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The Key Steps Involved in Successfully Selling the Family Business

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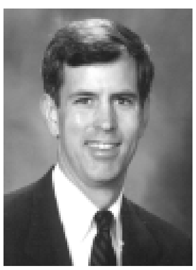
Introduction. Few family businesses in the United States survive into the second or third generation of family ownership. Either the offspring of the founder are unwilling to be involved in its management, are unable to successfully run the business, or the industry in which the company operates changes over time, leading to increased competition and diminished performance. Furthermore, much of a family's wealth may be tied up in the stock of their company. There may be a need to liquidate these holdings to meet the financial requirements of the owners' personal lives, to diversify assets, or to simply slow down and enjoy life. Therefore, many closely held businesses are ultimately sold, some while they are soundly performing and as a result of careful succession planning in concert with counsel from the owner's attorney. Other closely-held businesses are unfortunately sold under duress as the result of the death of a shareholder or deteriorating performance. The time to sell, however, is when times are good and performance is strong. In the current economic environment, the demand for the purchase of closely held businesses has never been stronger as acquisition pricing is at or near record levels. Untapping company wealth, however, is easier said than done, and usually best involves the assistance of an investment banker or merger and acquisition intermediary.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The selling process consists of a number of important steps that must be followed in order to realize a successful outcome. This article will discuss these steps as Banister Financial, Inc. and other successful intermediaries employ them, and how these steps are designed to achieve the business owner's desire to realize the highest possible price for the company while at the same time maintaining confidentiality. However, an outright sale to a buyer is not the only option available to the family business and may not meet with the family's long-term expectations for continued involvement in company affairs. Other options such as Employee Stock Ownership Plans (ESOPs) are available, however, an explanation of these plans is beyond the scope of this article.

Determining if Selling is Realistic. This article presumes that the selling shareholders have already gone through the most critical first step of all - determining if they are seriously interested in selling. As all estate planning attorneys know, family dynamics involving the closely held business are often the result of years or generations of past decisions and unspoken expectations by family members for continuing employment. This may occur even though the family members might not be suited for working in the company or, in extreme cases, may even be incompetent. The emotional attachment to the business can be great, making its sale difficult or impossible. Oftentimes, a crisis is necessary as the motivating force for a sale. To the founder, the business may be his or her "baby," the result of an entire life of commitment, long hours, and an unflinching desire to succeed. Before considering a sale at all, the

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founder must explore whether he or she will be happy without the ownership of the business. Also, the second or third generation family shareholders may have enormous feelings of guilt about the prospect of selling the company since mom or dad, who are now dead, wanted them to keep the business in the family for the future. In these instances, a sale either may not be possible, or may perhaps only involve the sale of a portion of the family's holdings, leaving the family with a tie to the company for the future (such as with a partial sale of shares to a newly-created ESOP).

Before the business is put up for sale, the shareholders need to deal with these and other issues. It may be that the best decision is to not sell the business, in which case the focus should shift on how to plan for succession and how to ensure for the business's long-term survival and prosperity. The business should only be placed on the market if a strong commitment to sell is evident. If no commitment to sell is present, the business should not be placed on the market solely to see if an unrealistically high offer emerges. While every investment banker seeks to control the process and maintain the confidentiality of the situation, there is a chance, however small, that word could leak out to customers, suppliers, and employees that the company is for sale. No family business wants this to happen, particularly if there really wasn't a desire to sell in the first place. Furthermore, it is not fair for the investment banker to invest six to twelve months of full-time effort to sell the company if the owners never really had any intention to sell. Finally, a hollow intent to sell can burn bridges with buyers who are investing substantial time, money and efforts in exploring the purchase of the company. Alienating these buyers may make it very difficult or impossible to receive a solid offer for the company in the future when or if a sale truly is desired.

Valuation and its Crucial Importance. A critical first step in considering a potential sale is to know the current market value of the company. Determining this issue answers several key questions:

- Is the owner interested in selling at that price? If not, there is no point in taking the company to market.
- What are the dynamics affecting the company's value and what are acquirors presently looking for in acquisition candidates in the industry? Who is doing the buying, how they are paying for the purchases (e.g., cash, stock, combination) and who is competing for those same companies (more highly motivated buyers wanting the same company can drive the price higher). The answer to these questions will enable the company to be presented to the right buyers and in the best possible light when it comes time to market the company for sale.
- Are there consolidators in the industry who have recently gone public and are seeking to gain economies of scale by acquiring small companies in a highly fragmented sector of the economy? If so, these consolidators will be under pressure to rapidly acquire companies to maintain the price of their stock. These consolidators will also be motivated to pay premium prices usually paid only by strategic buyers (see discussion later).
- Are there trends in the industry that suggest now is not the best time to sell? Is the industry presently tainted with a negative stigma by acquirors that might change in the future? Are conditions for industry demand likely to improve in the near or intermediate term? If so, this may lead to better financial results and a higher price than selling when industry conditions are depressed. Is the industry nearing a peak? If so, now may be the time to sell before valuation multiples drop.
- Does the business have its highest value being sold as a whole or by being separated into parts and sold to different buyers to maximize the selling price?
- How does the business perform compared to its peers in the industry? If it can be shown to be a superior performer based on objective industry data in a valuation, this may yield a higher value for the company. If the company's performance is sub-optimal, what changes could be made in the near or intermediate term to improve results to realize a higher value and make it a more compelling acquisition candidate? If tax motivations have driven the reported earnings or the income statement is padded with personal expenses, these factors can hurt the company's worth. In this instance, it may be better to allow for some time to groom the results to eliminate these unnecessary expenses before going to market.

As opposed to carefully determining the value of the business and the current market environment, taking a company to market with an unclear or vague idea of its potential worth is starting down a path fraught with potentially severe ramifications, as listed below:

- **Failure to Optimize the Sale Price.** The company is sold for less than its full value because the owner or the investment banker did not appreciate its true worth.
- **Overpricing Leads to No Sale at All.** The company is overpriced, causing serious buyers that would have been natural acquirors to avoid pursuing a possible purchase, and eventually resulting in the failure to sell the company.
- **Missed Hidden Asset Values.** A valuation might uncover valuable hidden intangible assets for which certain buyers might pay dearly.
- **Is Now Really the Right Time to Sell?** The owners decide to sell at a less than optimal time. Sometimes the best decision is not to sell, but to wait until the company's value is maximized (whether due to its growth, industry trends, size or other factors).
- **Needless Exposure of Company Information to the Market.** Taking a company to market when the ultimate price that can be obtained will not meet the seller's goals can be disastrous. Selling a company can take six to twelve months of intense effort, time and money on the part of the investment banker and serious time commitment on the part of the seller. The company for sale is ultimately baring its deepest secrets (customer base, strategy, etc.) with the risk that competitors could use the knowledge of a pending sale against the company or that customers, suppliers and employees will learn about the possible sale, negatively affecting their relationships with the company. While confidentiality agreements are obtained from possible buyers, there is still some chance that this information could leak out, damaging the company. Therefore, the company owner should only entertain a sale of the company when it is clear this is a reasonable course of action, the valuation climate is right, and the timing of a possible sale is in sync with the goals and desires of the shareholders.

Too many investment bankers and business brokers, who make their living solely on fees from "doing deals," have a vested interested in motivating the owner to sell, even though the time may not be right to maximize the price received. Valuation firms with expertise in merger and acquisition transactions are more objective and will use the valuation process to assist in advising the client on when or if they should sell and how to groom the company to realize the best price when they do decide to sell.

At Banister Financial, Inc., for example, we refuse to sell a company unless we have first been hired to prepare a comprehensive valuation. If the owner believes the resulting value warrants a sale and we believe the timing is right to do so, we are then glad to be engaged to sell the company and will credit the cost of the valuation towards our fee for selling the company. However, we believe the advisor must also be prepared to recommend to the owner that now is not the best time to sell if that is the case based on the company's particular circumstances as evidenced in the valuation. We can't know this without fully understanding the company and its value. The broker who makes a fee only from the sale of companies depends on making these sales to live, even if these sales are not in the best interest of the seller.

Some brokers and intermediaries agree with the prospective seller that they will prepare a valuation and include it as a part of what they will do for the commission they will receive on the sale of the company. Alternatively, a broker may do a valuation for free, hoping to be engaged to sell the company. The problem is that both of these situations give the broker a built-in incentive that may diverge from the interests of the business owner. If the broker does the valuation to "get the listing," they may treat the company as a "flyer" (questioning whether they will win the assignment to sell the business) and put little time and investigation into the valuation process. These brokers are probably out juggling this same free offer to many potential sellers. You get what you pay for, and this kind of attention may miss the true underlying value of the company.

Alternatively, the broker may give the owner an inflated estimate of value to ensure the engagement of his firm to sell the company. Brokers often calculate that once offers begin to emerge, the broker can deflate the owner's expectations with market reality and "push" a sale through to completion. This is completely unethical, a breach of the broker's fiduciary duty to his client, and also could lead to either no sale (the result of overpricing) or the owner getting cold feet at the closing after much hard work and anguish. Because the broker only makes a commission if the deal closes, these brokers aren't always looking out for the best interests of the seller.

Selecting the Investment Banker or Merger or Acquisition Intermediary. Selection of a skilled investment banker or merger and acquisition intermediary is crucial to the successful sale of the closely held company. The firm should be carefully interviewed to ensure that its principals have broad industry knowledge, substantial valuation and real-world transaction experience, and the willingness to devote their full attention and resources to the successful sale of the company. The firm must also have the utmost integrity and an excellent reputation among prospective buyers, investment groups, venture funds, and in the legal community.

The investment banker must have a commitment to work carefully with and rely upon the advice and counsel from the seller's legal, tax and accounting advisors from start to finish. Too many business owners hire a intermediary to sell the company and make the major mistake of involving legal and tax advisors at the final stages of a sale. This is a critical mistake which can cost the seller millions in taxes and cause a very difficult time renegotiating a deal that is disadvantageous to the seller.

Finally, the skilled investment banker must have the skills and willingness to be involved in all aspects of the transaction as well as the ability to help bring it to closure if warranted. All of this must be done in the best interests of the client. The investment banker must also have the personal integrity and fortitude to be willing to tell the seller to turn down a deal, even at the risk of losing a transaction fee, if the deal is not in the best interests of the client.

It is this final point that we feel is so crucial and why the middle market closely held company (companies with $5 million to $300 million in revenues) is often so poorly served. The business broker typically makes his or her sole living from the fees realized from a company's sale, so there is a powerful motivation to attempt to induce the company owner to sell even when the timing may not be right or the deal offered is inadequate. While the business broker may prepare valuations, they are typically not trained in doing so. Reports by business brokers tend to be overly simplistic and computer-generated, and are more often than not used as hype to attempt to win the engagement to sell the company, even if the valuation is totally unrealistic. The company owner should select a valuation firm that has derived the majority of its business from providing unbiased, fee-based valuations and advice to business owners for a wide variety of reasons. The valuation firm should be interviewed to determine if their transactions have withstood the scrutiny of real world buyers, banks, the courts, and governmental entities such as the IRS, the Department of Labor, and the Department of Justice. A valuation firm that is also involved in mergers and acquisitions is a much better resource in the sale of the small or mid-sized closely held business.

Identifying Prospective Buyers. The successful sale of a company depends upon identifying and marketing the company to the right group of prospective buyers that are financially capable and motivated to close a purchase at the maximum possible price. Identifying the right buyers is a key part of the selling process and is one of the most important steps of all. The identification process dictates how these buyers must be approached, the information they will be given about the company, and the negotiation and pricing strategy employed.

There are two broad types of acquirors of companies: financial buyers and strategic buyers. Within those two broad types of buyers there are numerous sub-categories. Identifying which buyer is the most likely acquiror of a specific company is crucial in the marketing and sale of the closely held business.

Financial Buyers. Financial buyers are typically individuals, investor groups, venture capital funds and other companies who are making acquisitions principally for the earnings or cash flow they will receive as a source of return on their investment from the acquired company.

Individual buyers generally purchase the smallest of companies (typically $2 million in purchase price or less) and are often the buyers least able to pay the best price. Individual buyers generally are also the most likely buyer to be unable to deliver at the closing. The typical buyer in this category is the former executive who has left corporate America to "run his or her own show." The problem with this buyer is that they often do not have sufficient personal resources to acquire all but the smallest of companies and/or often will need and request the seller to provide a substantial portion of the financing for the company purchase. Often, when asked if he or she possesses the funds for the purchase, the individual will bluff that they have the funds when they actually do not. The individual buyer may also bluff that they will have no problem putting together the investors to facilitate a purchase. The last thing the serious seller or his or her advisors want to do is to invest a great deal of time and energy dealing with this type of buyer if there are other more capable buyers available. For this reason, it is key for each individual buyer to be pre-qualified by the investment banker as having sufficient personal financial resources.

Does this mean the individual buyer should be avoided? Not at all. In some cases, an individual may be the best or most logical buyer. However, the advisor must be able to recognize these instances and know when this channel is the appropriate one for the company being sold. In the very smallest of companies (e.g., those with $5 million in revenues or less), this may be the only type of buyer available. The typical small business owner dreams of the day he is able to receive a big check for his company from a large acquiror that will overpay in a purchase. The reality in these small companies is that most of these businesses have no appeal whatsoever to a corporate buyer. These small companies either operate in a small niche-type of business with limited prospects for growth, are local in nature, or are heavily dependent upon the owner's continued involvement to operate. Therefore, the individual buyer may be the only way out for the small business owner.

Investor groups, leveraged buyout funds, and venture capital firms represent a key source of prospective buyers for the mid-sized and larger closely held company. Properly identified, these types of financial buyers are excellent sources for liquidating an owner's investment in a closely held business. While some of these buyers look for turnaround situations where new management can be brought in to restore or enhance profitability, most of these buyers look to acquire companies that have an established and successful management team that can continue to remain in place following the acquisition. For example, by bringing additional capital to the picture, venture capitalists can enable the acquired company to capitalize on growth opportunities, new markets, and other avenues that the company could not pursue on its own before. At the same time, the investment by the venture capitalist enables the existing shareholder to convert some or all of his or her holdings into cash, or enables existing non-shareholder management to receive an equity piece of the company as motivation to work towards its success. Many closely held business owners want to sell their company to the management team that has been loyal to them, yet are unable to do so because these key employees often lack the financial resources or knowledge to accomplish a buyout. Certain investor groups, leveraged buyout funds, and venture capital firms are interested in purchasing positions in just this kind of situation. Here, venture capitalists provide the funding to cash out the shareholder in return for a significant equity holding in the company. At the same time, the VC investment gives the key management an equity incentive to run the company.

Not every institutional acquiror within this category is a prospective buyer. Some buyout groups are only interested in certain specific industry groups or have certain size criteria (e.g., a minimum investment size, purchase price, annual revenues or earnings of the company to be acquired). Therefore, the investment banker will need to identify and direct activities towards a carefully identified list of candidates within these groups. At Banister Financial, Inc., for example, in our years of valuation and merger and acquisition related activity across a large number of industry groups, we have developed contacts with numerous institutional buyers and are intimately familiar with their acquisition criteria, their current appetite for new acquisitions, and their unique needs for information in examining a prospective company for sale. Institutional buyers look at literally hundreds of potential deals per year, a limited number of which are seriously entertained and only a few of which lead to transactions. Therefore, it is crucial that the offering memorandum presented to this type of buyer is compelling, well written, and addresses any unique needs in order to be read or seriously considered.

Strategic Buyers. Whether it is a competitor in the same industry, a related industry, or an unrelated industry, strategic buyers are typically corporate buyers who are interested in buying a company in a specific industry or a specific company itself for variety of possible reasons such as:

- Getting into an industry where the acquiror has no presence but feels it must have one as part of its long-term strategy, or where it feels it is weak or disadvantaged compared to the competition.
- To round out an array of products or services for an existing customer base.
- To increase its market share within an existing industry, whether by growing its product line, extending its geographical coverage, or eliminating a competitor.
- Competition is increasing in its existing industry, leading to pressure on profits and the desire to diversify into other more promising industries (and where the acquiror is willing to pay a premium to buy this immediate presence).
- To gain access to proprietary technology, intellectual capital, specialized expertise, etc., that is otherwise difficult or impossible to obtain, and which will enable the acquiror to leverage those assets within its existing business.
- The ability to realize "synergy" from the purchase. Probably the most-often used word when talking about mergers and acquisitions is *synergy*. The concept of synergy is simply that the sum of Company A's value and Company B's equals C, which is greater than the individual values of A and B. That is, 1+1 = 3.

The two companies combined are worth more together than the two are separately. The term synergy is most often used when describing fragmented and inefficient industries, where the potential exists to consolidate the industry into a few larger players who are able to eliminate duplicate costs (overlapping salesforce and distribution infrastructures, etc.), realize savings in negotiating volume purchases from suppliers, and other benefits. Fragmented industries, those with numerous publicly held companies and thousands of smaller, privately held competitors, are believed by some to operate less efficiently than concentrated industries.

Determining if the prospective company to be sold fits the characteristics sought by synergistic or strategically-motivated buyers is essential, since this type of buyer will often pay a premium far above those paid by financial buyers. Therefore, the strategic buyer is the usually the ideal purchase candidate.

Determining if the conditions exist for the presence of strategic buyers and who those buyers might be is typically uncovered as a part of the valuation process, since a properly prepared professional valuation examines internal and external aspects of the company and the acquisition environment. However, not every business appraiser is up to this challenge. Regretfully, some valuators churn out valuations as if all companies were alike, failing to delve into the company and industry in detail, and foregoing a detailed acquisition search of comparable sales. Instead, these "appraisals" usually rely on often-wrong formulaic valuation approaches with only a superficial study of the company and what makes it unique. Furthermore, many valuators have no acquisition or transaction experience whatsoever, and rely solely on textbook theory and accounting training.

"Consolidators" and Their Impact on the Company Sale. Many industries in the United States are highly fragmented, being made up of hundreds or thousands of small and mid-sized companies, each generally operating on a local or regional basis, with no one dominant company. While many industries are subject to consolidation through acquisitions, in recent years the highly fragmented industry has been the focus of a new breed of acquiror, the publicly traded industry consolidator. These consolidators have emerged as a major force in driving the prices paid for small and mid-sized private companies to new heights. Many of these prices are out of context with all historical norms and are fueled in large part by a favorable stock market that is receptive to the consolidator's "story."

Consolidators seek to purchase competitors in fragmented industries for a variety of reasons, including: cost reduction by removing owner perquisites (e.g., owner compensation and benefits at levels higher than a professional management team), elimination of duplicate distribution channels and sales forces, the increase of profit margins by using increased volume to squeeze concessions out of suppliers, and the purchase of access to new markets and new products. Also, consolidators believe they bring professional management skill to the table that is not possessed by the typical small, closely held business owner. Finally, consolidators may believe an entirely new business model is called for in an industry that stands to transform and reshape the landscape of how business is done.

Typically, an industry consolidator is a young publicly traded company or a company who is seeking to gain enough critical mass through acquisitions to go public. Using its story of efficiencies and increased earnings through market share, the consolidator aims to gain funds from an initial public offering of its common stock to fuel rapid growth through continued acquisitions. Once this kind of acquiror has gone public, it is under great pressure to maintain a rapid rate of growth, otherwise, it runs the risk that its stock price will collapse. Therefore, the consolidator is usually a highly motivated buyer and is often willing to pay a premium price for privately held companies in the industry it is consolidating. While some consolidators have shown the ability to transform industries and reap the economies claimed, their numbers are few, and most are simply stock market plays by those who take them public. The consolidators hope the investing public will buy their story about the gains from efficiencies, driving the stock price upward until management can realize a windfall through the sale of their shares and/or the exercise of stock options. The claimed ability to transform an industry usually does not pan out, the investing public wises up, and the share price craters. A number of publicly traded consolidators have actually gone from the concept stage at formation, to implementation, to IPO, and ultimately to bankruptcy in three years or less.

This does not mean the consolidator is a poor purchase candidate. On the contrary, the consolidator is often the best candidate. However, because many consolidators can only sustain their acquisition binge through a high share price, their shelf life as prospective acquirors is typically short (perhaps only two to three years). This has important implications to the owner considering the sale of his or her company in this type of consolidating industry. First, it is important to identify if consolidators are present or are emerging in the selling company's industry. If this is the case, there can be enormous windfalls from selling to such a consolidator. In industries where consolidators are active, this may present a once in a lifetime opportunity to cash out at a price that may never again be achieved. At Banister Financial, Inc. we continue to be amazed, as do our clients, at the prices consolidators are willing to pay in certain industries that were previously the domain of the individual buyer.

Second, since the consolidator's lifespan is usually short, the closely held business owner must carefully time his or her decision to sell before the consolidator's ability to sustain its acquisition binge has run its course and its source of funding dries up. Once this has occurred, the prospects for this type of buyer vanish and the multiples paid in the highly fragmented industry typically revert to historical norms. In an industry dominated by local or regional companies, this often means going back to individual buyers (financial buyers who are often under-financed and cannot begin to pay the multiples previously paid by consolidators), investor groups, or competitors as the primary sources of liquidity for the closely held business owner. As a result, the closely held owner in an industry being influenced by consolidators will need to carefully weigh his or her plans to remain independent for the long-term against an unprecedented, but very narrow window of opportunity to cash out.

Third, the risk that a consolidator's share price may collapse implies that the seller should be very careful about how much of the purchase price he or she is willing to take in the form of the consolidator's stock. The shares may be very thinly traded, affording few options for liquidity since the market may not be able to absorb all of the shares should the former owner later wish to sell them. Furthermore, the public company shares received are typically restricted from sale for one year, restricting the ability to convert them to cash. Since the high public share price of a consolidator is often only maintained for a brief period of time, that price could collapse before the former business owner has the opportunity to get out of the stock. Because of the thin trading characteristics of the public company's stock, this may limit or preclude the ability to use put options or other hedging strategies to effectively create a floor on the public company's share price, limiting downside risk. Therefore, the seller should seriously consider receiving all or a substantial portion of the purchase price in cash, viewing any portion received in stock as icing on the cake should the public share price perform well, but realistically viewing it as a possible full write-off whose value may never be realized.

Examples of Industries Where Consolidators Are Now Active. The list of industries where consolidators are active is enormous, so it is not possible to list every one. **Table A** shows a representative list of a few of the many diverse industries that we have seen recently here at Banister Financial, Inc. as being reshaped by mergers and acquisitions and the impact of consolidators:

Table A
A Few (of Many) Examples of Consolidating Industries

Convenience store chains	Heating / AC Contractors	Commercial printers
Printing supply wholesalers	Industrial supply wholesalers	Floral supply distributors
Fuel oil distributors	Automobile dealerships	Scrap metal dealers
Chemical wholesalers	Local telephone companies	Cellular phone operations
Banking	IT consulting firms	General / specialty contractors
Equipment rentals	Video retailing	Public accounting
Primary care medical practices	Beer distributors	Soft drink bottling companies
Food manufacturing	Temporary staffing firms	Trucking
Seafood wholesalers	Food wholesalers	Textile yarn producers
Freight forwarders	Water utilities	Propane gas dealers
Home insulation contractors	Electrical wholesalers	Funeral homes

Consolidators Versus Consolidation. It is important to note that consolidation and consolidators do not necessarily go hand in hand. Many industries are consolidating over time as industry participants seek to grow through the acquisition of competitors, or through expansion by geography or product line. Given the right trends and forces, consolidation can lead to attractive pricing for the closely held business since the motivating forces are often strategic in nature. Also, unlike the consolidator, which is largely a short-term stock market phenomena, industry consolidation based on sustainable forces can provide a longer-term source of liquidity for the closely held business owner.

Is Your Industry Ripe for Consolidation? As a closely held business owner or advisor, you may already know if your industry is currently consolidating because your competition is increasing, or your customers or trade publications are telling you so. Some signs that your industry is heading toward consolidation are:

- **Deregulation.** The elimination of regulatory protection of an industry lowers the barriers to competition, leading to new entrants into an industry. An excellent example is the local telephone industry, which previously benefited from monopoly protection. As a result of FCC rulings, for example, local telephone companies must now open their local markets to competition. This has led to a massive increase in mergers and acquisitions.

- **Product Life Cycle Nearing Maturity.** Product life cycle is an easy concept to understand. There are four stages in a product's life: development (low sales levels), expansion (large profits as demand grows), maturity (increased competition and reduced profit), and decline (consumer satiation, declining sales). The personal computer industry runs through a complete product life cycle each time a new generation processor is introduced. The initial price for the fastest processor is high, then declines as more are produced. The computer becomes functionally obsolete after only a few years because faster generation processors are continually introduced. Most products and services reach a stage in their life cycle where they are mature, with limited or slow-growing future opportunities. The days of rapid growth and fat profit margins are gone as existing industry participants fight to maintain market share as profit margins narrow and competition increases. Many participants either go out of business or leave the industry since profit margins become insufficient. Merger and acquisition activity increases. These factors lead to a sharp reduction in the number of industry participants. When the shakeout is over, a limited number of competitors remain that can meet the future demand for the industry's products, and profit margins recover to a level sufficient to provide a reasonable, but not excessive return. In short, equilibrium is reached.
- **Technological Change and Innovation.** A recent and increased reliance on technology in an industry can lead to greater competition. The heavy level of financial investment needed in technology in order to remain competitive often cannot be sustained by smaller, closely held companies. This often leads to consolidation. Additionally, technology can create the potential for new ways to transact business. A good example is the Internet, which brings the ultimate customer closer to the producer in many industries, eliminating or reducing the need for middlemen, such as wholesalers and distributors. Even if the need for middlemen is not eliminated entirely, even a modest degree of penetration by Internet-related companies into the distribution channel has the potential to significantly reduce the profit margins of traditional wholesalers and distributors.
- **Increased regulatory costs.** The costs to comply with various regulatory rules is becoming cost prohibitive for small and mid-sized participants in many industries.
- **Powerful suppliers and customers and increased competition.** Increasing bargaining clout from large suppliers and/or customers makes it difficult for smaller companies to compete. For example, large wholesalers and distributors have the ability to demand substantial volume-related pricing concessions from suppliers. These concessions are not available to smaller local and regional competitors. Also, mid-sized and larger customers are increasingly using "sole sourcing" techniques, where all or a majority of a business's needs are purchased from one or several broad range suppliers (as opposed to in the past, where many suppliers might have been used). Furthermore, these customers often demand that the wholesaler provide extensive online line ordering and transaction processing (electronic data interchange, or "EDI") and just-in-time inventory availability. Many smaller wholesalers do not have a sufficiently broad line of products to be a sole source, and often cannot afford the large investment in information systems and additional working capital resources needed to meet these demands.

Offering Memorandum ("Deal Book"). Once the decision has been made to market the company for sale and the prospective buyers have been identified, the offering memorandum (or "deal book") is prepared. Typically 60 to 100 pages in length, the offering memorandum is a detailed overview of the company that is very similar to a valuation report. The offering memorandum outlines the business's special characteristics, including:

- Background and history
- Management strengths
- Products and services offered
- Strengths versus competitors
- Suppliers

- Customers
- "Hidden values"
- Historic financial summary, analysis
- Operating analysis
- Areas for future growth

The deal book provides enough detailed information to enable prospective buyers to determine if they are seriously interested in exploring a possible purchase, if the acquisition candidate meets their investment criteria, and to determine the questions they will need answered (in order to make a later offer) once management interviews are allowed. It is important to screen out buyers who are not interested since they have no business wasting management's time. Furthermore, those buyers that are interested will now have compelling reasons to invest the time, money and resources to carefully examine a possible purchase. Sophisticated buyers do not want a deal book full of hype about how great the company is. In contrast, these buyers want sound analysis, factual information, and data presented in a professional manner so they can reach their own conclusion about the merits of the investment. Therefore, a high quality offering memorandum is a must.

The offering memorandum must be easy to follow and set forth all aspects of the business in a straightforward, concise manner. Since a closely held company's financial results can be impacted by compensation paid the owner that is above that which would need to be paid at a market rate by a buyer, the true earnings power of the company as reported in its income statement may be understated. Similarly, strategies to reduce reported income for tax purposes may have been employed by the owner that may not reflect its full earnings strength. Finally, there may be unusual or non-recurring expenses (e.g., legal fees from a lawsuit) that negatively impacted a given year's results that are not continuing in the future.

Therefore, normalizing adjustments to reported results will also be included in the offering memorandum, recasting historic financial results to what they would have been in the absence of these distortions. Also, if there are synergistic cost savings that can be realized by a potential specific type of purchaser (such as a competitor), these savings might need to be considered. In other words, it cannot be assumed that the buyer will know or ask about factors that led to the distortions in results. Therefore, these factors should be laid out clearly for the buyer to see.

Initial Exposure of the Acquisition Candidate to Buyers. Initially, the investment banker will only expose marketing information about the availability of the company for sale to those candidates who are financially capable, have a genuine interest, and are willing to maintain confidentiality by first executing a confidentiality agreement. However, just being willing to sign a confidentiality agreement does not guarantee confidentiality will be maintained. Therefore, part of the investment banker's job is to determine the motivations of prospective buyers before transmitting information to them. Before going to market, Banister Financial will discuss with the seller what conditions he or she is comfortable with in transmitting information about the company and if they are any potential buyers that should not receive the information. Sometimes competitors can be a likely buyer of the company, however this also brings certain risks, so the owner and Banister will decide if competitors are or are not eligible to be made aware of the opportunity for purchase. All of these hurdles must first be met before a prospective buyer receives a copy of the offering memorandum.

To gauge initial interest by the targeted buyers, it is typically useful to first mail out a summary description of the company which gives enough information to gauge the buyer's level of initial interest to receive a full offering memorandum, yet leaves out detail that would identify the company.

Buyer Preliminary Analysis and Due Diligence Phase. After the offering memorandums are received and initially reviewed by buyers, there will typically be a prescribed period (e.g., 30 to 45 days) during which questions and/or additional information needs can be addressed with the investment banker, but not the company owner. The seller, who is trying to run his or her business, needs to be shielded from these questions for several reasons. First, this process is very time demanding and would take away important attention from the business. Second, a flurry of calls back and forth with the company owner could alert receptionists, secretaries and other employees at the company that it may be for sale, creating morale problems and industry rumors. Third, the owner may take offense at some of the questions, since he or she may have a substantial emotional investment in the company, or may not understand the nature of the question or why it is being asked. Emotion needs to be removed from the process since it and ego have killed more deals than any other single factor. By interacting with the investment banker, the buyer can explain his or her concerns that can be effectively dealt with and addressed in a forthright manner.

Due diligence, in layman's terms, is the act of turning over every stone of the business to attempt to uncover problems, hidden liabilities and factors affecting the company or its potential performance. For example, an exclusive distributor of pumps and valves for a region may need to obtain supplier approval of a buyer prior to a closing. While the buyer will have been pre-qualified before this stage, the buyer now needs to know that the supplier can approve the buyer as a new distributor. Are there any key salespeople in the company, who, if they left after a purchase, would imperil the performance of the company? Are there any hidden legal or environmental problems?

Most of these other questions about the business should ideally be fully addressed in the offering memorandum. This will give the prospective buyer more confidence that the company is being fairly and accurately represented. The buyer can then focus on the merits of the company as an investment. Nonetheless, it is expected that the buyer will delve deeply in all aspects of the company and will have a suspicious skepticism about everything he or she is told. Therefore, it is extremely important that the owner and investment banker be honest and forthright in the offering memorandum about the business, and not leave anything out that might be considered material. Even if the factor might be relatively minor in its importance, leaving out information will result in a loss of confidence by the buyer. Also, full disclosure helps protect the seller against later allegations of fraud if the company is acquired and does not work out as the buyer intended.

Management Interviews. By now, the investment banker will have a clear idea of which buyers are seriously interested and which buyers will therefore be offered the opportunity to conduct an in-depth interview with company management prior to making an offer. In order to avoid disruption at the company, all interviews are typically scheduled to occur within a short time frame, typically two weeks or so. In fact, it is actually advantageous to schedule interviews back-to-back so that buyers will see each other coming and going from the meetings. This creates the perception that the company is in great demand and could potentially lead to higher offers as the sense of competition is heightened.

The Managed Auction. Once interviews are complete, the next step is to solicit offers. This is typically done through a controlled auction process. The parties have a fixed time frame to submit purchase offers, subject to any due diligence or other conditions that may be set forth in their letter of intent or purchase agreement. Auction has a negative connotation to many business owners who fear that the business may sell too cheaply or the owner will be forced to accept a low offer. Neither is the case in the sale of a business. The auction process forces serious buyers to avoid playing games with initial lowball offers and similar strategies and instead put their best foot forward for fear of losing the deal. No serious buyer wants to spend months of time and money on an acquisition that excites their imagination, only to lose it to another buyer. Auctions lead to higher prices, not lower ones, and auctions force buyers to get serious fast. Also, the seller is under no obligation to accept any offer.

Evaluating Offers. Offers come in many sizes, shapes and colors and are not necessarily compared based on price alone. For example, the purchase price may be all cash, all stock (of the acquiring company), a combination of cash and stock, cash and notes, all notes, or numerous variations in-between. Just because an offer is the lowest in total dollars does not mean it is the worst offer. From a tax standpoint, the way the offer is structured may actually result in the best total financial outcome for the seller, and vice versa. For example, assume one acquiror has made an offer to purchase ABC Corporation's assets for $10 million, while another is willing to purchase its stock for $9 million. Since ABC is a regular C corporation, if the owner chooses to accept the $10 million offer and sell its assets, this may expose the seller to double taxation, first on the gain on sale at the corporate level, and then again at the personal level when the proceeds are distributed to shareholder. By contrast, the sale of stock for $9 million to the second buyer may actually be far superior since it will only result in one level of tax to the seller.

If the offer is to pay in whole or in part with the acquiring company's stock, it is helpful to consider whether the public company's stock is a good investment. Will the seller be comfortable with the risk of taking all or part of the purchase price in the form of a public company's stock? The typical closely held company owner's initial reaction is that they want an all cash offer and will not take stock. Is this always wise? No. Many acquirors want or need to use stock to facilitate acquisitions. While accepting public company stock can include risk in the event the share price later drops, this risk may be reduced, or even eliminated entirely through the use of sophisticated put options and other derivative securities that will effectively put a floor on the price of the stock for a fixed period of time. The public company's underwriting firm may be willing to put such a instrument in place. While it costs money to use these techniques, these costs may still result in a net sales price realized that is above an all-cash offer. Also, the underwriters of some large public company acquirors now have the ability to pay the seller in stock, then immediately allow the seller to convert the new public company shares into the shares of a diversified mutual fund of publicly traded stocks. This further reduces the risk to the seller.

Another consideration for the seller is the degree to which the shares of the public company received are subject to restrictions on their sale for a certain period of time under Securities and Exchange Commission rules. Also, the seller must consider the issue of whether he or she will have to bear the costs of registering the shares for sale. Another article in this issue of *Fair Value* ("Selling Out to a Public Company Buyer- Blockage, Restricted Shares, and Value") outlines some of the considerations involved.

Some acquirors may propose that some of the purchase price be contingent upon post-closing achievement of certain financial milestones (e.g., hurdle sales or earnings goals) by the acquired company over time, particularly if the selling shareholders are to remain for some period of time in the management of the company. Typically, earnouts are used where the seller maintains that there is a substantial upside to the company's performance that has not yet been demonstrated in the company's historic actual results. The skeptical buyer will only pay for these illusory results if they actually materialize, hence, the earnout. Whether or not the portion of the purchase price paid as an earnout is actually achieved is speculative, so the selling shareholder should view this as icing on the cake if achieved. The selling shareholder generally should not count on these additional payments as a part of the sale price of the business.

Tax and Legal Ramifications of Offers. A crucial consideration is the legal and tax ramifications of the proposed offer. This issue necessitates a careful review and the solicitation of advice from the owner's legal and tax counsel to determine the implications. For example, what sorts of representations and warranties will the seller be required to make to the buyer that may later pose a significant financial or legal risk to the seller? Are there environmental issues that pose a threat? These and numerous other issues will need to be carefully explored. These and other requirements that must be met as a condition to closing will be spelled out in the purchase offer or letter of intent.

Working for a New Master is Not Always Easy for the Seller. The current owner must also evaluate whether he or she can work for the new owner. The current owner in all likelihood will not be able to walk away from the company, but will have to assist in the transition. This assistance usually takes the form of a multi-year employment agreement and a non-compete agreement preventing the seller from starting up a new business in the area or joining a local competitor. An owner might find it difficult no longer being the "top dog" as he watches his company being managed in a direction with which he doesn't agree. The business press is full of examples where former CEO's have been unable to function as the "number-two" executive after a merger or acquisition.

The seller must fully consider whether he or she is willing to work with the new owners during a transition period and is truly willing to exit the business by signing a non-compete agreement. Clearly, companies are sold without the current owner staying on, but buyers and sellers recognize the need of a transition arrangement to justify any "goodwill" or premium in the purchase price. The willingness of the seller to work for a buyer is a broad issue that needs to have been resolved before the company is marketed for sale. However, after actual buyers have materialized and made offers, this issue again may assume importance in evaluating which offer to accept. Again, the highest price offered isn't always the best deal as a number of considerations must be taken into account. Once all of these issues have been resolved and the offer selected, the parties can move forward to the preparation of closing documents.

Alternatives to an Outright Sale. This article has dealt with the situation where an outright sale is anticipated. However, there are other options that can used to meet the needs of the family that wants to liquidate some of its wealth without entirely divesting of its share ownership and its links to the company. Employee stock ownership plans (ESOPs) for example, are a powerful tool for enabling a tax-advantaged purchase of part of a family's shareholdings, and may provide a longer-term market for the remainder of the shares should the desire later arise to sell them. Another alternative is the sale of some or a majority of the shares to key management via a management buyout. Both of these issues are complex and are beyond the scope of this article.

Conclusion. Selling a company is a complex process that involves skills that the average closely-held business owner does not have. While it is possible to "go it alone" to save the fee of an investment banker, this course of action will most likely result in frustration for the closely-held business owner. Common pitfalls for the closely-held business owner who is striking out on his own include the improper pricing of the business, the failure to show the company to the greatest number of qualified buyers, the inability to address the information needs and concerns of buyers, and the failure to deal with the emotional issues involved with the sale of the company. Using a skilled investment banker dramatically increases the odds that a successful sale can be achieved, that confidentiality during the selling process will be maintained, and that a favorable price can be realized. The closely-held business owner must also keep in mind that an outright sale to a buyer is not always the best option, particularly since family desires for continued involvement in the company may dictate other alternatives such as the implementation of an Employee Stock Ownership Plan. ♦

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