exclusively for a period of time.

John: Are letters of intent binding or non-binding agreements?

Valerie: *The purchase price, the earn out, whether you're going to buy rollover equity or something like that- those provisions are typically non-binding. But the things that are binding include the exclusivity provisions --so for a certain amount of time you're going to keep your shop off the market-- and the confidentiality provision.*

John: Right, and I think you'll also see some items in there, sometimes you'll see a breakup fee that might be negotiated. And also which party pays the attorney's fees at closing, which could be very important.

Allen: I think it's important to note that, even on the non-binding aspects of a letter of intent, such as the purchase price. *The letter of intent certainly sets expectations. Rarely is it that the seller can negotiate a higher amount after it is signed.*

Valerie: Right. I recently received a letter of intent that had been fully executed by the time it reached Trusted Counsel, and then there was some talk about trying to renegotiate the price. And you're viewed as backpedaling, a bait and switch, that sort of thing. Even though you could've gotten more value out of the transaction had we been involved sooner.

John: It just feels like a lot of opportunities are lost by that point (if the letter of intent wasn’t reviewed before signed), which is why it's so frustrating because there's a lot of areas where we could improve a situation and maximize and improve the deal. As Allen said, expectations are a little bit set there, whether it's legally binding or not.

**Buyer versus Seller Goals**

John: What's the goal of the buyer versus the seller in the due diligence phase?

Valerie: I tell our sellers to reveal as much as they possibly can. I'm a firm believer in over disclosure. You really do want a buyer to come in and know exactly what they're buying. And that's what they're going to be looking for, documentation to show that the seller has its corporate house in order, it's finished its board minutes, its finished its shareholder minutes. The seller should keep track of who owns what shares of the company, and that it does own, in fact, everything the seller says it owns. That's on the plus side.

Then on the liability side, the buyer's going to be assuming liability for all those contracts in addition to assuming when the contracts are assigned to the buyer. They're going to get the benefits, but they also get the obligations. The buyer is going to have to thoroughly understand everything in the seller's business.

John: In some transactions, the seller has to substantiate their revenues as well, right?

Valerie: You have to be prove it.

John: And sometimes we're not ready to reveal at a certain point which customers are attached to what dollar figures of revenues. Sometimes we have customers redacted until we're very close to the end of the deal. *Also, one of the extra steps of diligence for technology companies is that there's a source code review. We're quite careful about that. We put a very specific NDAs as to how the buyer is going to review it, and under what circumstances the buyer is going to review it.* Sometimes we say, "Well, you will not get a copy of the source code. You can fly down to our location. We will have somebody in the room who will be with you, and you can review it there."

What are some of the major issues in diligence that can completely kill a deal?

Valerie: The biggest deal killer that I've found in my practice is when the buyer simply doesn't have the funds. I've actually gone to a closing table before, gone through all the negotiations, the diligence, the whole nine yards, and then I'm called by buyer's counsel and I'm told, "I'm sorry, my client doesn't have the capital." So you need to make sure as you're negotiating with the buyer that they've got the financial means to actually do the deal.

*Another thing that will slow things down is obtaining the assignment of customer contracts which require consent of the customers.* When do you actually have the customer learn or become aware that a transaction is even going on? Nonetheless you ask the customer's permission to be moved to the buyer. These things can all cause tension between the buyer and the seller because you've got competing interest. You want to protect yourself. But you also want to protect the deal. It's difficult, and it can cause delays.

John: I have something that is not a deal killer, but rather a symptom of a dying deal. Momentum. *You can almost sense when it starts to lose momentum. It's an indication that it's probably a deal that is not going to be successfully completed or that someone needs to step in to revive it.*

Valerie: Time kills deals.

John: What are some negative effects of a poor diligence review?

Valerie: From the buyer's perspective, the buyer sets a price based upon projections, what the earnings before interest and taxes are going to be. The buyer made it a multiple of that and decided that's the value of the company*. But until the seller makes it through the diligence stage, the buyer doesn't know if the information that the buyer has is true and complete, and the buyer may find the buyer wants to take deductions* because the 10 customers that are the seller's top 10 customers don't have a contract, or their contracts have gone to be monthly recurring contracts, just month to month, that could be terminated at any time. And that might cause the buyer to actually want to reduce the purchase price.

John: Right. And what about representations of warranties in the definitive agreements?

Valerie: Let's explain reps and warranties first. Just briefly because this is going to be two thirds of your purchase agreement's and it's so integral to both the seller and the buyer. The seller's going to say, "I own this company. I own this stock. I own the title to the assets. I own the real estate. I have these contracts, and these contracts are in force." *The seller is making all these representations, and then warranting that that information is in fact true.*

*So post-closing, what the seller opened itself up to as the seller is an indemnification obligation to the buyer.* What the seller is saying is, "I'm guaranteeing you for a period of one year, for a period of two years, after the closing, that everything I've told you is true, and I'm putting my money where my mouth is. We're going to actually maybe set some money aside in an escrow account." Typically, anywhere from 5-10% of the purchase price can be set aside to satisfy indemnification claims. The seller is giving the purchaser an insurance policy to say that, "Yes, I spoke the truth when I told you that I own the title to the assets." Representations and warranties cover intellectual property, customers, vendors, and really important things like employee relationships, employee benefits, employee pay, and taxes.

Allen: It's important to recognize that in most of our seller representation, both the company and the individual owners sign the agreements and have liability for the representations and warranties. There's individual liability for those reps and warranties that were just described.

John: This has been a lot of fun. This has been a great overview about how to prepare a business for sell but then also the selling process as well.

**Lessons Learned**

1. Sellers need strong written contracts with its customers, vendors, and employees that support the seller’s recurring revenue and operations well after the transaction is closed.

2. Sellers should review their shareholder or operating agreements to determine their rights to approve a sale of the company and to obligate each owner to participate in the sale.

3. It is important to identify and mitigate potential liabilities prior to starting the process of selling a business. If not, these items may appear in due diligence and result in a decrease in valuation or termination of the deal.

4. The letter of intent sets expectations, even if non-binding. To maximize value and minimize taxes, it is critical that sellers involve their attorneys and accountants to review the letter of intent before it is signed.

***John Monahon*** *is a Partner at Trusted Counsel. He serves as corporate counsel for high growth technology and middle-market companies. John's practice focuses on advising companies on matters pertaining to corporate finance, technology agreements, and mergers and acquisitions. He has significant experience representing venture-backed and private equity owned companies.*

***Allen Bradley*** *is a Partner at Trusted Counsel. He focuses on corporate and technology law; corporate finance and private securities; corporate and partnership tax; executive and other nonqualified compensation; corporate and individual real estate (1031 exchanges) and wills, trusts and estate law. He is involved with renewable energy and sustainability initiatives and has assisted clients with obtaining federal and state grants and other subsidies with regard to renewable energy projects. He also represents clients in the healthcare and hospitality industries.*

***Valerie Barton*** *is a corporate, mergers & acquisitions and intellectual property attorney. In 2019, she became a certified Exit Planning Advisor and received her certification from The Exit Planning Institute. She has wide ranging experience counseling clients from the start-up phase (including the selection of the optimal entity structure and the creation of a pragmatic workable governance model), to the formative stage of managing the business, creating employment and independent contractor arrangements, negotiating commercial transactions and joint venture arrangements, procuring angel and seed funding, through to the strategic investment and venture financing rounds that support the latter stages of corporate growth. She understands the evolution in her clients' legal requirements, tolerance for risk and negotiating position that comes with each stage of growth. She works to advise, manage and balance her clients' unique needs, goals and expectations. She has spent much of her practice focused on planning and managing short and long-term exit strategies, whether implemented by mergers, acquisitions, corporate spinouts, equity rollovers, reorganization or various combinations of the above.*

**Trusted Counsel**
**Transaction Goals for Business Sales**

We recognize that a business sale is an important and complex decision for every seller, whether founder/operator of professional management/boards/shareholders. As legal counsel to a seller, our goal is to provide value throughout the process. The following is a brief overview of our goals in a business transaction:

- **Assist in Developing Transaction Team.** Not every seller has the right professional team in place for an exit. We can assist with top notch and experienced wealth advisors, accountants and investment bankers (and the negotiation of your agreements with them) to help you develop a business and personal plan to assist you in getting the business "ready" for sale.

- **No Binding Commitments.** We seek to limit the seller's legally binding commitments to the buyer until due diligence is performed and definitive agreements are executed.

- **Valuation.** We seek to ensure that the valuation for the business is supported by the underlying assumptions of the acquisition as well as the prospective value to the buyer. The valuation may be affected by matters discovered during due diligence, such as contingent liabilities, accounting issues, material adverse changes to the business, and the quality of earnings. These matters are sometimes significant enough to cause a buyer to negotiate a reduction of the purchase price (or to hold back a portion of the purchase price).

**Acquisition Structure**

- **Liability.** There are significant differences in the legal consequences and complexities of selling a business via an asset sale or an equity sale. We seek to limit the seller's legal liability for past events by selecting an appropriate acquisition structure, obtaining limited indemnifications, and structuring suitable "baskets" before seller liability commences, caps on liability and limited escrows to help sellers sleep at night!

- **Minimize Tax Consequences.** We seek to minimize the tax impact of the transaction on the seller. Each transaction is reviewed to determine if an alternative structure may result in a reduction of the seller's tax liability in a practical manner.

- **Diligence.** We seek to provide the seller with a complete picture of the business. We recommend a full analysis of the critical components of the business, such as title to assets, liens on assets, transferability of revenue-generating contracts, and potential liabilities in order to make sure the Seller's future potential liabilities from the business are limited.

- **Strategic Negotiation with Collaboration.** Every transaction and every seller are different. Our philosophy is to provide you with the tools and information to provide knowledge of issues, assist in determining a hierarchy of importance in their negotiation and managing the deal with action consultation from the seller and their other professional advisors.

- **Consulting or Employment with the Buyer.** We support and assist in structuring the seller's decisions for future consulting and/or work with the buyer.

- **Post-Closing.** Depending on a transaction's structure, we will provide you with continued assistance after the deal has closed to navigate any post-closing ownership, compensation and benefits as well as escrow support.

**Trusted Counsel**
**Typical Phases of a Sale**

From a legal perspective, Trusted Counsel breaks down a business sale into four (4) phases, once the client is ready to proceed:

**Phase 1:**

- Enter into an investment banker representation agreement
- Preparation of financial information and basic diligence materials of seller for clean up (if necessary) and delivery to seller

**Phase 2:**

- Prospective buyers: Enter into seller developed mutual non-disclosure agreement

**Phase 3:**

- If seller and buyer decide to proceed, basic terms, including the expected purchase price and structure of the transaction is reflected in a letter of intent. The letter of intent typically includes a “no-shop” to prevent seller from attempting to find another deal while buyer does “deep” diligence and proceeds toward a transaction.

**Phase 4:**

- Conduct M&A due diligence. A detailed diligence request document is submitted to the seller, and buyer’s team performs an extensive review of corporate structure, agreements, intellectual property ownership, and clear identification of the assets and liabilities of the seller, as well as potential liabilities to be addressed as part of the deal. Determination of firm purchase price and definitive structuring. Seller’s counsel and seller must be prepared to address all questions and address issues from seller in order for the transaction to proceed – and to support the seller price and deal.

- If proceeding to a definitive transaction, receipt, review, negotiation and closing the transaction with buyer (see checklist for more detail on possible documentation). Buyer drafts most documents. Seller is responsible for ‘schedules’ to the purchase agreement which discloses issues in the business with intent of reducing future potential liability.

**Trusted Counsel - Sample Transaction Checklist**

| Document/Action | Responsible Party |
|---|---|
| Confidentiality/Mutual NDA amongst parties | S, SC, B, BC |
| Preliminary Diligence | B, A |
| Letter of Intent | S, SC, B, BC |
| M&A including legal due diligence; substantiating the transaction, identification of legal risks, etc. | B, BC |
| Organization of Purchasing Entity "Newco" (if intended) Shareholder/Operating Agreements/etc. (if equity involved in future) | B, BC |
| Jurisdiction Organization/Employer Identification/etc. | B, BC |
| [Asset/Equity] Purchase/Earn Out Agreement & Disclosure Schedules | S, SC, B, BC |
| Ancillary Documents/Executed Exhibits to Purchase Agreement:<br>· [Escrow Agreement]<br>· [Transition Services Agreement]<br>· Assignment and Assumption Agreement<br>· Bill of Sale<br>· Intellectual Property Assignment Agreement<br>· Employment or Consulting Agreements<br>· Restrictive Covenant/Non-Competition Agreements<br>· Real Estate Leases<br>· Transition Services Agreements | S, SC, B, BC |
| Seller [Board] Consent | SC |
| Seller [Shareholder] Consent | SC |
| Buyer Board & Shareholder Consents | BC |
| Third-party consents for assignment of contracts | SC |
| Good standing certificates and foreign qualifications | SC |
| Seller's & Buyer's Officers Certificate | S, SC; B, BC |
| Prepare funds flow memorandum | B, BC; SC confirm |
| Payment of purchase price/shares, etc. to Seller's account by wire transfer/ delivery of LLC/Stock Certificates | B |
| Post-Closing Actions (Depends on Transaction)(i.e., escrow, closing balance sheet) | B, BC, S, SC |

| **Parties** | |
|---|---|
| BUYER | B |
| BUYER’S COUNSEL | BC |
| SELLER | S |
| SELLER’S COUNSEL | SC |
| SELLER’S ACCOUNTANTS | A |

## **Estate Planning and Your Business**

A Conversation with

Alvina Lo

Of Wilmington Trust

*Recorded in August 2019*

*(Part five)*

***"….if you're a business owner and you're thinking about a potential sale, or potentially transitioning the business to the next generation, now is the time to act, because we have this incredibly generous gift from Congress, this incredibly high exemption amount."***

Many entrepreneurs and business leaders tend to put off thinking about selling their business, and what will happen to their assets without them, until it's too late. The results of not planning are often felt by families as well as business partners. From freezing assets to maintaining life insurance policies on key partners, there are many ways to protect a business that need to be part of the estate planning conversation.

### About Wilmington Trust

Wilmington Trust is a premier provider of Wealth Management services for M&T Bank, one of the most financially sound and successful companies in the U.S. financial services industry. For more than a century, it has built deep and lasting relationships, put their clients first, and provided innovative advice for complex situations. Their guidance has helped generations of families and businesses thrive, backed by the sound experience of the Wilmington Trust professionals and a forward-looking mindset. For more information, visit wilmingtontrust.com.

(Host)
John: Today, we have joining us via phone Alvina Lo, Chief Wealth Strategist at Wilmington Trust, who works out of the New York office. Alvina oversees the wealth planning, strategic advice, and thought leadership services for Wilmington Trust's fast-growing Wealth Management division. She's a seasoned wealth management executive and has more than a decade of experience in the financial services industry. Alvina, welcome to the show.

Alvina: Great, thank you so much for having me.

(Host)
Evelyn: Absolutely. Alvina, tell us a little bit about Wilmington Trust and the services it provides.

Alvina: Wilmington Trust is a boutique wealth management firm. We were founded by members of the Du Pont family in Wilmington, Delaware in 1903. Since then, we've grown from what was basically a family office for the Du Pont family, taking care of all of their private wealth management needs, to the proper wealth management company that we are today. Eight years ago, we were acquired by M&T bank, a community-based bank that is listed in the Fortune 500, so we're a part of the bigger M&T family. Together with M&T, Wilmington Trust provides clients with a range of private wealth management services that includes three things:

1) Asset management for private wealth clients.

2) Fiduciary services. We serve as trustee to our clients who choose to set up a trust or foundation, and as executor for estate settlement.

3) What is really core to our DNA, so to speak, and our culture, is planning. I head up the Wealth Strategy Group, a national team of lawyers, accountants, and

certified financial planners. Our job is to help clients successfully plan for the short and long term.

John: What type of client is best for private wealth services? In other words, does Wilmington Trust have a target client?

Alvina: At Wilmington Trust, we have three market segments. We have the affluent segment or what we call the U.S. markets, and the high-net-worth segment. And then we have family wealth, which is an ultra-high-net-worth segment. So we serve a range of clients on their private wealth needs. Generally speaking, a client with less than $3 million in investable assets would fall into our affluent market segment. The high-net-worth segment is anywhere from a net worth or investable assets of $3 million up to $20 million. And then third, anything above that will fall under our ultra-high-net-worth or family wealth segment. Depending on a client's particular needs and their complexity and their net worth, there will be a different range of services that are available.

John: I think that's why it's harder to hear about Wilmington Trust. You have to hang out with people worth at least have $3 million or more. It's not like finding a retail financial advisor or someone like that.

Alvina: I've worked at other places, two other financial institutions. Before that I practiced law as a trust and estates attorney. One of the core things one needs to realize is that not all wealth management firms are created equal, and they're not for everybody, right? Depending on what your level of net worth is, depending on what you need, there may be situations where Wilmington Trust is perfect, and there may be situations where somebody else might be a better fit.

We're a boutique firm. We do not have thousands of advisors across the footprint because we serve a very targeted segment. We also do a lot of leading with planning. Once again, we were founded by the Du Pont family and so we believe in planning for decades into the future. Depending on what the clients' needs are, my team and I know where they are in terms of the life cycle. Wilmington Trust could be a really good fit, but sometimes a prospective client is just not right for us.

John: I think it's great, especially for this podcast, because numerous business owners are looking for an exit that would land them solidly within your client profile. Trusted Counsel has been a part of many exits where we've partnered with Wilmington Trust, and it's been a fantastic experience. Many clients who are in the second half of their lives need to plan a business exit, and plan what they might want to do with their money when they do exit. The estate planning and wealth advisory services can have a huge impact on their life and the lives of others.

Alvina: Yes, and listen, that's why I got into the business. Because in law school, I was trying to figure out what I wanted to do after law school and what kind of law I wanted to go into. I found planning or estate planning to be incredibly rewarding, because you are tasked with helping to safeguard people's assets. So for me, while everyone's thinking about alpha in the market, which is incredibly important, I think we also need to go get tax alpha. How do you protect what you've grown, whether it's your business, whether it's your investable accounts, how do you protect that? For me, there's nothing more honorable than helping an entrepreneur to protect what they have, that it can be transitioned in the most protected manner and with tax advantages to the next generation.

John: Speaking of taxes, we've had some interesting developments since last year with the tax reform. I'm sure that played into your strategies. What should business owners be considering from an estate planning perspective with respect to tax reform?

Alvina: It's been, as you can imagine, extremely fun. Whenever Congress does something or changes the tax code, the estate attorney is perfectly giddy because it's good for business. But in all seriousness, it was a very important tax law change. I think there's incredible opportunity. From an estate planning perspective, and especially from a business owner perspective, the biggest news is the temporary increase in the federal estate tax exemption. *This means, that until the year 2025, each U.S. individual may give away as much as $11.4 million without any burden of an estate tax, gift tax, or generation-skipping transfer tax. If you're married, the amount doubles, so you're looking at $22.8 million that you can give away completely transfer tax free. This exemption is going to go away in 2025 unless Congress acts.* It's going to go back to the previous level which was around $5.9 million. The idea here is, if you're a business owner and you're thinking about a potential sale, or potentially transitioning the business to the next generation, now is the time to act, because we have this incredibly generous gift from Congress, this incredibly high exemption amount. It is the highest in the history of the United States. And what I always tell clients is that there's a legislative shelf life. In 2025, the law automatically sunsets unless Congress does something. But I think there's a political shelf life to this too. I think as we all learned from the last round of tax reform, anything can change with a stroke of a pen. If a Democrat comes into power in the next election, *it's very likely that this incredibly high exemption will go back to what it was before. So the time to act is now.*

Evelyn: I think this makes a lot of sense. Various private company owners do not actually realize that they can't just automatically transfer ownership of the company to their children without actually having a structure to do that. They don't realize that. They think, "Oh well, why is there a tax event?" But it's important for clients to understand that there absolutely is, and they need to seek ways to avoid that or to find a way to at least push the tax out into the future.

Alvina: That's right. M&T has an investment banking arm, and from my colleagues in the investment banking world, I'm also seeing that there is a lot more M&A activity because of tax reform. There are a number of changes in terms of the corporate tax rate. It made a number of changes in terms of deductions that are available for business owners if you fit within certain circumstances. So here because there is more cash, so to speak, in the business, my investment banking colleagues at M&T are seeing a lot more M&A activity. As a result, many business owners who may not have been thinking about selling are now getting offers. This will be the time to entertain them. *The idea of pre-transaction planning, the idea of having structure done properly is important, so you don't miss the opportunity.*

John: In addition to the exemption, what are some other things clients should be thinking about?

Alvina: The other thing that clients should think about if they are in New York, is the New York state income tax and the very dramatic decrease of what is known as the "salt deduction," which has really touched me and a lot of our clients here in New York personally. *The idea of asset location is becoming more important. This means that clients can move to another state where there's a better income tax rate, and if you can't move, you can move your assets. It is possible to set up a*

*<u>trust in an income tax friendly state, such as Delaware or Florida, to considerably minimize your income tax liability.</u>*

Mitigating income tax is another really, really big one. Protecting the value of one's business is also incredibly important, both from a gift tax perspective if you eventually do want to pass on the business to the next generation and now from a risk mitigation standpoint. What I’ve found is that many business owners are so busy running their business that they're not really protecting their downside. For example, what if something happened to them prematurely? Is there enough cash in the business or a proper succession plan in place? And so that actually couples with the increased exemption. *<u>We're seeing that many business owners are starting to think about that and using life insurance as a way to mitigate the risk to their business.</u>*

John: When you take a client through these suggestions, who's normally part of the team? In other words, is Wilmington Trust doing this work in house or do trust and estates attorneys still have a valuable role to play here?

Alvina: It's absolutely the latter. The way it's structured is that we are complementary to the client’s tax and legal advisors. We work hand in hand with the trust and estates attorney, and the M&A attorney. We're not in any way here to supplant any existing relationship. In fact, even though I'm a trust and estates attorney by background and training, because I work in a bank, my team and I do not give tax and legal advice. Think of us almost as consultants, if you will. Clients often come to us via their financial advisor or via their investment banking advisor, and they say, "Hey, we're thinking about exiting, what do we need to think about?" And so my team and I go in and lay out the overall groundwork, but at the end of the day, we absolutely partner with the trust and estates attorney and the accountants to make sure that the plan that's put in place is completely customized for the individual client.

Evelyn: Alvina, you talked a little bit about the benefit of taking advantage of exemptions and relocating, and then basically the sunset that's tied to that. Should business owners be concerned that an exemption might revert back?

Alvina: That's a great question. So I previously talked about the legislative as well as the political shelf life, and I do think yes, business owners should absolutely not feel like, “Well I could just wait. If the law changes in 2025, I'll call you guys in November of 2025.” That’s not really going to work.

Evelyn: But that's typical.

Alvina: Oh yes, indeed. And that's what happened in 2012 when we thought the exemption was going to go away. I don't think I slept that Christmas. But the reality is that to do it right and to do it well takes a lot of planning. It takes a lot of time and these are really important decisions, because for this to work the trust to which you transfer your business has to be an irrevocable trust, meaning that once you start it, there's very little you can change.

In order for it to accomplish the purpose we want, I would say the earlier the better. There's also a business shelf life to it. I often get calls, like literally the day before the sale, or there's a term sheet, and they ask me, "What can I do?" And the answer is not a whole lot**.** *<u>The whole point of pre-transaction planning is that if your business is worth X, and you think you can build it up to two X in a few years, you want to gift away the interest in the business today when the</u>*

<u>*business is worth only X. Because once it's inside the trust, any future growth and appreciation and income earned will not be subject to the U.S. estate tax system, and right now the highest rates are 40%.*</u> If you are lucky enough to live in New York like I do, you're looking at almost a total of 50% estate tax on your business before it goes to your children.

And this is on a business where you've been paying taxes all the while in terms of income earned or capital gains. So, the earlier, the better, because there is definitely not only a legislative shelf life and a political shelf life, but also a business cycle shelf life. So it’s best to start planning when you're thinking about a potential exit, even if you don't know for sure that that's definitely happening. And by the way, when I say exit, I mean it could be an IPO. It could be a strategic sale. Before you do that, I would really start assembling your team of trusted advisors—your accountant, your lawyer, your financial advisor, and your M&A advisor—to really think through what the right steps are.

At Wilmington trust, we have a team of people who are all ex-investment bankers, and they help the client think through how to build the business up from an evaluation perspective to get the best price.

What's the best structure? You want to have those conversations while you are talking about estate planning, because, as you are building up value, you want to make sure that you transfer those interests and your business into a trust that has enough flexibility to account for future needs. But from an estate tax perspective, it's already part of your estate. This way when you and your advisors are working together to increase that business value for the ultimate sale, all of that increase in value, that appreciation, that income earned is held inside the trust.

### Other Planning Strategies

Evelyn: What other planning strategies do you suggest? I know you've mentioned dynasty trusts and the like. Can you talk us through that sort of planning?

Alvina: So far we have been using the term trust pretty loosely as a singular vehicle. The reality is that a trust can come in many different flavors. It can be an asset protection trust, it could be a dynasty trust, or a generation-skipping trust, depending on your needs. But what I'm seeing now, especially given the increase in exemption, is that the most popular is the so-called dynasty trust. These are trusts that are set up in perpetuity, and there are some states in the country where you can set up a trust like that. As a New Yorker, for example, I can't set up a dynasty trust in New York, because New York has what's called a rule against perpetuities.

Evelyn: What happened to the rule against perpetuities?

Alvina: It still exists. It's funny because when you're in law school, a property law professor that I remember would say, "Oh, no one really needs to know this." You only need to know this for the bar exam and that's it, unless you're in trust and estates, which is what I ended up going into. So I know about the rule against perpetuities all too well. Now that said, if you're in certain lucky states, like Delaware, you don't have to worry about the rule against perpetuities, because in those states, your trust can literally last forever and ever and hence the name dynasty trusts.

So if you couple that with the proper use of the gifting exemption, which again, is at an all-time high of $11.4 million per person, you couple that with what's called another layer of tax, which we haven't talked about yet, which is the generation-skipping transfer tax.

That's the tax that hits when money goes to the grandchildren. The dynasty trust is really powerful because you literally could have a trust that you put your business in, and in a couple of years you sell your business with the high evaluation you want. Then the assets are invested not only for the benefit of your children, but for your grandchildren and great grandchildren. This is how dynastic wealth is built.

Evelyn: We must work on this, John.

Alvina: And please hire us. I could help you.

John: Alvina, one of the things that Trusted Counsel encounters often with our business owner clients is that many are control freaks. Plus they're entrepreneurs, and they're used to having control. That sometimes comes into conflict with estate planning where some of the solutions mean that you are no longer in control of certain aspects of your wealth. Can you tell us a little bit about some strategies that people like these may want to consider?

Alvina: That's a great question because that is the number one question I get from business owners. The reason they've been so successful is because they've had control over their business. So many clients come to me and say "What you're telling me makes a lot of sense. The numbers that you're showing me about the potential tax savings are incredible. And I want that. But you are crazy if you think that I'm to give up my baby. Even though I'm giving it up to a trust that benefits my family, and I love my children dearly, you are crazy if you think I'm going to give it up. I'm not giving up this baby for my other babies. Not happening."

And I can certainly understand that. So here I think is where advisors like us really have to do our job to educate our clients about modern trust law. Gone are the days where folks would place money into a trust, and then hand it over to a corporate trustee, and you don't know what's in it. You don't know how to invest it, and you basically just get a check, and it's a black box. That is no longer the reality. That might be your grandparent's trust, but believe me, today trusts are cool again. <u>*With modern trust language, with modern statutes, there is a lot of flexibility that we can build into the trust to give the client a level of control.*</u>

Now they can't have absolute control. Because if they have absolute control, then it's not going to work from a tax perspective or for asset protection purposes. But to give you an example of a way to build in flexibility and control: In states like Delaware, the trustee's duties can be divided up. Historically, what does a trustee do? A trustee manages the assets. So if there happens to be a business, then they manage it. They also work on distribution and decide how to use the funds. Trustees also make administrative decisions, keeping the books and filing tax returns. Delaware was actually one of the first states to allow the trustee's job to be bifurcated, meaning that you could have one individual who makes the investment decisions and another who holds the distribution position. Then there's a different individual who makes the administrative decisions. When I say individual, it can mean an individual or an institution.

At Wilmington Trust we have found that some business owners are okay with giving up control from a distribution perspective and from an administrative perspective, but they're not okay with giving up control from an investment perspective. In that case, it is possible to draft trusts, and they have to be done well by seasoned professionals who know what they're doing, but it is possible to do what's called a directed trust, which means that the investment decisions, hence the investment decisions about the business, are controlled by the grant holder or business owner. But the other responsibilities of the trustee would then be delegated or given over to somebody else. And sometimes it can be more than one person. We have many clients who say, "I really would like my spouse or my brother or my adult children to be involved, but I don't want them to do the job independently because I recognize the value of hiring a professional, who can serve as co-trustee." And the answer is absolutely, we could do that. So that's a way, I think, to get the best of both worlds: The tax savings and a degree of asset protection of a trust, while allowing the business owner some flexibility and control.

Evelyn: I think that idea does provide a lot of control to the business owner. If the owner decides this is how I want to sell the business, then the structure of the trust will allow them to do that. Is that correct?

Alvina: Yes, and oftentimes there's not just one structure. Often these trusts hold an interest in either a partnership or most often an LLC that in turn holds interest in the business. *<u>Most folks, when they give their interest in the business to a trust, divide the shares into voting and non-voting shares. So the degree of control comes in different forms.</u>* It can come in the form of the operating structure of the business itself, or it can come in the form of the holding company, or it can come in the form of the trust, which is at the top layer. So it really depends. But there are ways where the business owner retains a degree of control, without having to give up so much that it defeats the purpose for which we set up the trust in the first place.

The other flexibility that we often see is in the use of what's called a trust protector, which is again a relatively new thing in modern trust drafting. I mentioned earlier in the talk that these trusts need to be irrevocable. Once you set it up, there are very few things you can change, and that of course doesn't sit well with the business owners who want to be able to adjust it easily. What if the tax law changes? What if I change my mind about who the beneficiaries should be? You're telling me right now to set up a dynasty trust for grandchildren that are not even born yet. How could I possibly know what the terms should be? So here we could add in what's called a trust protector.

Think of it almost as the patriarch or the matriarch of the trust. Someone who’s not involved in the day-to-day affairs of the trust--that would be the trustee. But if you need to make a quick adjustment, have a different tax provision or take out a bad beneficiary, the trust protector can do that. Then again you must be very careful about how you draft the trust and the way you exercise those powers, because you can't really cross the line of complete control. But, in more and more trusts, you have that extra role, which is the trust protector, to take into account any future changes.

**Business Transition Planning**

John: Talking about business owners and continuing this whole theme of control: we talked about putting off estate planning, but then there's also business transition as well. And similarly, the owners often don't want to do it because of control issues. But Wilmington Trust helps with business transition planning. What are some things that people can think about on that front?

Alvina: *We've talked a lot in this conversation about taxes, and that's indeed on many people's minds, but a* *transition plan isn't just about taxes. Everyone wants to save money on taxes, but a transition plan also involves a lot of other things. For example, having the right governance in place.* We often have business owners who run family businesses. So you might have a business owner with three children, one of whom is in the business and the other two are not. How do you figure out a fair way to transition the business? You'd like you treat your kids equally, but from a control perspective, you will want the person who has been in the business to have control because the other two may have no interest in the business whatsoever.

We can help clients think through their operating agreement, how it's going to work, the governance. If there's a board of directors, how people vote. If there are business partners, what would happen if a partner were to die? Are you ready to be in business with the heir, maybe a spouse or a child? Is there an appropriate buy/sell agreement in place if one business partner were to become incapacitated or pass away? And if there is, where are you getting the cash to buy the heir out? This may be a situation where life insurance would be the proper vehicle. It's all part of the transition plan.

Some business owners might not want their business to transition to an individual. We have a lot of clients who are incredibly philanthropic, and they want either the vast majority of their estate, or even sometimes their business, to go to charity or their own private foundation. Well, there are specific rules against a private foundation holding active businesses. So we work through many of these non-tax issues with our clients. Often the first question is about tax, but inevitably, when it comes to finally putting together a plan, it isn't just tax driven. There are all these other considerations too. The other thing I find to be very interesting, and I've really seen how powerful it is since joining Wilmington Trust, is the area of financial planning or retirement planning.

So now you might ask, "Well, wait a minute. You just told us your clients are pretty wealthy, right? And they have some successful businesses. Do they need retirement planning? There'll be plenty fine." But think about what happens if, as part of pre-transaction planning, a business owner gives up some of their business into a trust from which they cannot benefit. It will be their children or spouse or grandchildren who are the beneficiaries. Then what will they retire on if they were to sell the business? Inevitably, we have clients who say to us, "Okay, Alvina, I understand what you're saying about this window of opportunity to give assets to a trust, but how do I know how much to give? If I gave up 50% of my business today and any future growth and appreciation is in that trust, that's wonderful from a tax planning perspective. But that means I've got only 50% left. What do I do? Is that enough?"

And so as an advisor, I personally never want our clients to give away too much, too soon. This is where financial planning comes in. It's not so much financial planning as, are you going to have enough money in your 401K, it's much more than that. It's, "Okay, let's think this through: you have a business, and you're drawing X each year, with expenses of Y. You're thinking about moving from New York to Florida in five years, so your tax rate is going to change. You have five different businesses, a vacation home, and you're paying for college. How much are you going to have realistically when the time comes, given all the fluctuations in tax rates? And if you were to remove, say, 50% of your business now and take that out of the equation, how much are you going to have? Is this a number that's going to make you feel comfortable enough to decide today to give 50% of your business into a trust?" So we do a lot of that. We are extremely analytical here at Wilmington Trust. I think that numbers speak volumes. You could talk about these strategies all day long in the abstract, but without numbers to react to, it's very hard for a business owner to make an educated decision.

We do have a lot of clients who come to us and say, "I inherently understand what you're trying to do, but I need help figuring out how much to give and what to give." Most of the time, it will be their business, because that's the most valuable or vastly appreciating asset they have. But sometimes they say, "I'm not quite ready to let this go, but I do have this portfolio of marketable securities," or "I have this private investment. Is it better to give this away?" So we help our clients think through all that.

Evelyn: Interesting. And that makes perfect sense because today people are living a lot longer. So if you're making those choices fairly early, you may not really know how much you will want for your own personal wealth. You need to be able to take those things into account.

Alvina: Absolutely. And wealth is relative, right? If you were to say to one person you have X dollars to live on, they might say, "Oh my God, that's plenty. That's more money than I ever thought I would have." And then other people might say, "Oh my gosh, no, I need to be able to have my boat and my jet and all these other things. How would I live?"

I once had a client when I was in private practice, a widow in her late 60s with a very nice apartment on Fifth Avenue and a very beautiful vacation home, all paid for, out in the Hamptons. Very sizable accounts, marketable securities account. There's artwork everywhere. She's probably worth $100 million, and she's literally looking at me like, how am I going to live?

But when you look at her expenses, you can see why she might worry. Health care costs are really high. It costs a lot of money to maintain a home in the Hamptons. When you go shopping, you really go shopping, and your children depend on you. She has a lot of people around her that depend on her grace. So, again, it's all relative. But to me, no matter what your number is, everyone has a different number. Until you see the number, you cannot make an educated decision about whether to take advantage of this increased exemption. It's a gift.

Evelyn: Right. That makes perfect sense. Alvina thank you so much for your insight. Are there any remarks you'd like to sum it up with?

Alvina: If I may just touch upon two things very quickly that we didn't talk about. One is charitable planning, philanthropy. A *lot of our clients are incredibly philanthropic. I referred a bit earlier to clients who wish to leave their businesses to a foundation, which doesn't really work from a tax or foundation rules perspective. I would be remiss if I didn't mention that there are many different strategies that a business owner might consider, many different charitable trusts, for example, to achieve their philanthropic as well as tax planning purposes.* So this conversation about business succession planning and business owners is not uni-directional. Often business owners want to follow Warren Buffet's example.

I'm leaving X amount to my children. The rest is going to charity. We do a lot of that. And then I guess as a closing remark, I would just say with the potential sunset of the high exemption in 2025, as advisors, we really want to get to our clients early and talk them through this. Business owners are incredibly busy with their business. But I feel it's incumbent upon us as the advisors to stay in front of them. We get a lot of, "Yes, yes, yes, I know, I know, I know." But we can't give up. We've got to keep doing it.

It's our job to stay in front of them, to get them to do what they know inherently they have to do. And in order to do that, we must have a complete picture of their needs and their future goals, so that we're not only helping them with their financial goals, but also helping them with their other life and wealth goals. My leaving message is do plan, plan early and don't give up. If your business owners are saying, "Yes, yes, yes, I've got it. We'll talk about it later," you just have to keep at it. That's our job.

Evelyn: That's perfect.

John: Alvina. Yes. Thank you for joining us. This has been a great discussion. We certainly appreciate all the insight. If people want to get in touch with you, where should they go?

Alvina: They should probably reach out to their local wealth advisor at Wilmington Trust. We are in every major metropolitan area, and we have a local team on the ground and local wealth strategists who help them with all wealth planning needs. So if anyone's interested in talking about any of these strategies, I would go to Wilmingtontrust.com, go to your local office or your local advisor, and they would know how to get in touch with somebody on my team.

**Lessons Learned**

1. The current high estate tax exceptions may go away in 2025 unless Congress acts.

2. Asset location is becoming more important. It is possible to set up a trust in an income tax friendly state to considerably minimize your income tax liability.

3. Modern trust language and statutes offer a lot of flexibility that can be built into the trust to give the client a level of control that was not available in previous generations.

***Alvina Lo** is Chief Wealth Strategist at Wilmington Trust. In this role she oversees the wealth planning, strategic advice and thought leadership services for Wilmington Trust's fast-growing Wealth Advisory division. She's responsible for managing a national team of strategists, financial planners and thought leaders who advise high-net worth individuals and families, business owners and entrepreneurs, and foundations and endowments. A seasoned wealth management executive, Lo has more than a decade of experience, she served as the director and senior wealth planner for Citi Private Bank. Previously, she was a director at Credit Suisse and earlier in her career, practiced law at Milbank Tweed Hadley & McCloy, LLP in the Trust & Estates Group.*

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This presentation focuses on federal estate, gift, and GST tax planning strategies. While some of these strategies may have favorable state tax benefits, those are beyond the scope of this presentation.

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**Wilmington Trust Checklist:**

## Business Owner Comprehensive Wealth Advisory Review

Protecting your loved ones, your assets, and the business you've built requires a strong team with a diverse set of skills and experience. Taking a holistic view of your life goals and financial objectives, our dedicated planning team works collaboratively with you, your attorney, and your other advisors to select and implement strategies that address your unique situation today, as well as prepare you for life's transitions.

In addition to all personal information needed (date of birth, citizenship, marital status, and address) for you, your children, your grandchildren, or any person you support, documents that we will likely need include:

### Estate Diagnostics

[ ] Wills

[ ] Trusts (both that you created or that you are a beneficiary of)

[ ] Powers of Attorney – medical and financial

[ ] Living Wills

[ ] Any pre or post nuptial agreements or property settlement agreements

[ ] Life Insurance policies

[ ] Keyperson Insurance

[ ] Disability Insurance

[ ] Operating agreements & buy-sell agreements

[ ] Business retirement plan detail (e.g., 401 (k), profit sharing plan, ESOP, etc.)

[ ] Net worth statement, showing titling of assets, market values, cost bases, liabilities

[ ] Last gift tax return filed (if any)

[ ] Last income tax return filed

[ ] If multiple businesses, a corporate entity organization chart

[ ] Business valuation (if one is available)

**Business Valuation/Analytics**

[ ] Financial statements with all supplemental schedules for past 5 years

[ ] North American Industry Classification System (NAICS) code that best describes the line of business

[ ] Schedule of owner(s) total compensation for last 5 years (base salary, bonus, etc.)

[ ] Details on facilities leased from related parties, including location, square footage, and year built

[ ] Details on non-operating/non-recurring expenses incurred and income received over the past 5 years

**Cash Flow Analysis**

[ ] Financial statements (investment accounts, brokerage accounts, retirement accounts)

[ ] A breakdown of annual living expenses – can be detailed or estimate – and list of any planned significant expenditures

[ ] Personal Income Tax return (duplicated from above)

[ ] List of current and future income from all sources (salary, bonus, pensions, rental properties, Social Security, etc.) as well as duration

[ ] Net worth statement showing titling (duplicated from above)

[ ] Information on long-term care, disability, and keyperson insurance policies

# **Thinking Outside of the Shoebox**

A Conversation with
Yelena Epova and Michael Levy
Of Aprio

*Recorded in August 2019*
*(Part six)*

***"…. it's not only the planning piece of it, but also the execution on understanding where buyers are looking for value and how you, as a seller, can position yourself to get the most value"***

Businesses often leave money on the table when considering a sale transaction. Yelena Epova and Michael Levy get in-depth on how a company can maximize value in a contemplated sale or recapitalization transaction by leveraging its financial statement audits, tax planning, and strategic transaction structure when approaching a sale. In addition, they review discussions to have with your CPA to prepare for sale.

## **About Aprio**

Since 1952, clients throughout the U.S. and across more than 40 countries have trusted Aprio for guidance on how to achieve what's next. As a premier CPA-led professional services firm, Aprio delivers advisory, assurance, tax and private client services to build value, drive growth, manage risk, and protect wealth. With proven expertise and genuine care, Aprio services individuals and businesses from promising startups to market leaders alike. For more information, visit aprio.com

## The Current Mergers and Acquisitions Market

(Host)
Evelyn: Michael, Yelena, what's the state of the M&A market?

Michael: It continues to be very robust in activity, though the first quarter of 2019 was slower than 2018's first quarter. While there was a little bit of a slower start, activity certainly ramped up as 2019 has progressed. This is driven by continued low interest rates, low unemployment and certainly lots of money on the sidelines, both at private equity groups, as well as banks for leverage. I do anticipate that 2020 will be a great M&A year. Though, there has certainly been some slowdown in various sectors that private equity is seeing, they view this as an opportunity for multiples to decrease slightly from the rates they are at today.

(Host)
John: Can you elaborate on what sectors are those that might be decreasing?

Michael: Definitely. The real estate sector has seen a little bit of a slowdown, as well as manufacturing, and the current tariff situation has added a bit of surprise here. There were hopes of seeing increased M&A activity in the manufacturing space and distribution industrial space, but there is some slight pull back, as companies wait to see how the tariff situation resolves here in the US.

Evelyn: Talk to us a little bit about the difference between CPA firms that provide advisory services such as diligence and structuring, versus CPA firms that just provide audit and tax compliance services?

Michael: Sure, so audit and tax compliance is compliance work. It's fulfilling a compliance requirement in association with a regulatory or maybe an internal revenue source requirement.

We at Aprio are very focused on more advisory services in addition to our compliance services. These advisory services are meant to help clients understand various transaction structures, financial due diligence, and the cash flows associated with that financial due diligence. Our advisory services also help clients think about where there are opportunities and risks that need to be considered when entering into a transaction.

Evelyn: So, really the advisory services help the client step back and plan, if they are a business owner or an executive team that is looking at selling or exiting a business. How far in advance does that usually happen and what does that entail?

Michael: The planning really should happen two to three years out. That's where we see that our clients receive the most value when executing a transaction. *Though, it's not only the planning piece of it, also the execution on understanding where buyers are looking for value and how you, as a seller, can position yourself to get the most value out of that.* Understanding those initiatives that buyers will execute on in the future adds value to your position as a seller.

John: Let's say someone makes an appointment with your firm Aprio two to three years before they are planning to sell their business. What are some of the items that you might discuss with them?

Michael: With respect to the financial due diligence aspects of it, it's really getting the house in order from an accounting perspective. We will ask that someone, are your financial statements in accordance with GAAP? Are you executing where you can get more profitability out of the business? That's the most important thing from a financial perspective that you can do when preparing for sale.

Yelena: Just to add to this, on the financial side, very often we advise clients to start getting audited financials if they're not getting them already. At the very least, review the financials because the buyer will probably look for two, three, probably three years of the financials to be done, and the sooner they get in going in the process, the better.

Michael: Yes. <u>*Certainly, having two or three years of financial information, audited or reviewed, really gives the seller that much more credibility in the process*</u> and prospective buyers feel that much more comfortable with the financial statements that are provided to them in the process.

Evelyn: Invested companies will typically be GAAP compliant, but from our experience, many privately held businesses without external investors typically are not. Can you explain the difference? In other words, why should a private company owner think about GAAP compliance when coming up to an exit?

Michael: Most buyers in a transaction expect that the seller will have representations and warranties in the purchase agreement stating that these financial statements are in accordance with GAAP. Certainly, there are exceptions to GAAP that may be identified and the seller will have an opportunity to list those out in a purchase agreement**.** <u>*But, in order for a financial statement to be read with certainty that this is the operations of the company, this is the financial position of a company at a point in time-- having it stamped as audited gives that buyer that much more comfort on the financial performance of a business.*</u>

Evelyn: I know that we've actually seen companies that are not GAAP compliant come up for a sale where a buyer actually will force them to comply with GAAP and the seller will often get clipped on the price because they weren't compliant.

Michael: That's right and we do have various clients from a sell-side perspective that have not been audited. Clients can get by with unaudited financial statements, but typically you would have a professional service provider do sell-side due diligence to quantify what the quality of earnings are and the normalized EBITDA of the business (which is adjusted for any one time, non-recurring items). Having a third-party diligence report does give a buyer and a seller that much more information for understanding what the normalized EBITDA and the true cash flows of a business, truly are.

John: For the quality of earnings, how long does that take to put together?

Michael: Great question. It varies from seller to seller, buyer to buyer, certainly, depending on if it's multi-locational or the complexity of the business. We find that most engagements we work on from a normalized EBITDA perspective takes probably about a three-week timeframe to do the analysis and prepare a diligence report. But certainly, there are instances where it can take longer, again based on the complexity of the business itself.

John: Are there any rules of thumb as to when a quality of earnings might be appropriate versus audited financials, as far as dollar amounts, or the type of sellers or buyers?

Michael: We get that question often. Should the seller do an audit, or should the seller do a quality of earnings report? <u>*I often say that a quality of earnings report is more advantageous to you as a seller because we're trying to identify those one-time, non-recurring items that may impact EBITDA both positively, as well as negatively.*</u>

An audit typically does not lay out those one time, non-recurring items. <u>*When you think about a business*</u>

*that's being sold based on a multiple of EBITDA, you do want to know what EBITDA is on a normalized basis and use that as a negotiating starting point* when speaking with a buyer.

Evelyn: Yelena, talk to us a little bit about the importance of getting tax and legal advice not later than the letter of intent stage.

Yelena: The sooner the better, of course, definitely not later than the letter of intent stage. *It's going to be very hard to change the structure of the transaction after a certain period after the LOI. It's very, very important to understand how the buyer wants to structure the transaction so you understand your tax impact as a seller and* can understand how much money you net after tax. Normally, we work with a legal team because there are certain things we do, and certain things that lawyers do. Although we often get clients who have representation from different firms prior to the transaction, and they engage us to represent them in the sale transaction. Generally because we've done a lot of them, and we are experts. But getting it done early is super-important.

John: *What are some of the effects that a corporate structure might have on a business if it's a C Corp or S Corporate Partnership?* That's a big question because there are a lot of differences.

Yelena: It's a good idea for Aprio to be able to discuss with the client ahead of time how to structure their business so that the client has more flexibility on how to sell the business. *In most cases, the buyers want to buy assets or stock and make an election to treat the sale as a sale of assets.* The main reason for that is to markup the book value, goodwill, and get some tax benefits from amortization, instead of having a carryover basis. *If your business is an S Corp or Partnership, if you're a pass-through entity, it's much easier for the seller to* *sell the assets because the seller will have one level of tax.* The seller will definitely become more marketable from that standpoint. Very often, the seller can get a premium for being able to sell assets. Therefore the seller can get a higher price for the sale. In the C Corp scenario, unless the seller has deep, deep NOLs (net operating losses) it's going to be very costly to sell assets because once the seller sells assets, the seller has to pay corporate level taxes, and then the seller has to pay dividends to get money out, so the seller pays taxes again.

*Of course, in today's environment, it's not as bad as it used to be because corporate rates went down, but you still pay more if you sell assets through a C Corp. Definitely think about it ahead of time; you cannot just change the form of your entity right before the sale because the gain will be tainted in most cases.* Or, if you convert to LLC, for example, it can be taxable liquidation. That's why it's super important to think about the exit, maybe as soon as you incorporate the company.

John: Has the tax reform (Tax Cuts and Jobs Act of 2017) changed a lot of these conversations? And what is the general advice that you've typically given regarding structures of LLCs and C Corps?

Yelena: We receive a lot more questions from clients when they know that the federal corporate tax rate is 21%. They get super excited and ask, "Should we convert to a C Corp?" *Again, the answer is, if the seller is not planning to take money out and if they are continuing to re-invest, maybe it's not a bad idea to be a C-corp. If the seller is planning to take money out, which most people do at some point, then it's probably not such a good idea because the seller will end up still paying more tax.* Plus, like I mentioned, with the sale, the seller is somewhat limited on how the sale can be structured. _Of course, if the seller sells stock of a C Corp, the seller will pay capital gain tax and it's a good scenario; but in most cases, buyers will want to buy assets._ There were changes in the pass-through taxation, as well. Even that C Corp tax is still less than 21% with pass-through entities, depending on the industry, you can receive up to 29.6% taxation on profits which is a huge change. Lawyers and CPAs do not qualify in most cases.

John: With all the attorneys in Washington, how does that happen?

Yelena: I don't know. I'm still trying to wrap my head around that one, but most of our clients qualify.

Evelyn: We have received these questions also, and I think that it's a really important point that buyers still are more interested in assets. Business owners do not typically understand the whole idea of, "If I buy stock of the company, it's sweeping all of the potential liability that goes along with that." So, the agreements can be much more complex and the shift of that liability is going to go right back to the seller. Asset sales are often just a cleaner way to close that deal. We have some clients right now that are legacy companies, C Corporations, which I still can't believe they're not flow-throughs. They are trying to sell and it's hard. It's very hard and very expensive.

_What are the tax implications of earnout structures?_ Basically, that could be an asset transaction where the company hasn't actually, or maybe the seller hasn't, realized the full value of the business and the buyer may say, "Hey, we'll pay you something on the other side if performance hits x, y, z."

Yelena: _It's kind of like an installment sale. You're not taxed until you actually get paid._ So, if it's a three-year earnout, you may end up paying taxes on your transaction for three years, but definitely not before you get something in your hands. There are a lot of business owners that are, a little bit delusional, for lack of a better word. They think they can sell and then they're good to go. But, then they have to work for the company to get the earnout. If I were the buyer, I would structure it just like that with an earnout.

John: When we are seller’s counsel, I'm not a fan of having to draft earnouts but, of course, earnouts are a good way of solving valuation gaps between a buyer and seller. Michael, what are you seeing in the market as far as earnouts? Has the strong market affected the nature of earnouts?

Michael: <u>*A lot of times, I see earnouts come into play when there's a renegotiation of an initial term sheet.*</u> The buyer has come in and found something in the business that questions the true value of the business. The buyer wants to substantiate value, and they do it through the future operation of the business under their watch, or maybe it's with the existing management of the seller. Those things are good when they work really well and they're structured really well. There's a lot of questions that come into question with an earnout, such as how much cost is the buyer going to burden the seller with, how much revenue is going to come into the business that results from the sale, and will the seller get credit for that? There are tons of questions that happen in an earnout scenario.

<u>*The best thing that a seller can do, as well as a buyer can do, is making sure the definition of how that earnout is being measured, post-transaction, is spelled out in detail in a purchase agreement.*</u> It's common that we see examples of the calculation in those purchase agreements as a schedule to the purchase

agreement. Earnouts are something that have been a tool used in buyers and sellers transactions for years. I don't see it going away. If I had to guess the future, as the market shifts and changes over time and risk tolerance may increase, I think earnouts may be one way that buyers mitigate their risk for paying higher than the multiples that are being paid today-- for overpaying for a transaction.

John: What's the CPA's role in diligence? Because a lot of people think, "Well, attorneys do due diligence," but not all of it.

Michael: We, as financial due diligence folks really want to help our clients understand the historical cash flows that are generated in a business and for them to use that information to think about what happens in their financial model, as they project out years ahead, after the close. There are several other streams of due diligence that a buyer, as well as a seller, absolutely want to consider. Aprio provides information to a seller for their consideration in connection with the sale. Also, it's very common that the buyer has a financial and tax due diligence advisor come in and perform due diligence on the behalf of the buyer, as well as the other streams. Whether it's customer due diligence, operational due diligence, environmental, HR and certainly legal due diligence.

**Due Diligence Trends**

John: What have you seen as a trend in due diligence recently, particularly on the privacy front?

Michael: Every day, you can pick up the newspaper and see an incident where there's security and privacy breaches of an IT platform at a business. *We are seeing that buyers are coming in to make sure that the business that they're buying is a secure IT environment, that security* *__and privacy related matters are addressed, but also mitigated.__* So, you as a seller, need to make sure you're prepared for that buyer to come in to look at that IT platform. We, at Aprio, are helping our clients think through security and privacy. It's another advisory service, but we also have assurance related to IT advisory. I highly recommend that you, as a seller, not only if you're just operating the business into perpetuity, but also if you're going to sell the business, look at security and privacy matters today.

Evelyn: We had a client about a year ago who terminated their chief operating officer, and they were checking the network to see what documents he had downloaded. They found out that they were the subject of a botched ransomware attack as part of that review; but it was only because they were there looking for other things that they found it. This is a company that is in a small area where there was no reason for them to believe that they might be subject to that threat. I think that's what happens. Small businesses will sit there saying, "It's not going to be me. Why does anyone care about me?" But, they care about everybody because your files are valuable to you. Of course, as more privacy laws are adopted now state by state, who knows if we'll ever have federal policy on that, but we have seen buyers looking at that and being quite concerned.

Michael: No question about it.

John: I think it's one of the items in the sale transaction where buyers really push for this uncapped liability on the seller a lot of times, and is something that can hang over the seller’s head for quite some time after a sale. What are some of the mistakes that people make on the financial side?

Evelyn: The letter of intent is signed when they call.

John: Well, yes. Of course that. But in other words, when the buyers are going through the financial statements, what are some major no-no’s that just must be cleaned up before someone comes in to look at your company?

Michael: Two to three years out, it's good to start thinking about how to become prepared and work with your advisor on what it means to actually go through the process. Regarding your question about financials, it really goes back to-- do you have reviewed and or audited financial statements that you can hand to a prospective buyer? That is the biggest thing that we would recommend to our clients from a financial perspective. It's understanding what the revenue recognition criteria is, expense recognition criteria are, and putting an internal control structure around that, based on the benefits that you can get from those types of internal controls structures.

*The biggest thing that we would recommend to our clients today is, as you think about getting prepared for sale, go ahead and get your financial statements reviewed or audited.* Also, while those things are happening from a third party, that you as a seller continue to operate that business and continue growth is always very, very important. If you have a slipping growth and the hockey stick goes the other way, that's when you lose a lot of credibility and value in a transaction.

Evelyn: I think the other thing that's really important with planning is even outside of the idea of selling the business, the tax law changes. As your business grows, there might be other opportunities for you to receive R&D credits for development. It just seems so reasonable that there needs to at least be an annual meeting to discuss, "Well, what's going on?" I think business owners don't necessarily do that.

Yelena: There are a lot of opportunities that are missed. A lot. Tax credits, but even with the law changes, this 29.6% tax rate for pass-through entities; there are ways to better get to that rate, how to maximize the benefit. It's amazing that-

Evelyn: People don't take advantage.

Yelena: There are so many people who don't pay attention. CPAs sometimes don't pay attention, either. With every law change, there are some opportunities and things, that with careful planning, can be really, really improved upon.

Evelyn: Is there anything that we've missed?

**It’s a Sellers’ Market**

Michael: This is a great time to be a seller. It is a sellers’ market out there. When you look at the amount of capital that's out there, there are private equity groups and strategists that are eager, eager to grow their business and it's more expensive for them to grow it internally or green field it. It's cheaper for them and quicker for them to just go out and buy it. It's a great time to be a seller and sellers that get the most value are those that are most prepared for the process.

Use your advisors to help you drive value. The cost of an advisor may look a little bit daunting at times, but at the end of the day, don't look at it as a cost; it really is an investment in value creation in a transaction. We see that all the time with those clients that are selling. When they're most prepared, they get the highest value, while also being able to execute on a transaction that is much more efficient.

Evelyn: That makes perfect sense.

**Lessons Learned**

1. To maximize execution in a transaction, begin planning with your CPA and attorney two to three years before the transaction.
2. If a seller is preparing for a sale, it is important to have financial statements reviewed or audited.
3. Unlike an audit, a quality of earnings report identifies one-time, non-recurring items that may impact EBITDA. If a business is sold based on EBITDA, it is important to know the normalized EBITDA.
4. The seller should understand the tax impact of the transaction structure prior to signing the Letter of Intent, and the amount the seller will net. It can be difficult to change the transaction structure after the Letter of Intent is signed.

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