"Preparing for an exit"

Advice for SMEs thinking about selling their business

By *Nick Pearch*

1. Background to an exit

- A well designed and well executed exit strategy can create as much value as all the other work building shareholder value over the years.
- Preparing in advance for an exit and managing the sales process professionally will almost certainly result in a higher price being achieved.
- Companies should be 'sold', not just 'bought'. Resist the temptation to accept the first unsolicited offer that comes along.
- A professional sales process run by an experienced advisor will also increase the chances of success, not least by introducing more than one bidder.
- Start planning for an exit early… because 'stuff happens' and you may lose several months trying to resolve a problem.

2. Advance preparation (12-24 months before exit)

- Identify your Unique Selling Proposition (USP) - the principle feature of your business that differentiates you from your competitors. This is likely to be the key element that will create strategic value for a buyer. Focus on this feature and strengthen it. Don't be distracted by non-core activities – they are unlikely to add value to your business.
- Prove the business model. This means to prove that the sales life cycle from customer acquisition to final fulfilment and after-sales service is profitable, on a customer by customer basis.
- Build your sales pipeline and prospect list. Invest in your sales and marketing resource. Growing sales is one of the key value drivers for your business.
- Try and build recurring revenues into your business model if possible (eg subscription renewals, maintenance contracts, etc). These are valuable to an acquirer and improve the predictability of future revenue projections.
- Identify opportunities for your business in other countries and other sectors. Try and develop at least one of these to demonstrate that your business has growth potential beyond its core market (scalability).
- Reduce reliance on the founder/CEO. Ensure other managers are capable of running the business and taking it forward without you being around longer term. Incentivise them with share options to ensure they are focussed on increasing the value of the business. Make sure their employment contracts are consistent with best practice.
- Check Investor or Shareholder agreements for any drag-along or tag-along clauses, liquidity preferences for certain shareholders or liquidity clauses obliging you to seek an exit within a certain timeframe.
- Discuss the possible sale of the business with your major shareholders to understand their aspirations and any timing constraints for their funds. Many

institutional funds are obliged to sell their investments within a fixed timeframe. Make sure all the shareholders are aware of your plans and agree with the process.

- Start to document the processes that drive your business (technical manuals, training manuals, employment contracts, IT systems, etc).
- Reduce the risk in the business. Try and achieve a spread of different customers and a range of products.
- Check key contracts for onerous ‘change of control’ provisions. Make sure these are renegotiated if they would block an exit or reduce the value of the business.
- Ensure patents, trademarks and brand names are properly registered and up to date.
- Make sure your accounting policies are appropriate and ideally consistent with international accounting principles. Ensure that any capitalised development costs are still relevant to the business. If not, write them off.
- Ensure your budgeting and financial reporting is of a high standard, ideally with monthly management accounts showing the full P&L account with variances against budget. Also historic and forecast cash flow reports.
- Start keeping proper minutes of board meetings and shareholder meetings so you can demonstrate that your business is run professionally.

3. Identify potential acquirers (12-18 months before exit)

- Consider potential acquirers from all aspects of your business:
    - i. Customers
    - ii. Suppliers
    - iii. Competitors
    - iv. Partners (eg joint bidders for complex RFPs)
    - v. Big corporates operating in your sector
- Consider the synergies that could exist between your business and a potential acquirer. The more added value that could be created by a merger, the more the buyer will be prepared to pay.
- Consider their ability to complete an acquisition (are they profitable, cash rich, acquisitive, etc)
- If you can identify two or three logical buyers for your business, try and strengthen your relationships with them, eg cooperate on RFPs or share views on industry issues. Try and make the highest level contacts you can, eg CEO or board directors.
- Look outside your own country and marketplace – acquiring companies are often looking for access to new markets.
- If your business is growing and profitable with good long-term potential, potential ‘exits’ could include other financial structures:
    - Secondary financing by private equity firm (development capital)
    - IPO on an unregulated market (Alternext, AIM).
    - LBO/MBO – company acquired by founders/management using leveraged financing.

- The best choice of exit will depend on your motivation, eg access to new capital; creating a market for employee shares; enabling financial investors to exit; credibility with customers, etc.

4. Select an advisor (6-12 months before exit)

- Ask all your contacts for recommendations – a personal reference is valuable.
- Choose a firm who has knowledge of your sector and who has successfully completed sale transactions before. A credible track record is essential – there are a lot of sharks out there!
- Choose a firm that is reasonably local to your business and where you have a good compatibility with their team. Make sure you know who will be working on your transaction – often this is not the smooth sales guy who convinced you to choose their firm!
- The exit process can be time-consuming and stressful. It is very important that you get on well with your advisors and enjoy working with them. You're going to spend a lot of time together!
- You also need adequate financial resources to pay advisors, lawyers, accountants, etc for exit work. Any sign of cash constraints during the exit process will be perceived very negatively.
- Some boutique corporate finance houses follow a routine process for all transactions, mainly driven by email circulars. This may not be the best approach for your business. Interview them carefully to understand how well they understand your sector and how they propose to manage the sale process.
- Define their mandate precisely and ensure the engagement contract includes the specific tasks you expect them to carry out.
- Consider a two-stage approach for their mandate (particularly in France):
    i. Review strategic options for the business (funded by the company, normally by a monthly fee or retainer). If/when a sale is confirmed as the best option, then;
    ii. A full sale mandate (normally success-fee based and funded by the shareholders from the sale proceeds)
- Fees are variable but typically include a modest retainer for the preparation period, often paid monthly, followed by a success fee for a completed sale. The success fee will normally be a percentage of the sale proceeds but subject to a minimum fee.
- For an SME, the retainer or fixed fee is typically € 50-75k or €10-15k per month. The success fees can vary from 2-3% for sales value > €50m, 4-6% for sales value of €10 – 50m; and 7-10% for sales < €5m.
- Make sure that the success fee is the most important element of the total fee proposal for the advisor. You want him to be highly motivated to achieve a successful sale!
- Consider negotiating a lower fee for acquirers introduced by the company rather than the advisor – you don't want to pay them for your own contacts! Also try and ensure that the fixed fee or retainer is deducted from the eventual success fee.

5. The role of the exit advisor

- Plan and coordinate the sales process
- Help prepare the documentation, challenge the assumptions and ensure the sales pitch is compelling and consistent.
- Research and identify potential acquirers, make contact and follow up any interest. Use their background knowledge and contracts to fast-track companies known to be on the acquisition trail.
- Identify the strategic value of the acquisition to potential buyers and 'sell' this value.
- Increase the probability of success and reduce the time to closing. Eliminate time-wasters.
- Protect the CEO from the initial process and negotiations so he can continue to run the business.
- Decide on the best structure for the sale, eg:
    - sell assets or shares;
    - for cash or equity in acquirer;
    - deferred payment or cash up front;
    - 100% sale or partial sale with put/call options.
- Maximise the price & terms, whilst ensuring the buyer remains committed.
- Close the deal!
- Follow up any conditions between closing (signing the sales contract) and completion (handing over the cash).
- Provide the champagne at the closing meeting!

6. The ideal exit team

- Every company needs a team dedicated to maximising the price and ensuring the transaction completes. You will need to make sure you have adequate people resources to manage the exit process whilst still running the business.
- The ideal exit team is made up of:
    i. The CEO
    ii. The CFO/FD if you have one and they have adequate experience.
    iii. An exit advisor (a corporate finance firm)
    iv. An experienced exit coach (optional)
    v. A small committee of the board (NB: The board itself should continue to focus on the core business and ensure that momentum is maintained).
    vi. A good lawyer (to draw up the contractual documentation, once a deal is agreed in principle). This could be your regular company lawyer if he has the right experience.
- The exit coach must have multiple experience of the exit process. He can work with the CEO to help prepare and to help select the exit advisor. He may already be a non-executive director or one of your investors may be able to recommend someone.
- Be cautious about letting one of your investors <u>lead</u> the exit process. They may not have the same ambitions as the management, particularly if they have preferential rights on exit or if they are under pressure to liquidate their fund.

However they may well have good experience and can be useful members of the exit team.

- the CEO is NOT the ideal <u>leader</u> of the team either.
    i. he rarely has any exit experience,
    ii. he needs to focus on continuing to deliver sales & profits,
    iii. he can be conflicted with other shareholders
    iv. he needs a good relationship with the new owners (cannot be the 'bad guy')
    v. he needs to be held in reserve for final negotiations on price and terms.
- One of the most common problems in an exit is 'deal distraction'. The CEO gets so involved in the exit process that he takes his eye off the ball and the business starts to suffer. The current year forecast has to be down-graded and the buyer uses this to renegotiate the price downwards. You can help to avoid this by following the above advice.

7. Documentation preparation

- You will normally require 4 key documents about your company to embark on a sales process:
    i. A 'teaser'. This is normally 2-3 pages and is an executive summary of your company and the investment proposition. It is a selling document with the objective of encouraging potential buyers to take a further look. It normally contains no confidential information and can be disclosed without restriction.
    ii. The Information Memorandum (IM) or prospectus. This is a detailed document that describes the key elements of your business in more detail, gives details of customers, products/services, organisation, management, future prospects, summary financial results and projections. It is likely to contain confidential information and is normally released under a non-disclosure agreement (NDA).
    iii. The detailed financial model. An excel spreadsheet that details and consolidates the sales revenue by product/service/market, gross margins, itemised costs and net profit. It also should include cash flow statements and balance sheets. The typical period covered would be two years history, current year estimates and three future years projections.
    iv. A powerpoint presentation of the key elements of your business for face-to-face meetings
- All these documents should be completed, reviewed, challenged independently and checked for consistency before any contact is made with potential purchasers. You don't want to lose momentum from a promising early contact while you wait for documents to be finalised.
- Be realistic with your business plan assumptions and financial projections. If they are too optimistic, buyers will discount them heavily and you will lose credibility.
- Above all, make sure that the forecasts for the current year are achievable. There is nothing more guaranteed to reduce the price than a sales or profit 'warning' during the final negotiations.

8. Basic valuation methods

- Market price compared to other similar quoted companies
- Multiple of EBITDA (P/E ratio)
- Discounted value of future cash flows (DCF)
- Return on investment (if profits stable)
- Net assets (eg property holding companies, investment funds)
- Specific sector ratios (eg hotel beds, unique visitors for e-commerce)

9. Valuation principles

- Young innovative companies are very difficult to value objectively (short history, uncertain future projections, no significant assets, higher risks)
- DCF is the most common method, but for young companies a multiple of sales is often used too.
- The following steps are required for the DCF basis:
    - i. Review commercial assumptions (customers, volumes, pricing)
    - ii. Carry out market research and challenge assumptions
    - iii. Review other financial assumptions (headcount, costs
    - iv. Stress test all assumptions: build in contingency to offset risks
    - v. Calculate free cash flow (NB: working capital requirements, future investment needs)
    - vi. Select a discount rate to reflect risk (As a rough guide 10% = low risk; 25% = high risk)
    - vii. Calculate the residual (or infinity) value at the end of the measured period. (depends on life cycle of product/service and ability of company to evolve into new products/markets)
- Don't forget that an acquirer will only pay what your company is worth to them, which may bear no relation to any theoretical calculations!

10. Valuation drivers for your company

- Profit! The most important factor that drives the value of the business is the expected profit margin that the new owner can derive from the business. If your business is not already profitable, you will have to demonstrate how it will achieve and maintain profitability, based on credible assumptions.
- A valuable technology or customer base that would be difficult or time-consuming for an acquiring company to achieve by itself.
- Sales growth. The faster your business is growing, the more value it is likely to produce for future owners.
- Consistent results. If the business is growing steadily with no big ups or downs, this demonstrates stability and adds confidence that future projections will be achieved.
- Hitting budget or sales targets. Again, this adds credibility to the projections if the business has a track record of budgeting conservatively and hitting targets, rather than constantly falling short.
- Low risk level. Try and eliminate as many risks as you can, particularly the risk of long-term performance of your product or service. Ensure production quality is high and consistent, that software upgrades are managed

professionally, key staff are well remunerated and motivated through share options, key data is securely stored and duplicated offsite, political and regulatory issues are minimised, etc

- Be open about the risks facing the business and what you are doing to mitigate against these risks. Document these in a ‘Risk’ section of the Information Memorandum. Potential buyers will be impressed that you have a risk management process!
- Ability of business to transfer to new owners and maintain or grow value. Key to this is to reduce reliance on the founder or CEO, to have a stable and motivated management team in place and to have all business processes well documented.
- Adequate cash resources to carry on if the sale does not complete. If a prospective buyer senses that an exit is urgent as the company is running out of cash, then this is highly likely to reduce the perceived value.
- The cost to the buyer includes not just the price paid to the selling shareholders but also any cash injection or investment required in the business. The less cash investment required, the more money will be available for shareholders.
- Have a good reason for selling now, rather than continuing independently. Demonstrate to the acquiring company that you have thought the options through carefully and you are convinced that they can add more value to your company than you could achieve on your own. Support this with suggestions and examples.

11. Achieving the highest price

- ‘Price’ is not the same as ‘value’. Value is a perception – it is theoretical, based on comparatives and financial models. Price is cash in the bank!
- During negotiations try and leave the discussion on price until last. The more time the bidder has spent evaluating your business, the greater the likelihood of them perceiving the strategic value to them and gaining confidence in you and your team. Before price is discussed, all relevant information needs to have been disclosed, all the concerns discussed, the risks evaluated and the commercial assumptions and financial projections validated. If you try and reach agreement on price too soon, it will almost certainly lead to disappointment later.
- The most important factor for achieving the highest possible price for your business is ‘competitive tension’, ie having at least two bidders competing for your company. This helps to avoid the common problem of last minute ‘chiselling’ of the price following due diligence or profit downgrades.
- Try and avoid giving ‘exclusivity’ to one bidder for as long as possible and if you do, limit the period of exclusivity to keep the pressure on the bidder. Once a deal is agreed in principle, most buyers will insist on a period of exclusivity while they carry out due diligence, typically for 2-3 months.
- ‘Leave something on the table’ for the purchaser. A good negotiator will discuss and challenge your assumptions and try and argue that your projections are over-optimistic. It is a good idea to hold back some ‘upside’ that you can use to counter these negotiation tactics.

- Sell the promise, not the reality. Have a number of opportunities ‘up your sleeve’ to counter any negative arguments raised by the bidder during price negotiations.
- Make sure that you continue to hit your sales and profit forecasts during the negotiation phase and up to completion. Any shortfall is an invitation to the buyer to reduce the price.
- The purchaser may offer shares in their business rather than cash, or perhaps a combination of cash and shares. The shares may appear to have a higher value than the cash, but there’s a reason for that! If you do accept shares, try and avoid any restrictions on selling them in the future. They are only worth anything if you can convert them readily into cash (eg a listed company) at something close to the ‘value’ paid.
- Some of your shareholders may require either cash or shares in a listed company, particularly if they have to liquidate their portfolios. They may not accept shares in another unquoted company as purchase consideration.

12. Due diligence

- Once a buyer has been identified and outline terms have been agreed, the buyer will need to carry out ‘due diligence’ to ensure that everything is as it should be and there are no surprises.
- This will require you to deposit a large number of documents in a data room (normally electronically via a secure web site) for the buyer to scrutinise. These normally fall into three categories
    i. Commercial (distribution agreements, customer contracts, orders, sales pipeline, trading terms & conditions, etc)
    ii. Legal & corporate (details of any current disputes, copies of all contracts, employment terms, leases, corporate structure, shareholder agreements, share register, options, etc)
    iii. Financial (statutory accounts, loan agreements, invoice discounting agreements, bank statements, taxation, etc).
- Preparing these documents can be time-consuming and can identify issues that have not been addressed previously or have been forgotten. It is a good idea to start preparing very early in the sales process, to allow time to put right any issues.
- If you are aware of any ‘issues’ that might put off an interested buyer, eg a legal dispute with a customer or an ex-employee, it is best to mention these early on. You want to avoid a serious buyer being put off by what he discovers in the data room. Full disclosure is the best policy.

13. Warranties & indemnities

- The general principle of warranties should be discussed early on in the process if possible, and before detailed due diligence is carried out. The exit advisors should ascertain what general warranties the purchaser is likely to request.
- You will almost certainly be expected to warrant in the sale agreement that certain key information is true and that you have disclosed everything relevant. The more you disclose, the less you will have to warrant.

- If the buyer is concerned about the level of risk in the business, he may insist that some of the sale proceeds are held back 'in escrow' for a year or more in case of claims against the warranties.
- In certain cases, you may be asked to indemnify the buyer against certain specific risks, eg back tax claims or damages awarded against the company in a law suit. Indemnities are stronger than warranties. The buyer does not have to raise a legal claim against you but can pass the liability directly on to you.
- Minority financial investors generally do not offer warranties or indemnities. They have no detailed knowledge of the business and they rely on the majority owner(s) to give comfort to the buyer.

14. Management retention.

- It is highly likely that the Founder/CEO will be required to stay on after the exit for at least 1-2 years, probably longer. If you want to stay with the business longer term, you will need to come to terms with working for someone else and demonstrate that you can still add value in the new environment. If you are no longer part of the future, you need to be prepared to let go of your baby!
- A good and experienced acquirer will draw up a 'management retention package' which will ensure the key members of the management team are motivated and incentivised to remain in the business and continue to grow it.
- Good acquisition practice will also involve drawing up an integration plan and post-acquisition strategy and action plans. You should be involved in these to help address any cultural issues and ensure a smooth transition.
- Part of your proceeds from the sale may well be linked to the future success of the business (an 'earn out'). The amount you receive will depend on whether the sales or profit targets are achieved. If you do accept an earn-out, try and ensure it is based on 2 years results, not just one year. Your business is unlikely to perform really well in the first year due to the disruption of the deal itself and subsequent settling down of management and strategy. Make sure the results can be properly measured – sales are easier than profits, due to cost allocation issues.
- You may also be offered shares in the acquiring company rather than cash. The buyer wants to be sure that you will still be motivated to work hard for future success and not just 'take the money and run'.
- Generally speaking, hard cash up front is better than either shares or earn-outs, even if the price appears to be somewhat lower.

15. Conclusion

- Preparing in advance for an exit and managing the sales process professionally will almost certainly result in a higher price being achieved. Follow these guidelines and you will be well on the road to a successful exit!

Nick Pearch is an independent director and strategic advisor for developing international businesses. He is currently Chairman of Roberts Metal Packaging, Blue H Group Technologies and a director of Boatbookings, Gratnells, M4G and MeetingSphere. He also manages a small investment fund focussed on European Technology companies.

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In his executive career Nick was Managing Director of Dyson Appliances International during its rapid expansion. He also jointly led the successful MBO, IPO and eventual sale of Taunton Cider plc.

In all his roles, Nick's primary goal is the creation and realisation of shareholder value. He has achieved several successful exits for investors.

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