# PRIVATELY HELD COMPANY

the report on transaction issues




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## Key Factors on the Acquirer's Side

There are several key factors on the acquirer's side of a sale, most of which are necessary to achieve a successful closing. Just as a seller has to deal with quite a few factors, the acquirer must also. Some of the more important ones on the acquisition side are:

1. Sufficient financial resources to complete the deal as specified.
2. Depth of capable staff to run the existing business and also execute an acquisition at the same time.
3. A rational approach to the type, size and geographic location of target companies.
4. The willingness to "pay-up" for acquisitions such as 6x EBITDA and, if necessary, the willingness to pay 100% cash, whether the sale is one of assets or a stock transaction.
5. Assuming the acquisition search generates satisfactory deal flow, a willingness to stay the course for 6 to 12 months in the search process.
6. A confirmation by the board of directors of their commitment to complete a deal.
7. A "point person" in the search process, preferably the CEO, CFO or Director of Development who is reachable on a daily basis to discuss relevant matters.
8. Complete access to sales manager and others by the business intermediary to discuss suggestions of target companies.

## Company Weaknesses

Take two seemingly identical companies with very similar financials, but one of the companies was worth substantially more than the other company. One company will sell for $10 million "as is" or some changes can be made and the same company can be sold for $15 million. Following is a partial list of potential company weaknesses to consider in order to assess a company's vulnerability.

**Customer Concentration:** First, one has to analyze the situation. The U.S. Government might be considered one customer but from ten different purchasing agents. Or, GM might have one purchasing agent but be directed to ten different plants. One office product manufacturer with $20 million in sales had 75% of its business with one customer…Staples. They had three choices: 1. Cross their fingers and remain the same; 2. Acquire another company with a different customer base; or 3. Sell out to another company. They selected the third choice and took their chips off the table. The acquirer was a $125 million competitor which was unable to sell to Staples, so after absorbing the smaller company, the customer concentration to Staples was only about 10% ($125m + $20m=$145m of which $15 million was sold to Staples or 10+%).

**Single Product:** Perhaps the most famous example of a single product acquisition is when General Motors overtook Ford's single product, the Model A, with Alfred Sloan's brilliant concept of a different model for people with different financial thresholds. Henry Ford's stubbornness to stay with one product (Model A) almost cost the company its existence.

**Regional Sales/Limited Marketing:** Companies with parochial focus have limited capabilities to grow other than within their own domain. A widget company with national and international sales has substantially greater prospects to grow than one limited to its own region.

**Aging Workforce/Decaying Culture:** Skilled workers in certain trades, such as tool and die shops, are not being replaced by the younger generation. This is a sign that the next generation will not provide the companies with a skilled workforce in certain industries.

**Declining Industry:** Some companies are agile enough to completely change their industry, such as Warren Buffet's Berkshire Hathaway and Fashion Neckwear Company which completely changed from neckties to polo shirts.

**Pricing Constraints/Rising Costs:** Companies who sell a commodity product often lack pricing elasticity and are unable to pass on their increased costs to their customers. For a while, the steel industry was in this predicament, but through massive industry consolidation and a booming demand from China, the situation changed.

**CEO Dependency/No Succession Plan:** Many middle market companies have successfully been built up by the founder/entrepreneur/owner and some critics call these individuals a "one-man-band" for good reason. These superman types tend to dominate most aspects of the company, but this is no way to build a sustainable business long term. Furthermore, these CEOs usually have not created a succession plan.

**One potential weakness that is very easy to overcome is to implement a succession plan.**

**Maximizing Value**

If the owners of a company, many of whom may be outsiders, want to increase the value of their investment, they should, through the Board of Directors, try to overcome the company's weaknesses. On the other hand, the CEO may not be either capable or motivated to do so. The alternative is to implement a CEO succession plan, preferably with the cooperation of the current CEO. Kenneth Freeman's thesis in "The CEO's Real Legacy" (*Harvard Business Review*, Nov 2004) is that the CEO's real legacy is implementing a succession plan.

Freeman advises:

> "Your true legacy as a CEO is what happens to the company after you leave the corner office.
>
> "Begin early, look first inside your company for exceptional talent, see that candidates gain experience in all aspects of the business, help them develop the skills they'll need in the top job…
>
> "During good times, most boards simply don't want to talk about CEO succession…During bad times when the board is ready to fire the CEO, it's too late to talk about a plan for smoothly passing the baton…Succession planning is one of the best ways for you to ensure the long-term health of your company."

Both buyers and sellers should assess the company's weaknesses. While some weaknesses are difficult to overcome, especially in the short term, one potential weakness that is very easy to overcome is to implement a succession plan…especially during the company's good times before things go bad and it's too late.

# Surprises CEOs Face When Selling Their Company

### Surprise #1: Substantial Time Commitment

In the real estate business, once the owner engages the broker there is very little for the owner to do until the broker presents the various offers from the potential buyers. In the M&A business, there is a substantial time commitment required of the CEO/Owner in order to complete the sale properly, professionally and thoroughly. The following examples are worth noting:

*Offering Memorandum:*
This 30 + page document is the cornerstone of the selling process because most business intermediaries expect the potential acquirers to submit their initial price range based on the information presented in this memorandum. The intermediary will heavily depend on the CEO/Owner to supply him or her with all the necessary facts.

*Suggestions of Potential Acquirers:*
Chances are that the sales manager is the only person who knows the best companies to contact and those not to contact (competitors). Arguably, this information should be mostly supplied by the intermediary, but as a thorough team effort, the CEO/Owner should play a major role in this endeavor.

*Management Presentations:*
Assuming the intermediary conducts the normal process of boiling down the bidders to 4 or 5 potential acquirers, it is then customary to have management presentations before the final bids are submitted. In order to help extract the best offers, it is advisable that the CEO show the benefits of combining the acquirer and seller and/or the future upside for the selling company.

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### Surprise #2: The Need to Enjoin Other Employees in the Process

A number of owners selling their company are paranoid about a confidentiality leak regarding the sale of their company. In fact, some owners prefer that no other person in the organization is aware of the pending sale of the company. At a bare minimum, the CFO and Sales Manager should be informed. The CFO will be asked to pull all the financials together, to supply projections, to articulate reconstructed earnings (add-backs) and to supply monthly statements…all of which suggest that the company is being sold. The Sales Manager will be asked to supply the names of synergistic companies in or around the particular industry. And, perhaps, the CEO's secretary will be asked to set up a "war room" where all legal and contractual information is assembled for the buyer's due diligence team. In order to protect the company from confidentiality leaks and assure retention of key employees, the CEO/Owner should implement "stay agreements" for these key employees.

### Surprise #3: The Need to Maintain, or Accelerate, Sales

The tendency for some owners is to become so distracted with the M&A process that they take their "eye off the ball" in running the business on a daily basis. Potential acquirers will be watching the monthly sales reports like a hawk to see if there is a turn-down in business. Acquirers become very apprehensive when they see a recent downward trend in the company they are about to acquire and may, as a result, want to negotiate a lower price.

### Surprise #4: A Confidentiality Leak

Naturally, most CEOs expect the M&A process to go smoothly and usually it does. However, there should be a contingency plan in place for such occurrences as confidentiality leaks. The degree of damage determines what action should be implemented. On one occasion the draft of the Offering Memorandum was e-mailed to the CEO/Owner for his corrections; however, the sender from the brokerage firm used one incorrect letter in the CEO's e-mail address. As a result of this misstep, the e-mail was rejected by the CEO's computer and ended up in the company's general mailbox which was administered by the employee in charge of IT. The employee was told by the quick-thinking CEO that the Offering Memorandum was being used to raise growth capital. Luckily, the incident went no further. Much more serious confidentiality leaks can occur, and it is wise to discuss ahead of time how the matter is going to be handled with those concerned.

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## Surprises CEOs Face When Selling Their Company (Continued)

### Surprise #5: Unexpected Low Bids

Ultimately, the M&A market sets the price of the company. However, rarely does a seller go to market without having certain expectations of price. Let's use a hypothetical case in which a company is growing at 15% annually. The CEO/Owner believes that it is worth \$6 million based on \$1 million of EBITDA. However, the top bid is \$5 million cash or, obviously, 5 times EBITDA. Assuming the business intermediary has exhausted the universe of acquirers, the seller has two choices to reach his desired \$6 million selling price. Either he can take the company off the market and return several years later when either the company's earnings have improved or when the M&A market has heated up. Alternatively, the CEO can negotiate further with the top bidder by selling 80% of the company now and the remaining 20% in three years on a pre-arranged formula on the expectation that business will improve. Or, the CEO can sell the company now for \$5 million with an earnout formula that might give him the additional \$1 million.

### Surprise #6:
### The P&S Agreement is Not What the CEO Expected

Numerous CEOs drive the M&A process to the letter of intent and then turn over the deal to their attorney to iron out the details of the purchase and sale agreement. While the CEO should not micro-manage his designated professional advisors in the transaction, he should be involved throughout the process, or otherwise the CEO will invariably object to the final wording of the document at the signing state. The area most likely to be overlooked by the CEO/Owner is the critical section of reps and warranties.

### Surprise #7: Agreement of Other Stakeholders

While the CEO can negotiate the entire transaction, the sale is not authorized until certain stakeholders agree in writing, namely the Board of Directors, majority of the shareholders, financial institutions which have a lien on certain assets, etc.

*Conclusion*

For many CEOs, selling their company is a once in a lifetime experience. They may be very experienced, very talented executives, but they can also be blind sided by surprises when selling their company.

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