FAMILY WEALTHREPORT

# Business Owners: What Risks To Ponder Before Selling

Tom Burroughes, Group Editor, March 21, 2019

The author of this article examines the issues at stake in preparing to sell a business.

*The following article approaches an issue that business owners confront at different stages of their lives – how and when to sell what they have built, assuming they aren't interested in handing it to their children.*

*The author of this article, Jonathan Moore, partner in the transaction advisory services practice at PKF O'Connor Davies, explains a number of considerations for owners.*
*These can be daunting issues, and owners rightly worry about selling an organization too cheaply, or being hurried into acting before the "time is right".*

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Many business owners share the same dream: one that begins with a simple knock on the door. They open it to encounter a well-funded buyer presenting an extravagant, unsolicited offer to buy their company. Yet, as appealing as this scenario may seem, it is rarely the route to a top dollar sale.

Instead, maximizing a business' value requires a sound strategy, shrewd management and advance planning – none of which is particularly difficult but, all of which, requires expert guidance. As successful as entrepreneurs and owners may be, their talents typically lie in areas other than accounting, business valuation, financial reporting and quality of earnings analyses. Furthermore,

they may not be objective in assessing a company which they lead and may have built from scratch.

**Expert guidance and advance planning are key**
Business owners are wise to include the possibility of a sale or acquisition in their long-term planning. Ideally, owners need between 12 and 24 months ahead of a sale or acquisition to implement preparations in those areas likely to increase the value of the business or ease the transition process after a deal. These may include instituting optimal management infrastructure, hiring new talent, introducing new systems and technology, altering budgeting processes and operating through enough business cycles to produce results that are positive and sustainable.

Every owner or entrepreneur can benefit from the help of experienced transaction professionals – and particularly those with very specific goals, such as these:

-- To achieve significant EBITDA [earnings before interest, taxes, depreciation and amortization] multiples for an otherwise ordinary business, particularly when there may be strategic buyers looking to prevent competitors from acquiring the business.
-- To attract acquirers willing to pay a premium over normal enterprise value in order to purchase a business' real estate or other intangible assets, which may be more valuable than indicated in the financial records.
-- To promote brands recognized by one enterprise as "loss leaders" to multi-brand businesses that may be better equipped to capitalize on the associated marketing opportunities;
-- To position moderately profitable businesses to sell at a premium to larger firms that need access to a geographic region or a specific customer base.

Optimizing value is not a quick fix. It is a process that, when properly handled, offers a meaningful, lucrative outcome. Engaging the support of specialists can help owners realize their objectives more quickly and, just as importantly, avoid deal-threatening pitfalls along the way. The four most common risks to a successful transaction are the following:

**Risk #1: Brand, client or supplier imbalance**
Business owners are obviously and invariably critical to the success of any enterprise. In some cases, however, they are so intricately linked to brand and image that potential acquirers may fear that an owner's departure will result in damage to, or even failure of, the business. Naturally, this may reduce the purchasing pool, decrease the value of the company or preclude a sale altogether.

To reassure buyers that an enterprise's value is secure and that its future profitability does not rest in the hands of a few key players with one foot out the door, it is critical to deploy corrective strategies ahead of time. Ensuring that a strong management structure is in place is as essential to everyday operations as it is to an acquiring entity. If an owner or key player is planning to exit the business, it is equally vital that the remaining management team is cohesive, effective and poised to assume leadership. In addition or alternatively, plans to retain high profile managers can appeal to buyers who understand the importance of enlisting their help in representing to both clients and staff that the new ownership team is qualified and trustworthy.

Companies face a similar dilemma when they have relied heavily on a single client, customer or supplier. Not only does this imbalance increase operational, production and sales risk, it also may expose the firm to any added, and unknown, risk faced by clients and suppliers. Mitigating these threats requires honest and in-depth discussions between buyer and seller and surprisingly, often reveals opportunities to tap into advantageous synergies. For example, a firm made larger by sale or acquisition might benefit from economies of scale and access to a broader customer and vendor base. It might enjoy more leverage in negotiations with external vendors or the ability to manufacture more products and meet the supply demands of larger customers. Clearly, opportunities to expand capacity, geographic reach, market share and profitability may help boost purchase price and strengthen negotiating power.

Sound strategies can mitigate the threat of imbalance.

**Risk #2: Inability to deliver accurate financial data to metric-centric buyers**
Potential buyers – and especially private equity firms – are metric-centric. They want as much detail as they can secure on every financial aspect of a business. The more management can provide, at the appropriate time in the process, the greater the value of the business and the higher the likelihood that the sale process will continue beyond the exploratory stages.

Count on serious buyers seeking in-depth and accurate quantitative analyses, including current financial results, future budgets and forecasts, accounting data and more – all of which are standard and essential to sound ongoing operations.

Having in place a robust financial reporting system serves several essential functions. On a practical level, it makes it easier to provide the data sought by potential buyers and dealmakers. Up-to-date reports and systems facilitate the preparation of projections and provide better underlying evidence of the potential for realizing vital forecast benchmarks. On a profitability level, an existing reporting system is an instant value enhancement that assures buyers that adequate financial controls and systems are already in place. This in turn, may support a more favorable purchase price and help reduce both costs and fees at the time of sale. On a psychological level, it indicates that data, both current and historical, is readily available; this suggests that owners have nothing to hide and helps increase confidence in the information being provided. Many a deal has fallen through as a result of a buyer's hunch that something is amiss or that the business will require more work and investment than originally expected.

Unfortunately, not all business owners invest in such reporting systems, operating under the mistaken assumption that with adequate cash on hand and regularly filed tax returns all is well. Introducing formal processes is not difficult; accounting, transaction advisory professionals and other firms can build and implement the necessary systems quickly. Even those companies that do have internal reporting systems often benefit from an external audit of their financial statements and a review of accounting policies or a sell-side quality of earnings analysis to ensure they meet industry standards.

**Risk #3: Distracting non-business assets, liabilities and expenses**
Most business owners and entrepreneurs recognize the value of reducing costs as part of the pre-sale process as long as such cost cutting doesn't jeopardize research and product development or important customer, supplier and key staff relationships. Equally important is minimizing or removing non-business assets, liabilities and expenses that may distract from the business' real value or complicate the sale process.

Businesses with multiple locations or those that own office buildings or condominiums that are not essential to operations, for example, may find it harder to arrive at an appealing – much less exact – asking price. Pricing is further complicated when accompanying upkeep expenses, rental and association fees may be unclear and unpredictable. The degree to which these assets are obviously and directly related to the business' bottom line often helps determine optimal scenarios. For example, if the real estate is not critical to ongoing operations and the current owner wants to retain it, it may be advisable to remove the asset and its related costs prior to listing the business for sale.

In some cases, such as with closely held family businesses, a variety of assets get put on the books that are more personal in nature or unnecessary to the business, such as cars, boats and planes used occasionally for client development but primarily for personal use. If the owner wants to retain the asset post-sale, it makes sense to separate it from the business in advance of positioning the company to be acquired.

Those experienced in maximizing value recommend that owners evaluate the roles non-critical family members have with the ongoing business and consider removing them from the payroll as well as removing unrelated outside activities, real estate or side ventures from the books. An urgent care center or medical practice, for example, that owns and manages the entire strip mall in which it is located may present more of a responsibility than potential buyers wish to assume.

**Risk #4: Managing working capital perceptions**
An important step in the sell-side due diligence process is the preparation of both quality of earnings and quality of working capital analyses. A business' value generally reflects multiples of adjusted EBITDA (i.e. the normalized earnings of a company) and most buyers expect sellers to leave behind a "reasonable" amount of working capital to fund ongoing operations and to generate the EBITDA the business is reporting.

To determine what is reasonable, buyers will look at historical trends for accounts receivable, inventory, prepaid expenses, accounts payable and accrued liabilities. Buyers expect to acquire sizeable amounts of working capital when owners have unwittingly created the effect of high apparent working capital. This occurs when owners are generous with their customers – granting extended payment terms, for example – and also with their vendors – such as when they pay suppliers quickly to take advantage of payment discounts. In these cases, an effective strategy is to keep customers to payment terms and extend vendor payments, whenever possible.

Conversely, non-cash working capital levels can appear low when customers routinely pay in advance of receiving the services or products or when seasonal sales troughs coincide with the business' sale date – additional concerns that must be resolved properly before the sale.

Owners often assume that all of the working capital is theirs to take because, in their experience, it is not necessary to run the business. Buyers, naturally, tend to take the opposing view. Not dealing with this issue until late in the process may reduce both bargaining power and purchase price, which is why savvy owners make a point of including discussions of working capital early in negotiations in order to secure the most favorable purchase price.

Avoiding pitfalls such as these is not only possible, it is essential. To capitalize on the potent tactics that are part of a sound exit strategy, it makes sense to secure the help of experienced professionals well in advance of a projected sale or acquisition.

For today's entrepreneurs and business owners who have launched, nurtured and grown successful businesses, realizing premium value and return is not just a priority – it is a testament to their vision, dedication and hard work that they deserve and have every right to expect.

*About the author*
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