PRIVATELY HELD COMPANY

the report on transaction issues

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A "Pig in a Poke"

Once a buyer has negotiated a deal and secured the necessary financing, he or she is ready for the due diligence phase of the sale. The serious buyer will have retained an accounting firm to verify inventory, accounts receivable and payables; and retained a law firm to deal with the legalities of the sale. What's left for the buyer to do is to make sure that there are no "skeletons in the closet," so he or she is not buying the proverbial "pig in a poke."

The four main areas of concern are: finance, management, specifics of the business, and marketing. Buyers are usually at a disadvantage as they may not know the real reason the business is for sale. This is especially true for buyers purchasing a business in an industry they are not familiar with. The seller, because of his or her experience in a specific industry, has probably developed a "sixth sense" of when the business has peaked or is "heading south." The buyer has to perform the due diligence necessary to smoke out the real reasons for sale.

Finance: The following areas should be investigated thoroughly. Does the firm have good cash management? Do they have solid banking relations? Are the financial statements current? Are they audited? Is the company profitable? How do the expenses compare to industry benchmarks?

Continued on Inside

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A “Pig in a Poke” (continued from cover)

Management: For a good quick read on management, the buyer should observe if management is constantly interrupted by emergency telephone calls or requests for immediate decisions by subordinates. Is there a lot of change or turn-over in key positions? On the other hand, no change in senior management may indicate stagnation. Are the employees upbeat and positive?

Financing: Buyers should make sure that the “money is there.” Too many sellers take for granted that the buyer has the necessary backing. Sellers have a perfect right to ask the buyer to “show me the money.”

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Marketing: Price increases may increase dollar sales, but the real key is unit sales. How does the business stack up against the competition? Market share is important. Does the firm have new products being introduced on a regular basis?

By doing one’s homework and asking for the right information and then verifying it, buying a “pig in the poke” can be avoided.

Off-Balance-Sheet Items

Although off-balance-sheet items are not obvious to the acquirer, if they are not disclosed by the owner up front, the acquirer’s confidence in the owner will be shattered when, and if, they are disclosed in due diligence.

The best policy is to be up front with the acquirer early in the process about a number of issues, including the following off-balance-sheet items (most of which will be discovered in due diligence):

- Prepayments or deposits from customers
- Work-in-progress billing, frequently exercised by large capital goods manufacturers and/or companies with government contracts
- Contract obligations, such as predetermined pricing over the next several years
- Lease obligations, such as escalation clauses or a contractual restriction from subleasing
- Legal threats by customers, vendors, or employees that have not yet materialized

Many times off-balance-sheet items are innocently overlooked by the seller. Take the example of a sporting goods store that was sold. The seller, not knowing whether or not the pending sale would be consummated, ran the business in the normal manner.

To promote a new line of Fuji bicycles, the seller placed a discount coupon advertisement in the local newspaper. Over the next few weeks, the seller focused on the sale of the business and failed to inform the buyer of the discount coupons. The day after the sporting goods store was sold, customers started to redeem their coupons with the purchase of bicycles. This undisclosed liability amounted to only $5,000, which the seller did not hesitate to repay. The point of this story is to show that off-balance-sheet items can be overlooked unintentionally.

If this “surprise” had revealed itself prior to the sale closing, the buyer would probably have been concerned about what other suprises the seller was keeping hidden.

Representations and Warranties

The following seller's representations and warranties are important to a buyer, but both sides should look at them carefully. Buyers want to cover all of the bases, but sellers also don't want to over-reach on what they represent and warrant.

Financial statements

A closing audit is critical to cover authenticity of all items, particularly inventory, receivables and payables. A post-closing statement is used to handle any loose ends.

Assets

Buyers almost always want assurance that all of the machinery, equipment, etc. will be in working condition at the time of the closing. Also, they would want to make sure that they are getting full title to the intellectual property, patents, copyrights, etc.

Taxes

Buyers obviously want to make sure that all taxes have been paid and that there are no tax liens on equipment, etc.

Employee relations

Employee agreements and contracts are important, even in an asset sale. If a new owner makes employee changes unknowingly (or knowingly), serious problems could result.

Environmental

This is a serious issue. Even if the business premises are leased, a new owner could be held liable for a previous owner's environmental contamination.

Pending and potential litigation

The seller will want to have a time period or cap on his or her total responsibility. The buyer is most concerned about his responsibility for previous products or services.

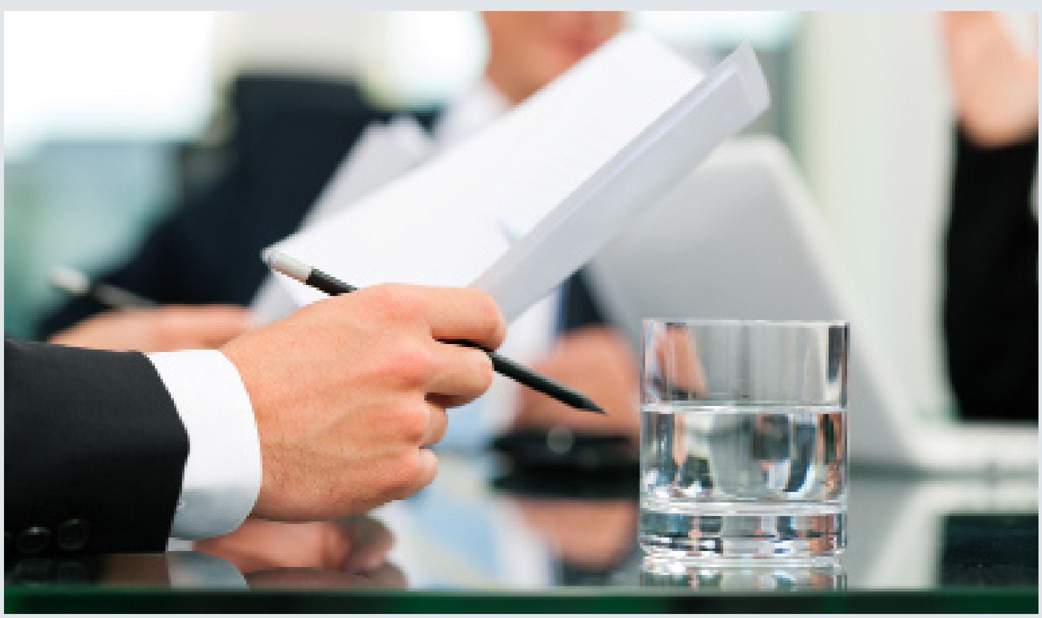
The important issue is which representations and warranties survive the closing, and for how long, and which ones cease.

Never on a Friday

It is important for both sides of the transaction to be represented by the principals of their respective companies so that changes, material or otherwise, are not challenged for lack of authority. Closings should not take place on a Friday or a day before a holiday in case the closing continues into the following non-business day without the ability to transfer or invest funds.

It is important to have adequate support staff to make last-minute revisions in documents and to deal with technical snags. One particular transaction failed to close because of improper wiring instructions from one bank to another (a wire transfer of funds is payment through a series of debits and credits transmitted via computers; bank deadline for wire transfers is usually 3 P.M.) The next day the seller changed his mind about selling.

For both the seller and the buyer, the closing represents the apex of the transaction, usually celebrated by uncorking champagne bottles. The sparkling bubbly will taste a lot better if you have confidence that your attorney has protected you properly from any possible ramifications after the business is sold.



Key Considerations

Questions such as the following will help a buyer (and a seller) better understand the business and help value the business more prudently:

What's for sale? What's not for sale? Does it include real estate? Are some of the fixtures and equipment leased instead of owned? What are the arrangements?

What assets are not earning money? Perhaps they should be sold off.

What is proprietary? Consider formulations, patents, software, etc.

What is the competitive advantage? Is it a certain niche, superior marketing, more efficient manufacturing, patents, copyrights, or intellectual property? What are the expirations, if any?

What is the barrier of entry? Capital, low labor, tight relationships?

Are there employment agreements or non-competes? Has management failed to secure these agreements from key employees?

How would someone grow the business? Perhaps it can't be grown.

How much working capital would someone need to run the business?

What is the depth of management and how dependent is the business on the owner or the key manager?

How is the financial reporting undertaken and recorded, and how does management adjust the business accordingly?

Saving a Deal from Undue Diligence

There are a number of ways to avoid killing a deal as a result of due diligence. The most effective way is to divulge all the company's warts up front and get them on the table early on. Of course, you should also have explanations as to why or how the warts can be addressed and overcome.

The most effective way is to divulge all the company's warts up front...

For example, say your company has excessive customer concentration, a major concern for buyers. You should be able to either explain that this situation has successfully endured for the past five years or that you have successfully addressed this situation by substantially reducing your company's dependence on these customers over the past year.

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