The Art and Science of Preparing Your Business for Sale

10 Steps to Maximize Enterprise Value and Achieve Your Exit Goals

In the midst of building a company, very few new business owners take the time to envision the day they will sell the business. But they should. In fact, it is often said that when building a business, you should begin with the exit in mind. In other words, from the day you open its doors, in order to get everything you want out of the blood, sweat, and tears you're putting into the company, you should be preparing for the day you sell it.

Building a company is a journey. The goal of that journey is to continuously look forward with a focus on creating and maximizing enterprise value, and ultimately to choose the right time to go to market.

Here are 10 steps to take along the way to help ensure that when the journey is over, you're happy with where you have arrived.

1. **Know your motivations**

Before you put the wheels in motion to go to market, it's vital that you engage in some introspection. Ask yourself: Why am I now considering selling the business that I spent my life building? And if I sell it, what do I hope to accomplish? What will I do with all the free time during this next stage of my life? It's important to clarify your motivations before you spend all the time, resources and opportunity costs required for a successful sale process. You don't want to go down this path, get to the finish line and then have regrets.

How important is legacy to you? The answer to this question will help drive a lot of your planning, particularly the type of buyer you should target and the type of transaction structure to consider. If legacy is important, you might be compelled to transfer a minority interest to family, sell to a management group backed by a sponsor, or utilize a tax-efficient Employee Stock Ownership Plan (ESOP) structure. Conversely, if legacy is not a priority, and the primary goal to maximize business valuation, you might do better selling 100% to strategic buyer or private equity backed company with plans to fold your company into a large corporate division or platform entity within the sponsor's portfolio.

Building a company is a journey. The goal of that journey is to continuously look forward with a focus on creating and maximizing enterprise value, and ultimately to choose the right time to go to market.

2 Understand value drivers

Building a business is all about increasing its value from year to year while mitigating risk factors. To do that, you must understand what drives premium valuations in your industry and continuously incorporate those drivers into your company's growth strategy.

Traditionally, when people talk about preparing to sell a business, they focus on steps to take in the months prior to the sale, or even some that make sense two or three years out. But from day one of your business, it's essential to develop a strategic plan focused on the most critical value creation drivers and how you will implement them during the business's life cycle—including things like corporate culture, scalability of business model, recurring revenue streams, digital channels, the "stickiness" of customer relationships, organic versus M&A growth, and intellectual property development.

Commanding premium valuations increasingly reflects the ability of a business to rapidly scale and disrupt a category and win in the digital economy with a differentiated offering and business model.

Commanding premium valuations increasingly reflects the ability of a business to rapidly scale and disrupt a category and win in the digital economy with a differentiated offering and business model.

3 Diversify the revenue base

Some components of your strategic plan will take several years to implement. This is one of them. Your goal should be to fashion your business, so your revenue stream is diversified in all respects—by product, customers, and geography.

For instance, in most cases, it's not advisable to allow a single product to make up the vast majority of your sales. If anything occurs to diminish that product—say a recall or a competitor launching a better version of the product—you could experience a disproportionately negative impact on your business and its profitability. Additionally, having customer concentration of greater than 15% will often result in a materially discounted valuation from buyers, or in extreme cases make the business unsalable.

Buyers are concerned with what can go wrong after they buy the business, and having predictable and recurring revenues can greatly mitigate these perceived risks.

4 Grow market share

Companies grow market share organically or through acquisitions. In the best of circumstances, a business can grow both ways.

For a company already growing organically, acquisitions can turbocharge enterprise value, particularly if you recognize the value drivers in your industry and acquire competitors with solid attributes around those drivers, such as a new product line, profitable customer base, geographic beachhead, or an excellent management team. By making smart acquisitions, it is possible to accelerate by many years the value of your business.

In order to grow their brand and market presence, companies often benefit by acquiring troubled companies and smaller competitors, typically good companies with bad balance sheets. From a value perspective, acquiring smaller companies in the private market can offer a multiple arbitrage opportunity. You might buy a smaller company at a multiple of 5x EBITDA (earnings before interest, taxes, depreciation, and amortization) but then reap a significant benefit on those assets a couple years later when the combined business sells for 7x EBITDA.

5 Avoid the trap and fortify the management team

One of the biggest mistakes business owners make that can detract from value is making the company too reliant on them. This is often referred to as the "founder's trap."

The goal of company founders should be to build a culture and team that eventually can operate independently from them on a day-to-day basis. Thus, as your business grows and evolves, you should constantly be asking: What are the management skills and resources we need to move the business forward and take advantage of growth opportunities?

At many companies, the founding management team consists of family members or others who have only worked in small businesses. But as businesses mature, they often need to bring aboard managers and outside advisors with experience supporting larger organizations with all that entails—formalized workflow processes, sophisticated customer data analytics, creative talent acquisition, and enhanced financial/accounting reporting capabilities.

This doesn't mean you have to hire a group of expensive MBAs to run your business. In fact, in today's gig economy, you can hire talented professionals with the requisite experience on an interim basis. A good example: If you are eyeing the sale of your business and have no experience with such a transaction, you can probably find a CFO who knows the M&A ropes and is willing to work on a short-term contract to assist with the pre-sale due diligence preparation.

It's also important to have an effective management retention plan in place prior to embarking on the sale process. A large component of a company's enterprise value resides within the talent of a management team and its track record of executing on the business strategy.

It's also important to have an effective management retention plan in place prior to embarking on the sale process. A large component of a company's enterprise value resides within the talent of a management team and its track record of executing on the business strategy.

6 Optimize the corporate structure

One way to do this is to eliminate unnecessary corporate entities. For example, some businesses may have been formed as a limited partnership (LP). An additional business entity, an S corporation, may have also been created to act as the general partner in the LP to minimize liability to the partners. Rather than keeping this structure, the business can reorganize as a limited liability company (LLC), which for most taxpayers encompasses the LP plus the S corporation structure.

Additionally, it's important to separate your personal expenses and assets from those of the business. For example, it's not unusual for a business owner to pass certain personal expenses through the company. Reconciling such "owner add-backs" can help increase enterprise value and portray a true cash flow picture for potential buyers.

7 Execute tax and estate planning

Working closely with an advisor on tax and estate planning well in advance of selling your business is critical. Before implementing any strategy, a qualified advisor can provide guidance on both income and estate tax laws which are complex and subject to change. As stated above, if you understand your motivation for a potential future sale of the business, incorporating income and estate tax strategies may provide significant benefits upon the sale.

For example, if one of the goals of the business owner is to maximize the gifting of assets to their children, it may be wise to transfer interests in the business prior to appreciation of the value. If the business is currently valued at $20 million but you expect it to rise in value to $100 million in three or four years when you plan to sell, then gifts or transfers made currently to the children (either directly or through a trust) will lock in the lower value for estate tax purposes and future appreciation will not trigger any additional gift tax consequences. Under certain circumstances, early planning can also enable you to take valuation discounts to minimize the amount of the transfer to family that will be applied to your gift tax exemption.

Working closely with an advisor on tax and estate planning well in advance of selling your business is critical. Before implementing any strategy, a qualified advisor can provide guidance on both income and estate tax laws which are complex and subject to change.

From an income tax perspective, one important element to consider is the entity structure of the business. For example, S corporation status comes with strict rules on who can be a shareholder and does not allow a charitable trust to be one. A charitable trust offers significant income tax benefits, so restructuring the business from an S corporation to another entity may be beneficial. But as with any income tax planning, analysis is required to fully understand the pros and cons before executing an entity change.

Often, the owner does not consider planning until the letter of intent is signed. Because the letter of intent establishes the value of the business, planning after this point may not yield as much benefit as planning prior to this event. So, timing the planning process is important in achieving the goals.

8 Remove barriers to sale

Review charter documents to spot impediments that can either block a sale or, at a minimum, delay the closing. Business owners need to eliminate, or address, these in advance of going to market.

Partnerships, for instance, sometimes have buy-sell agreements with right-of-first-refusal provisions that can prevent the business from being sold to the desired party without giving another party, such as an investor, the first opportunity to bid on the business.

Another type of barrier is a third-party consent stipulation requiring an owner to get another party, such as a key supplier, customer or government agency to green light any sale.

9 Organize company and financial records

This important step is aimed at streamlining the diligence process and fostering credibility with potential buyers. As part of the sale process, you will need to allow potential buyers to review company records such as tax returns, contracts, HR compliance, stock records, and annual director, shareholder, and special meeting minutes. It's important to have all these records organized before you go to market. If you don't, with so much going on in the sales process, even as you continue to run your business, this task can become a major distraction.

You can outsource much of the job of assembling this data to your attorneys, accounting firm, and investment bankers and manage it in a secure third-party hosted virtual data room.

On almost all deals today exceeding $25 million, buyers will require a "quality of earnings" report from a third-party accounting firm. The firm will evaluate whether the revenue and expense entries of the business comply with generally accepted accounting principles (GAAP) and report on its true cash flow. The goal of the quality of earnings report is to give potential buyers some assurance about the revenues and expenses they can expect once they assume ownership, and to help them assess the company's valuation.

> ***"Positioning your business to generate predictable future cash flows will increase the chances of a premium valuation."***
> ***– Rick Chance***
> ***Intrepid Investment Bankers***

Most companies will want to conduct their own analysis prior to going to market. That way they can correct any mistakes the third-party accounting firm might identify, and that the buyer might try to leverage in negotiations.

10 Maintain business as usual

Finally, in preparing your business for sale, it is important to operate the business as usual—continue to invest in systems, people, new products, customers, and geographies that all align with your value creation strategy. This approach will help ensure buyers evaluate your business relative to its potential to capitalize on future growth opportunities that will drive their return on investment. This evaluation may ultimately allow buyers to justify paying a premium for a business that you spent a lifetime building.

For more information about how Intrepid Investment Bankers can help your business plan for a successful sale, contact Rick Chance. To further explore how The Private Bank can assist with your Tax and Estate Planning, speak to your relationship manager or visit The Private Bank to request an appointment with an advisor.

Authored by:

Rick Chance
*Head of Strategic Relationships, **Intrepid Investment Bankers***
rchance@intrepidib.com

Min Yoo
*Senior Wealth Strategist, **Union Bank, The Private Bank***
minyoo@unionbank.com