



Preparing Your Company for a Merger or Acquisition

Introduction

As discussed in another article by Highland Global, entitled “Selling Your Company,” business owners are confronted with a number of decisions each day that impact their business, none of which may be more important than the decision to pursue a merger or acquisition of the company. This is often an issue that many privately-held business owners are reluctant to discuss or even put much time into planning for, as the thought of no longer being involved in their business may be overwhelming. In addition, many business owners do not recognize the actual need to consider developing an ‘exit strategy’ for their company—whether it relates to a merger or acquisition due to nearing retirement or for estate/succession planning purposes. Assessing the feasibility of pursuing a strategy to achieve some degree of personal liquidity through a transaction should be a major concern for privately-held business owners, particularly those who are nearing retirement age.

The process of selling a privately-held business is complex and involves many facets with which the owners are likely unfamiliar. The merger or acquisition of a privately-held business is not accomplished overnight and requires significant efforts by the owners and their advisors in order to prepare the company for presentation to potential acquirers or merger partners. To be successful in bringing the company to market, privately-held business owners should be cognizant of the many dynamic stages and issues associated with preparing their business for a merger or acquisition. These stages and issues include the following:

- **Determining the Need to Sell the Company**—Typically, there is a wide range of reasons that a privately-held business owner may have for selling the company, including retirement, family succession issues, illness, unforeseen circumstances, loss of interest, financial distress, other investment options, etc. Whatever may motivate the owner(s) of a privately-held business to pursue a sale of the company, the results of such a transaction generally include an

increase in their personal liquidity, diversification of their portfolio, and a reduction in the overall risk of their personal portfolio.

- **Preparing the Company for the Sale**—Once the decision is made to sell, the owners of a privately-held business are typically unprepared for the process of selling their company; they usually are not sure where to start. To adequately prepare the privately-held company for sale, the owners should retain a competent transaction advisor to guide the process from start to finish. In addition, the owners must ensure that preliminary legal work is in order and that the company's most recent annual and interim financial statements are prepared (audited, if available) by their accounting firm. In preparing the company for the sale, the owners must also adopt the appropriate mindset, including a level of commitment to the process that is conducive to a successful and optimal transaction.
- **Understanding the Value of the Company**—Most owners of a privately-held business have preconceived notions regarding the value of their business. The valuation process is crucial in estimating the fair market value of a privately-held company and in establishing a minimum price expectation for the owners of the company and its team of advisors. The valuation process involves extensive analysis of broader and company-specific factors that impact the value estimate. Under the income, market, and asset approaches to valuing a privately-held business, there are numerous methods for estimating the fair market value. Once the fair market value has been estimated, the transaction advisor then attempts to assist the owner(s) in securing the highest price for the company, typically including a wide range of consideration types, beyond just cash.
- **Marketing the Company to Various Types of Potential Buyers**—Once the valuation of the company is complete, the privately-held company's transaction advisor typically begin marketing the company to potential acquirers via a non-confidential (and anonymized) one- or two-page summary of the company. This summary is sent to potential buyers via fax or e-mail. Those potential acquirers who express an interest are then required to execute a Non-Disclosure Agreement (NDA). Once the NDA is satisfactorily executed, the prospective buyer receives the confidential selling memorandum – an in-depth overview of the company and its merits, which has been prepared by the transaction advisor. The transaction advisor utilizes a variety of resources to identify and contact potential buyers who are categorized into three categories—financial, strategic, and individual buyers. Once the prospective acquirer receives and reviews the confidential selling memorandum, if there is further interest, the transaction advisor has more in-depth conversations with them to further qualify their level of seriousness and ability to do a deal. Should all indications be positive, the transaction advisor coordinates a site visit(s) with the owners, respecting their desire for confidentiality and their desire to spend time only with 'qualified' potential acquirers.

Motivations for Selling a Company

Typically, there is a wide range of reasons that a privately-held business owner may have for selling the company. The ultimate outcome of the sale of a business is liquidity for the owner(s) of the privately-held company. A few of the most popular motivations for selling a privately-held business, and thus gaining liquidity for the owners, include:

- **Retirement**—One of the most common reasons for selling a privately-held business is that the owners are nearing retirement age and no longer desire the burden of running the business. These owners have usually invested a significant portion of their lives and resources into building the business and seek liquidity in order to enjoy their retirement.
- **Succession Issues**—While many owners of privately-held businesses hope that their company will be a multi-generational enterprise, the children of the owners sometimes do not take an interest in making the family business their career. With their children pursuing other interests, the owners may be reluctant to maintain ownership and pass management control to outsiders or strangers. These owners instead often opt to sell the business.
- **Illness**—Owners of privately-held businesses are usually deeply involved in the operations and management of their company. When the owner(s) is stricken by a life threatening or lengthy illness, the business may suffer as a result of lack of owner-level attention and guidance. Under these circumstances and given the uncertainty of the owner's ability to continue running the company, the owners often choose to sell the business rather than hope the business will survive until they have recovered.
- **Loss of Interest in Business**—After many years of building their business, some owners of privately-held companies simply lose interest. Once the thrill of nurturing and growing the business subsides as the company matures, the owners may desire to free themselves of the burdens associated with continued management of the company in order to pursue other challenges. Some entrepreneurs may build and sell several businesses during their lifetime. Other owners of privately-held businesses may grow tired of their routine for personal or family reasons and, therefore, seek a sale of the company to gain liquidity to pursue other interests.
- **Financial Distress of the Company**—Few things are as discouraging to a privately-held business owner as financial distress or performance that does not meet their expectations for whatever reasons. It is not surprising that owners of financially distressed firms often desire to remove the day-to-day burden of their business via a sale of the company.

- **Other Investment Options**—There are any number of investment options available to investors—bonds, stocks, fine art, real estate, private equity, etc. Privately-held business owners may be constrained in their ability to pursue other investment options, given the large amount of their wealth that is invested in their company. To pursue other investment opportunities that may have a lower level of risk for an acceptable return or an investment with a higher return (and higher risk), privately-held business owners may seek liquidity through a full or partial sale of their company.

It should be clear by now that most privately-held business owners are motivated to pursue a sale of their company in order to achieve some degree of personal liquidity. Their reasons for seeking this liquidity include those examples discussed previously. Furthermore, a privately-held business often accounts for a large portion of the owners' assets or personal investment portfolio, regardless of their age or the life cycle of the company. The following table, for example, provides a sample of a typical privately-held business owner's personal balance sheet.

Mr. & Mrs. John Doe Personal Balance Sheet					
As of December 31, 2003					
ASSETS			LIABILITIES		
Cash	\$	56,000	1.1%	Short-term Debt	\$ 5,000 0.1%
Marketable Securities	\$	175,000	3.5%	Mortgages	\$ 100,000 2.0%
Insurance Policy	\$	250,000	5.1%	TOTAL LIABILITIES	\$ 105,000 2.1%
House	\$	389,000	7.9%	EQUITY	\$ 4,845,000 97.9%
Cars	\$	80,000	1.6%		
Fair Market Value				TOTAL LIABILITIES	
of Equity in Business	\$	4,000,000	80.8%	& EQUITY	\$ 4,950,000 100.0%
TOTAL ASSETS	\$	4,950,000	100.0%		

As can be seen in the preceding table, Mr. & Mrs. Doe's investment in their business (based on the fair market value estimate of the equity) accounts for 80.8% of their total assets. The concentration of their wealth in this single asset prevents them from having adequate diversification of their portfolio, thus increasing their risk (and lowering their liquidity). In addition, the risk associated with owning a privately-held business can be much higher than the risk associated with many other investment assets.

If Mr. & Mrs. Doe are fairly young, the level of risk associated with the investment in the privately-held business is probably well aligned with their risk profile. If Mr. & Mrs. Doe are nearing retirement age, however, this risk level is most likely unsuitable for their risk profile. Therefore, it is probably prudent for Mr. & Mrs. Doe to consider selling all or part of their business in order to provide personal liquidity for their retirement and to invest in assets with a lower level of risk.

Whatever may motivate the owners of a privately-held business to pursue a sale of their company, the results of such a transaction generally include increased personal

liquidity, diversification of their portfolio, and a reduction in the overall risk of their personal portfolio.

Preparing the Company

Once they have made the decision to sell, the owners of a privately-held corporation have overcome the largest hurdle in the process of selling their company—this is typically the biggest hurdle (at least mentally) because the decision to sell is filled with emotion stemming from the long-term commitment to making their company successful. However, even once the decision to sell is made, the company and the owners are generally still not well prepared for the remainder of the process.

In order to prepare the company for a potential transaction, the owners should first retain a competent, seasoned transaction advisor to guide them through the process of selling the business and to maximize the value that may be realized through a transaction. Some factors that privately-held business owners may consider in selecting a transaction advisor include experience, credentials, resources available, the level of attention that can be expected, etc. Though many large investment banks offer a wide array of experienced and credentialed advisors, small boutique advisory firms may provide individualized attention that may not be offered by the largest firms. The most important factor in determining the appropriate transaction advisor to represent the company in a potential transaction is the level of trust—which is essential to a healthy, sustainable relationship between owner and advisor. The privately-held business owner must have a strong degree of trust and confidence in their advisor if the relationship is to be successful and to maximize value through a transaction.

Once a transaction advisor has been selected and the process has been adequately explained, the business owner should begin taking steps to prepare the business for valuation and presentation to potential buyers. This involves consulting the firm's legal counsel to ensure that all corporate legal work is in order for a potential sale. Issues such as transferability or updates to corporate documents need to be resolved before the process has progressed too far. The owners should also ensure that all financial statements have been prepared by the company's accountancy firm in accordance with generally accepted accounting principles (GAAP).

Internal financial statements, though a helpful supplement, are generally regarded as unsophisticated by most acquirers of privately-held middle market firms. Many businesses have compiled financial statements which provided limited information and no opinion by the accounting firm. Reviewed statements, though more informative, are not as detailed as audited statements that are the most insightful and credible source regarding the company's financial position and performance. Audited statements require the most time to construct and are the most costly to prepare. However, audited statements are the most sophisticated and, generally, the most favorably viewed by potential acquirers. Audited statements, as a result of the depth of disclosure required, are also the most useful in the preparation of the valuation of the closely-held company.

Finally, the owners must form the appropriate mindset in order for the process of selling the business to be both successful and smooth. Many owners of privately-held businesses do not adopt the mindset that is required for them to have the level of commitment necessary for the sale of their business to be completed. Selling the business requires time to prepare the appropriate information for presentation to potential acquirers and continued time investment in the process to see the deal through to its conclusion. This may involve meetings with various potential acquirers, answering questions posed by the potential acquirers, securing documents required by a buyer during due diligence, etc. The process, at times, can seem very invasive and inefficient.

The transaction advisor, as the intermediary, manages the process of selling the business and facilitates communication throughout the process. This enables the business owner to continue running the business on a daily basis, thereby continuing to create value for the company and its shareholders, without spending a disproportionate amount of time on managing the full-time process of selling the business. However, the transaction advisor, though equipped with a great deal of information regarding the company, is not endowed with all of the information or knowledge of the business that is necessary to carry the process entirely from beginning to end without additional cooperation from the business owner at various times. Developing the appropriate mindset enables the privately-held business owner to provide a level of commitment to the process that is conducive to a successful and optimal transaction.

Valuing the Company

Before the privately-held company may be brought to market, the company must be appraised (either by an independent appraiser or by the transaction advisor) to provide the owners with an estimated range of the company's value. Though many business owners may have an idea of the value of their company, the appraisal process is conducted using widely-accepted methodologies to provide an indication of value. This estimate of value is useful in enabling the owners to develop a level of expectation for the potential value of a transaction and in assisting the transaction advisors in setting a threshold price for the company. Business owners must be aware, however, that the value estimate provided by the appraisal is different from the price that may be achieved in a transaction as there are many standards of value upon which the worth of the company may be based.

For contemplated merger or acquisition purposes (and tax purposes), the most common premise of value is fair market value, which the IRS defines in Revenue Ruling 59-60 as:

...[T]he price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts...the hypothetical buyer and seller are assumed to

be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.

Under the fair market value standard, the hypothetical buyer is assumed to be a purely financial buyer seeking a return on the investment. The financial buyer lacks synergies or strategic benefits associated with the transaction. As a result, the fair market value estimate is typically lower than the strategic value estimate, which is based upon the price that encompasses synergies or strategic benefits that could be obtained through the acquisition. Therefore, the price that a buyer typically is willing to pay for the company is equal to the fair market value estimate plus the value of any synergies associated with an acquisition of the company^[1].

To arrive at the fair market value estimate, the appraiser must examine a number of factors associated with the company such as history, financial condition, earnings capacity, dividends, industry and economic conditions, etc. The appraiser may also make adjustments to the financial statements of the privately-held company to remove any non-recurring items or perquisites to the owners. Adjustments are also made to remove any real estate owned by the company that should be appraised separately by a qualified real estate appraiser. These adjustments are made to adjust book values to reflect market values and to provide a value based on future earnings that would not include controlling decisions regarding discretionary expenses. These factors are then incorporated into the overall analysis of the company to determine the value drivers as well as specific company risk factors that may have an impact upon the value of the company. See our article, “The Specific Company Risk Premium” for a more detailed discussion of the subtleties of this calculation.

The appraiser must then select the appropriate approaches and methods to apply to the company’s specific conditions to derive an indication of value. The approaches that the appraiser must consider include:

- **Income Approach**—The income approach derives an indication of value based on the sum of the present value of expected economic benefits associated with the company. Under the income approach, the appraiser may select a multi-period discounted future income method or a single period capitalization method.
- **Market Approach**—The market approach derives an indication of value by comparing the company to other similar companies that have been sold in the past. The guideline publicly-traded company method uses the prices of similar and relevant public companies as guidelines for determining the value of a privately-held business. The direct market data method relies on transaction data of similar privately-held businesses to determine an indication of value.
- **Asset Approach**—The asset approach examines the estimated fair market value of all of the company’s assets less liabilities to develop an indication of value. Given that the valuation is typically conducted under the premise of a

going concern, the appraiser may determine that the asset approach is inappropriate for determining an indication of value. However, the appraiser may test if the company is worth more in liquidation as opposed to as a going concern by utilizing an asset approach.

After selecting the appropriate approaches and methods, the appraiser typically adjusts the value indications to reflect the relative lack of marketability of privately-held businesses as compared to liquid and readily marketable public counterparts. These values are then reconciled to provide an indication of value or an estimated value range for the company. Though not always the case, the transaction advisor and the owner of the privately-held business typically recognize the fair market value produced by the valuation as the minimum price that the owner should accept in a potential transaction. The transaction advisor then attempts to secure the highest price during negotiations, in order to maximize value for the owners of the business.

Marketing the Company

Once the valuation of the privately-held firm has been completed, the transaction advisor then prepares the confidential selling memorandum, which includes all relevant information pertaining to the company, which will be presented to potential acquirers. The selling memorandum includes the history of the company, nature of the business, financial analysis, strengths and weaknesses, etc. but does not include the valuation of the company. The valuation is prepared only for the benefit of the owner(s). Once the selling memo has been reviewed by the owners of the privately-held company, the transaction advisor begins researching the potential acquirers of the company. In this process, the transaction advisor may utilize a variety of resources including trade association members, personal networking, public companies, journals, private equity databases, other databases, etc. in efforts to identify those companies that may acquire their client for either horizontal or vertical integration. These potential acquirers are first provided a blind, non-confidential profile of the company, in order to protect the identity of the transaction advisor's client. Following the execution of a confidentiality agreement, potential acquirers are provided a copy of the confidential selling memorandum.

The potential acquirers will generally fall into three categories—financial buyers, strategic buyers, or individual buyers. Individual buyers are rare with middle market firms—they more typically acquire small business, though there are some exceptions. Very few individuals have the financial or borrowing capacity to acquire a middle market firm. For middle market privately-held companies, financial buyers and strategic buyers are the most common acquirers.

Financial buyers invest in a business solely to generate an acceptable return on their invested capital for the level of risk associated with a privately-held company. Pure financial buyers typically have no strategic or synergistic benefits associated with an acquisition, but seek value investments that offer the potential for substantial return.

Private equity funds, such as KKR (Kohlberg Kravis Roberts) are considered financial buyers that acquire a business, grow the business, supply capital as needed, and liquidate their investment either through a sale of the business or through an initial public offering. Private equity funds may be bound by a strict set of investment guidelines and are typically focused on a limited number of specific industries in which the principals of the fund may have experience.

Strategic buyers are companies who are able to derive some level of synergies from acquiring a particular privately-held business. Strategic buyers may include competitors seeking economies of scale or market share, suppliers seeking vertical integration, or firms engaged in similar businesses who seek diversification or expanded complementary product lines. An example of a strategic acquirer is Exxon whose acquisition of Mobil expanded its upstream and downstream capabilities and generated substantial synergies. The ability of a strategic acquirer to benefit from potential synergies typically enables a strategic acquirer to pay a premium over the estimated fair market value of a privately-held firm to reflect the value of these synergistic benefits to the firm.

Conclusion

As can be seen from the above discussion, the process of bringing the privately-held business to market for a merger or acquisition involves a great deal of time and effort on the part of both the business owner and the transaction advisor. Diligence on behalf of the business owner and the transaction advisor during the process of preparing and bringing the privately-held company to market will increase the probability of a more successful and smooth due diligence, negotiating, and closing of a transaction. A well-integrated approach that involves the combined efforts of the owners and their advisors, working towards a common goal, is essential to achieving maximum results for a merger or acquisition of a privately-held company.

^[1]The privately-held business owner must realize, however, that the appraisal provides an *estimate* of value, not a precise value. The actual price at which a transaction is consummated may be higher or lower than the fair market value estimate.