

Let's make a deal

ADVISERS SHARE KEY ADVICE FOR BUSINESS BUYERS, SELLERS

WHAT ACCOUNTANTS SAY

Interviews by Beth Ewen

Starting early can help owners get best exit

Upsize: Why should sellers get ready well in advance?

Tim Kenyon, Cummings, Keegan & Co.: It's better to plan early rather than late. They should look at, how do I get out of this in the end? You want to set up a buy/sell plan on the front end, because you don't want to end up in litigation.

We'll recommend to start looking 10 years out, and start identifying potential buyers. Internally you might have the best possibility of finding successors but sometimes they might not have available funds. If it's a family member, you want to give them the chance to test out the opportunity, to test their ability in

handling the job, and to get some financing.

If you have a successor in mind, as the business owner, you're going to want to challenge that individual by testing them. How can they transition from being maybe the head of a department to being the visionary of the business? You're also getting them involved with your bankers and outside advisers, so they see that person as having the wherewithal to step in. So ultimately if you look to sell the banker will say, 'We know this individual, we know the abilities.'

Upsize: What do you advise when doing business valuations?

Kenyon: The owner's view is sometimes vastly different from what the market is telling them the company is worth. If you have the valuation done, even 10 years in advance of a sale, it helps owners focus on some of the things that need to be done to grow the value of the busi-

TOP TIP

"Most owners don't plan 10 years down the line, because they say, 'I'll get to it. Not this week, but next week.' We try and prompt some of that discussion."

TIM KENYON, Cummings, Keegan & Co.

ness.

Upsize: Switching to buyers: Are banks more hesitant to finance transactions these days?

Kenyon: I'd say they're not coming forward unless the client is really strong. My own personal opinion is, the regulators are requiring quite a bit more capital from the buyer, so banks are kind of hamstrung compared to what they may have done five years ago.

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THREE WAYS...

...for buyers to prepare for a purchase

JOHN KIMBALL, head of SBA lending at Park Midway Bank in St. Paul, expects to be extra busy in the months ahead. "We think there is a potential for a lot of m&a activity coming up, because there are family owners of businesses that were likely ready to sell and couldn't sell.

"The value of your business is generally a multiple of the excess cash it sheds, so when you're in the back end of recessions it's difficult to get the amount you need. And we are starting to see the financial conditions of these companies improve," Kimball says.

His bank funds many transactions around \$1 million up to \$3 million, often using the SBA 7A program. Most such deals involve a combination of three financing sources, he says: the buyer's personal cash, often recently in conversions of 401ks; carryback financing from the seller, meaning the seller is paid over time; and a bank loan using Small Business Administration-backed loans. He offers three tips to help prospective buyers find success with the bank:

1. Develop the skill set. "We see a lot of cases where people will identify an industry or a specific business that they want to buy and they'll go to work for that company. And they'll spend time getting to know it from the inside." Before making the loan, bankers will evaluate the cash flow the company generates under current ownership, and consider whether the new owner can duplicate that performance. Having the right skills is key.

2. Know what your credit bureau says and clean it up to the extent possible. "That's still a very important factor in the decision," Kimball says. "Even though this is a business loan, the banks look at your personal finances." That includes an analysis of all household revenue and expenses, to see how much cash the new owner will need from the business in order to live.

3. Conserve cash. "Most of these deals require a real equity injection," Kimball says, as much as 30 to 40 percent down payment, and not borrowed money. Home equity loans in general don't qualify anymore, he says, as they used to before the financial crisis. "Not only do you need an equity injection sufficient to buy the business, but you have to think about the business's liquidity and cash needs. Cash is the oil that lubricates everything in these transactions," Kimball says.

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TOP TIP

"Sometimes people get so attached to a deal that they forget about the business side of it. They think, 'I want this so badly.' Part of our role is to be the non-emotional person, and really look at the facts."

Laurie Waterman, Schechter Dokken Kanter

Structure of deal affects taxes, price and seller's future

Upsize: Your work in mergers and acquisitions is from the tax perspective. What are the top issues?

Laurie Waterman, Schechter Dokken Kanter: The initial conversation with sellers would be about, are they looking at a transaction that is going to be structured as taxable or as non-taxable? We ask them: What is their vision for their future? Do they have an interest in staying involved in this company? Do they want to get totally out? Are their kids in the business or other family members that will be involved?

If you really want to get out, you're probably looking at a taxable transaction. And if the decision is it's taxable, then whether it's a stock transaction or an asset transaction comes next. That decision is oftentimes related to what kind of an entity it is. For example, if you have a partnership the asset acquisition isn't as important. In general the seller is going to prefer a stock transaction; the buyer is going to prefer an asset transaction. You reconcile those through negotiation; there's perhaps a movement on price, because the seller needs to get compensated for the fact that there's to pay more in tax.

If you do talk about an asset sale, then the purchase price allocation from a tax perspective is very important. Let's say you're buying the assets of a manufacturing business, so you're buying equipment; you're possibly buying receivables; you're buying inventory; you're buying some type of customer list. The tax treatment of each of those pieces is very different. If you buy equipment the writeoff is over a longer period than, for example, if you buy inventory. Buyers also have to be aware that there may be sales tax payable on some assets.

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FAST FACT

Most companies spend between \$10,000 and \$30,000 on due diligence, says Karen Monfre of Wipfli, which she calls “a drop in the bucket” compared to the acquisition costs. Most transactions will close in 60 to 90 days; it takes a good 30 days to do due diligence. Financing takes 30 to 60 days, especially for a smaller transaction that may include SBA loans, Monfre says.

Due diligence marks difference between pros, amateurs

Upsize: What's a common mistake that buyers make?

Karen Monfre, Wipfli: If you look at all the institutional and professional buyers, they really use their advisers and they do thorough due diligence. The biggest mistake that first-time buyers do is to not do the proper amount of due diligence. They fall in love with the deal, or they don't really spend the time, or they're rushing to close.

Experienced buyers do far more analysis and due diligence than first-time or inexperienced buyers. Data is king, data is power, and you really need to spend the time to analyze it. The most important thing with due diligence is you're validating what you're hearing from the seller.

Upsize: What about first-time sell-

ers? What can they learn from the veterans?

Monfre: No. 1 is be prepared. Often times a seller will be approached by a buyer and they'll want the buyer to give them an offer, but they need to understand that just as if you're going out to prospect for a new customer, you don't go out without being prepared. You have a game plan, and a story.

Sellers who aren't experienced don't take the time to tell their story, don't put an offering memorandum together. A buyer is looking for a deal. So if a seller wants to get a good price, they need to tell their story about why their company is worth more.

Sellers need to understand that process has everything to do with price. What I mean by that is when you work with an intermediary and you go through a process, that drives value, because we take the time to tell the story, to find the value and to

TOP TIP

“You spend millions of dollars during the acquisition, so do the due diligence to find the skeleton in the closet, to make sure you can do something about it.”

KAREN MONFRE, Wipfli

articulate the value through an offering memorandum.

To get leverage in a transaction you want to have multiple interested parties. You will get a better price when buyers know they have to put in a competitive bid. Process equals price.

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WHAT ATTORNEYS SAY

People side may trump financials when making deals

Upsize: You say selling a business can be a very trying process for the owner. Why?

Dan Young, Lommen Abdo:

Most small businesses are highly personal to the owner, because they've put their life, soul, blood, sweat and tears into it. Most good businesses feel very strongly about a couple of things: their customers, and their employees. And when they look to sell, a lot of these owners say, I want to know what's going to happen with

my customers who've been with me through thick and thin, and I want to know what's going to happen with my employees. It's a very emotional side of selling, or buying or merging.

The people side of selling a business or buying a business is the best part. It's the most intriguing, and the most unpredictable and the most challenging.

Upsize: What things tend to come up that are unpredictable?

Young: The interesting thing is to push the client to determine that selling is the right thing. And sometimes clients will be upfront about it, and sometimes they won't be upfront about it. If you go to the emotional level of selling a business, some people don't want to talk about it. But where that comes out is in the negotiations, in the structure of the deal, in the announcement. If they're reluctant to sell, that transition on the sell side can be cumbersome, or there can be hiccups.

A lot of times private deals are structured to keep the owner on for a period. That is going to be very different for that owner. Mentally, if you're in business for yourself for 30 years, and now you're reporting to someone else, that can be tough.

Upsize: Who gets involved in these deals?

Young: It completely depends on the client. So for example, a client would call me and say they're looking to sell, and I would send a due diligence checklist to the client, and it shows what to be aware of. So it says, be aware they'll be looking under the sheets so you have to get comfortable with this. It's going to feel like an audit, and it's going to feel not so exciting, but you're going to have to do it.

Upsize: I've heard business owners say they thought their company was worth much more than the market said it was. Does that happen in your experience?

Young: Every day. Think of it like you're going to sell your home, and you've been there for 20 years and you love your home and you know your home. Say you're going to sell it by yourself and you don't do compa-

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TOP TIP

"A lot of times what sellers don't think about is what are they going to do after they sell. The people side of the business is the best part. It's the most intriguing and the most unpredictable."

DAN YOUNG, Lommen Abdo

rables. Generally people will put it at a much higher price than the market would. I was doing some reading recently, and Bloomberg said the reason why private deals don't close is because of the price that the owner expects.

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Avoid 'wearing the money' when sale in sight, attorney says

Upsize: You say business owners have to keep their eye on the business. Why?

Tim Scallen, Oppenheimer Wolff & Donnelly: My first piece of advice to sellers is to assume that they won't do a deal. They have to continue to operate their business with the long-term view. What they cannot do is get too focused on the transaction. My experience is, once they get to the point that they're thinking about selling the company, they have this sense of relief about it.

There's this concept that some people use in the m&a process called 'wearing the money.' The psychology of the buyers is they want the seller to think about what they would do with the money after the sale, so they get committed to the transaction. Once someone crosses that

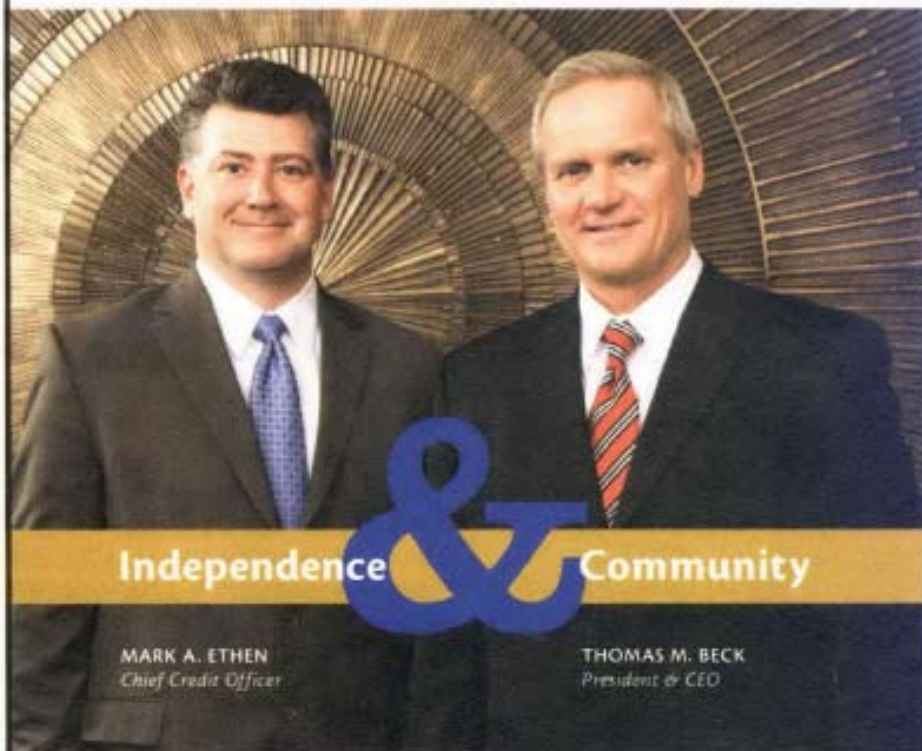
threshold and becomes a seller mentally, then they can become too committed to selling the business, and focus more on life after the sale than continuing to operate their business.

My experience with those types of sellers is they don't appreciate the transaction risk that's present in all sales of businesses. Sometimes buyers change their mind; sometimes they run into problems with financing. The seller needs to understand that and conduct the business appro-

priately, so performance doesn't drop just when the buyer is poring over the books."

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TO-DO LIST...

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1. **Make sure you have a sophisticated transactional attorney involved**, not simply a general business lawyer. "There are many, many subtleties in drafting purchase agreements that you only learn from experience," says Mark Williamson, Gray Plant Mooty.

2. **For example?** "One of the key sections in a purchase agreement will be indemnification. That can affect what you get in your transaction, because if you are saddled with an indemnification claim after the fact and you have to pay money it will come out of the purchase price. That can be kind of a gotcha," Williamson says.

3. **Enlist lawyers early enough in the process.** "Preferably the latest you'd get someone involved is for the letter of intent or term sheet," Williamson says, when the basic terms of the deal are first negotiated. "It's common for the final deal to vary, but that being said it's hard to change the original terms. It helps set the big picture; it helps make sure you have the right deal."

Sellers should expect buyers to 'pore over' three years of books

Upsize: What should owners do when they're only thinking about selling some day?

Scott Erickson, Leonard Street & Deinard: "If you're interested in selling a business it's a three to five year horizon and you have to be smart about what you do. Most sophisticated buyers want at least three years of financials and they're going to pore over those. Those buyers are going to want sustainability, to see that last year's profits aren't going to go away next year.

So what I work with sellers on is, let's be smart now. Let's not spend a lot of money on marketing or golf tournaments, let's do what we need to do to bring in the income and the customers, but let's be smart about it. And let's be careful that we don't run too many owner things through the business. What you find is the owners of those businesses do well, but when it comes time to sell you have to normalize the earnings.

An example: a president of the business might dictate in the marketplace a \$300,000 salary, but that president who is also the owner often makes \$700,000. That difference, when you go to sell, you tend to normalize those earnings, and you work with the buyer and convince the buyer that we should be more profitable because there are certain things that you wouldn't normally pay.

Another example: If I have a company that I represent that has two or three very distinct divisions or distinct revenue generating portions of the business, I may either form separate businesses for those income generators, or I may be very clear that these are at least divisions inside the legal company shell, and actually run separate p&ls, because it's possible the company when it sells won't sell the whole but sell one or two of the whole. If you don't run those separate p&ls, you're going to have a heck of a time showing the profitability.

Upsize: What are you working on with buyers in this economy?

Erickson: From a buyer perspective, you want to buy at the right time. So in this not great economy I have been working with a lot of clients who are very strong and want to grow, and have been encouraging them to fill in a certain hole in their business to eventually make themselves more marketable to sell. If I have a client who has operations throughout the U.S. but not in the Northeast, I've encouraged them to go out and look for comparable businesses to theirs in that geographical location. What you've found in the not great economy is, there are a lot of struggling businesses, and those are great businesses to buy.

TOP TIP

"The best way to create a lot of value in a business is for the owner to work himself or herself out of a job."

SCOTT ERICKSON, Leonard Street & Deinard

As a buyer, you almost always want to buy assets, so you can pick and choose what you want, and you don't buy all the liabilities. The general position is I'm buying assets and I'm buying no liabilities.

As a buyer if you find a target you want to do a mutual confidentiality right away so the seller gets comfortable. And then you jump almost immediately to a letter of intent. One of the things that you want as a buyer is exclusivity: now that you're pouring all this time and money into it, there is a no-shop or exclusivity that for a certain period of time you, potential seller, are only talking to me, potential buyer."

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TOP TIP

"Ideally you do the due diligence on your own business that you would expect a buyer to do. That way you can best position yourself for a future sale."

MARK WILLIAMSON, Gray Plant Mooty

Early actions can lead to higher sales price when time comes

Upsize: You say owners can make lots of changes in advance of a sale. What should they do?

Mark Williamson, Gray Plant Mooty: It even begins before they're ready to sell. If they have an expectation that at some point in the next two to three years they're going to sell, that's the ideal time to do some planning.

First, it's a great time to do estate planning and make sure that if they want to do some charitable giving or succession family planning, that's a great time to do it because they can help mitigate the taxes on the transaction as a whole.

The other thing is, there are a lot of things you can do to make the business more saleable. If you're looking at it in a couple of years, you can do the critical looking at the business.

For example: make sure your employees have signed the important non-competes, confidentiality agreements. You can get those things in place before you have someone snooping around, doing their due

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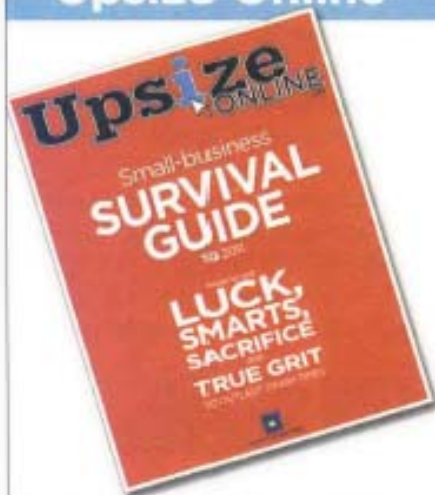
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diligence. They'll be looking at whether you have concentration with a single customer, they may be looking at diversification of customers.

Anything that would raise a red flag to the buyer, the more you can do something—the cleaner the business is the better the sales process.

Upsize: How long does this take?

Williamson: A normal business sales process is six months or nine months to a year, and the times clients get more frustrated is when they underestimate it on the front end. People would come in the summer, hoping to get a deal done by the end of the year. That's not enough time, especially when investment bankers are involved."

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Strong management team a must to carry on smart business

Upsize: What's your best piece of advice for sellers?

Shawn McIntee, Maslon Edelman Borman & Brand: Selling your business is literally a full-time job, and people can really take their eye off the ball, and get sucked into the process and not keep their eye on the prize. Be prepared. Have your books and financial statements in order.

You have to ensure you have a strong management team that can carry on the business.

Make sure you, in advance, hire a good investment banker, good attorneys, good accountants, that have experience in m&a transactions. There are a lot of times where you've had a counselor you've worked with for decades, but you need additional experience.

TOP TIP

"People are always willing to give you money until it comes time to write a check. Be realistic in what you can raise."

SHAWN MCINTEE, Maslon Edelman Borman & Brand

You can bring experts in who work along side the general attorneys.

Upsize: And for buyers?

McIntee: Be mindful of your skill set and be specific in what you're looking for. There are tons of businesses that are always out there for sale; you really need to know what you want. These small businesses don't run themselves. The larger you get you get a more professional management team, and a new buyer can help and learn the ropes over time. But for a smaller business, the CEO/founder/seller has made it successful, and it's hard to duplicate.

I've always advised people that when the buyer is putting forth a letter of intent or term sheet, if you can get some good advice up front you can potentially get some terms negotiated in that letter of intent that you may have trouble with down the road: maybe more favorable legal terms; maybe streamlined reps or warranties or indemnification. At that stage of the game the seller is focused on dollars and cents.

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