The Sale of a Privately Held Company:

valuations, process and best practices

The reasons behind the decision of shareholders to sell a business are unique to each situation, but they usually involve issues of liquidity, timing and emotions. One of the most common drivers is the need for a succession strategy within family owned companies. Often times the decision is purely financial — private companies are highly illiquid assets and a sale can generate liquidity for diversification and financial security. In other situations, entrepreneurs find their drive and passion for the business fades over time. Finally, we are seeing an increasing number of transactions triggered by unsolicited offers from a competitor or a private equity group even though shareholders were not even contemplating a transaction.

Whatever the driving force for the transaction, the sale of a privately held business is an often emotional undertaking that can cause serious disruptions in the enterprise unless it is managed properly. The sale process can impact relationships with suppliers, shareholders, family and employees in ways that can damage the value of the company. A well-managed process can enhance the value of a business and position the company for a continuing legacy under a new ownership structure.

The sale process is the final stage of the entrepreneurial cycle when the value of the business is ultimately realized and shareholders receive liquidity for their ownership interests. It is a culminating event yielding financial rewards for years of hard work and risks taken. To maximize the value of the business, the process should be well planned, well executed and given the attention that any other crucial business event deserves. Planning the process and executing the plan in a disciplined manner is the shareholders' best guarantee that the business will be sold to the right buyer, at the best price, and under the most favorable terms and conditions.

THE CAST OF PLAYERS

The world of mergers and acquisitions (M&A) involves immense sums of money controlled by buyers, lenders and investors. Understanding these key players and their roles in the process is critical for a seller navigating the M&A arena.

THE BUYERS

Buyers typically fall into two general categories: strategic and financial. Strategic buyers can be either public or private companies that target acquisitions for a strategic purpose: gaining market share through the purchase of a competitor, managing production inputs by acquiring a supplier or gaining distribution channels by consolidating a dealer network. Other strategic objectives may include diversification of business lines or cost reduction.

The objective of a strategic buyer is to build value by integrating an acquisition with existing operations, executing a joint strategy, and growing revenues and managing costs. From a seller's perspective, the importance of strategic buyers lies in their ability to pay higher values than other buyers evaluating stand-alone acquisitions. Strategic buyers typically have a unique value proposition that provides a rationale for an acquisition other acquirers may lack. Furthermore, they often have greater access to capital at a lower cost. These factors usually translate into an ability to value potential acquisitions higher.

Private equity groups constitute the vast majority of financial buyers, the other major category of buyers. Their objective is to make acquisitions that generate returns for their investors, including pension funds, university endowments, wealthy individuals, banks and other investment firms. They acquire companies using a combination of the funds raised from their investors and loans from banks and other capital sources. A positive return on their investment is earned as long as their profits exceed their cost of capital. The objective of a financial buyer is to achieve, on average, their targeted return on equity — currently around 20%.

Given the right price and an appropriate capital structure, financial buyers employ a whole host of strategies to build value. Such strategies include bolstering management teams, improving cost structures, introducing new sales strategies and achieving economies of scale through additional acquisitions.

The sale process should be well planned, well executed and given the attention that any other highly critical business event deserves.

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A financial buyer's objective is to buy at the lowest price possible, grow earnings and eventually sell at the highest possible price once the investment has been held for an optimal period of time, typically three to seven years. When financial buyers exit their investments, they usually focus on selling to a strategic buyer, or if the stock market is healthy and the company is large enough, executing an initial public offering (IPO). However, there is a growing trend for smaller private equity groups to sell their portfolio companies to other private equity groups that focus on larger transactions.

Financial buyers can often act as strategic acquirers through one of their portfolio companies — sometimes called hybrid buyers. A portfolio company owned by a financial buyer may grow to such an extent that they accumulate significant resources. Such financial resources and other opportunities for synergies may allow them to outbid other potential buyers for companies in the industry.

Exhibit 1 provides a summary of the characteristics of different types of buyers. In M&A transactions it is important to know the potential buyers and communicate accordingly. A strategic buyer and a financial buyer will look at the same acquisition differently. Knowing their "hot buttons" is something that can be assessed through financial analysis, for example, by studying the potential dilution aspects of a deal for a strategic buyer, or by identifying the key elements affecting the returns for a financial buyer.

EXHIBIT 1: CATEGORIES OF POTENTIAL BUYERS

	FINANCIAL BUYERS	HYBRID BUYERS	STRATEGIC BUYERS
PRIMARY OBJECTIVE	Generate returns through growth of earnings combined with financial leverage	Grow portfolio company return through strategic acquisitions	Enhance value through synergistic acquisitions involving market share or cost reduction
FINANCING SOURCES	Minimal equity, bank loans, subordinated debt, seller notes	Typically same as financial buyer, but may come from existing cash resources	Sources vary from cash reserves to banks and public/private debt and equity markets
INVESTMENT HORIZON	Medium term	Short to medium term	Longer term
EXPECTED VALUE OF DEAL	Determined by capital structure, projected earnings and return expectations	Can be higher than other financial buyers due to synergies	Typically higher, depending on synergies and ability to pay

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THE ADVISORS

The seller's M&A team typically includes key members of the management team in addition to attorneys, accountants and investment bankers. The smooth functioning and interaction within this team in the execution of the deal process is a critical element in the success or failure of the sale.

Control of the deal team should never be fully delegated by the seller. This is often difficult for clients who are successful entrepreneurs in their own right but may be overwhelmed when they venture into the unfamiliar world of M&A. Those clients who manage the process best exercise executive control and daily involvement, while relying on their team to manage their respective responsibilities within the process and coordinate with the rest of the team.

Most companies contemplating a divestiture or a sale already have a law firm relationship already in place. However, an attorney that deals with the day-to-day aspects of a business may not have the specialized knowledge required for M&A transactions. An experienced deal attorney is essential in any sale. He or she is responsible for ensuring that the deal is structured and documented properly. The best attorneys know where pitfalls can occur and how to protect their clients well after the deal is closed. Most law firms either have this expertise in-house or know other firms that can assist.

The role of the accounting firm has expanded as the M&A world grows in sophistication. Buyers need to have confidence in the accuracy of the financial statements. Furthermore, the company's accounting firm is pivotal for due diligence when buyers are conducting their investigations of the business. Companies should plan early for an M&A transaction and establish procedures and reporting systems that are reliable and accurate. A preemptive due diligence review conducted early on in the process is a good investment for any firm contemplating a transaction. "Clean" companies command greater value and can withstand pressures by buyers to lower valuations as the deal proceeds.

The third leg of the M&A team is the investment banker, who acts as process manager, financial analyst and head marketer. The investment banker must understand the company, its industry and all of the elements that determine the value of the business. Duties of the banker include the preparation of marketing documents, building financial models, developing a target list of potential buyers, contacting interested buyers and conducting the auction that ultimately maximizes the value of the deal for the seller. Good bankers excel at developing the strategy of the deal and adapting the marketing process as it evolves.

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Choosing the right deal team is critical. More often than not, the deal team is chosen based on those who have attained a position of trust with the seller or have been selected through a "beauty contest." Compatibility with other team members is an important trait for any potential team member. Other criteria include competence (do they know what they're doing?); market credibility (do they have a good reputation?); and a proven track record for getting things done. Many potential sellers weight industry knowledge heavily. However, this can be a double-edged sword. The team should be loyal to the seller and not the industry.

Any seller recruiting a team should pay as much attention to assembling their team as they have invested in growing the business. The sales process is so disruptive and time consuming that a seller often has one shot at getting the sale done right. Changing the team in the midst of a deal is very difficult and will be perceived poorly by the marketplace.

THE PROCESS

There is a common progression of stages that characterizes most M&A processes. Each deal is different, as are the players, but most well-run deals progress from one stage to the next in similar fashion. A typical deal process is illustrated in Exhibit 2. It shows each major stage of the process, the major tasks performed in each stage and the approximate time frame involved at each phase of the process.

EXHIBIT 2: ILLUSTRATION OF THE M&A DEAL PROCESS

PLANNING	DOCUMENT PREPARATION	MARKETING AND AUCTION	NEGOTIATIONS	CLOSING
Assemble Advisory Team	Create "Teaser" and Information Memorandum	Develop Target List	Choose Final Bidder	Assemble Final Documents
Formulate Objectives	Prepare Financial Projections	Distribute Memorandums	Coordinate Final Due Diligence	Execute Purchase Agreement
Determine Deal Structure	Draft Confidentiality Agreements	Choose Next Round Groups	Finalize Purchase Agreement	Transfer Funds
Develop Marketing Plan	Construct Data Room	Conduct Management Presentation		
Establish Procedures		Solicit Final Bids		
2 WEEKS	2 - 4 WEEKS	8 WEEKS	4 - 6 WEEKS	4 - 6 WEEKS

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PLANNING

The process kicks off once the deal team is assembled. It is essential that the objectives and expectations of the seller be clearly defined at the very beginning of the process. Value expectations, indemnification risks and expectations for the post-divestiture roles of management should be clearly defined. Misunderstandings over what the seller is willing to accept in a final deal are typical mistakes that can be avoided in the planning stage. Defining potential deal structures (asset versus stock sale and full sale versus partial or leveraged recapitalization) should also be defined early in the process.

The development of the marketing strategy for the sale of a company is a crucial theme that cuts across the entire process. The most important question that must be answered is this: Why would someone be interested in buying the company? Other questions include:

- What messages should be conveyed that will entice strategic buyers as opposed to financial buyers?
- Is the company a good stand-alone investment or is it a growth play as part of a larger strategy?
- Does the company's value depend on a competitor's willingness to gain market share through the purchase of the company?

Once this thesis, or multiple variations of the thesis, is developed it is important to carry that theme through the entire marketing process.

Finally, planning should include establishing deal procedures, including assigning responsibilities, gathering contact information and establishing communications procedures.

Detailed planning is important and helps ensure confidentiality of the process by eliminating the risk of careless mistakes.

DOCUMENT PREPARATION

The next stage of the process is to develop the materials used to communicate information to potential buyers. The first task is to create a "teaser," which is used to stir up interest in the deal without disclosing either the company's name or information that might allow potential buyers to guess the identity of the seller. Next, a confidential information memorandum (CIM) is prepared in draft form and revised numerous times before distribution. This document describes the company — its products, markets, customers, competitors and industry, in addition to summarizing historical financial information and projections. The CIM must effectively communicate the marketing themes of the deal. The first few pages of the memorandum, comprised of the executive summary and the key investment considerations, provide an opportunity to communicate what is special about the company and why it would make a great acquisition.

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The work of constructing a data room begins at this early stage. A data room is a collection of documents that contains more detailed information than what is included in the CIM. Such documents include audit reports, employee information, contracts and environmental studies. Honest and accurate disclosure should be the guiding rule in assembling the data room — holding back negative information will result in lower values before closing and lawsuits afterwards. Initially, only the CIM is available in the data room and access to other documents is provided as the deal progresses. The data room is an excellent tool for tracking interest in the deal as an audit trail is created, which provides data on which documents buyers are looking at and how often.

MARKETING AND AUCTION

Prior to distribution of the memorandum, a significant amount of research is applied to developing the target list of potential buyers. Who are the logical buyers? Who has been making acquisitions in the industry? Which private equity groups are looking for deals of this size in this industry? Investment bankers maintain and subscribe to comprehensive databases used to ensure that the deal is shown to the right buyers and that no stone is left unturned in the process.

Once the documents and the target list are complete and accurate, marketing can begin. It starts with a phone call to potential buyers or a broader distribution of the teaser. After a confidentiality agreement (NDA or CA) is negotiated and signed, the memorandum is then distributed via email or data room access. A tracking list of targets is used to communicate information on the marketing process to other team members. This report typically contains contact information, milestones (such as NDA sent or data room access granted), and includes notes on discussions requiring communication to the client or other team members.

As the process of book distribution continues, the number of parties on the tracking list grows as the investment banker uses his or her network to expand the target list of acquirers. A skilled banker will add value to the process by finding potential acquirers that might not have seemed intuitive to others, or by pitching the deal to other potential buyers as an idea that they might not have otherwise considered.

Once the memorandum is distributed to the list of potential buyers, the deal makes its way through the evaluation processes conducted by the potential buyers. Follow-up questions and discussions between the banker and the buyers lead up to a target date when potential buyers are asked to submit a letter called an indication

A rational, logical and organized process, designed to reap the benefits of the competitive auction, must be conducted to maximize value.

of interest (IOI), a non-binding document that identifies a value, or range of values, that the buyer proposes paying for the company. Other elements of the letter may include deal structures and offer an opportunity for the buyer to make a case for considering them in pursuing the acquisition.

The client and the M&A team sift through these letters to determine which potential buyers are chosen to advance to the next stage. This is the point when the market value of the company begins to crystallize. Clues as to how the market assigns values to different aspects of the deal and where there are weaknesses in the company's value thesis become apparent at this stage.

The process of marketing a company is analogous to a funnel. If the target list begins with 100 potential buyers, perhaps 60 receive a book. If 10 submit indications of interest, perhaps only five are chosen to meet management and conduct additional due diligence in the data room.

Once a smaller group is chosen, a management presentation provides buyers with the opportunity to assess the management team, discuss strategic issues and tour the facilities. Often the buyers will bring their bankers. If presentations and discussions go well and the data room tests out to their satisfaction, potential buyers will likely have comfort with the deal and enough confidence to push their valuations to the top of the range of their original indications. The goal at this stage is to move the buyers' range of valuations even further above those that were originally submitted.

However, there are also things that can move buyers' perceptions of value in the opposite direction. Common pitfalls that might result in negative perceptions include earnings deterioration, inaccurate or unfavorable information that was not properly disclosed, or a stale management presentation.

Once the presentations are finished and the data room has been fully updated, the next task is to choose the best buyer. Potential acquirers are given a couple weeks to refine their value calculations and line up their financing sources. The investment banker then asks the bidders to submit their final offers. These offers are structured as a letter of intent (LOI) that addresses how much they propose paying, the structure of the payment (cash, seller notes, earnouts, etc.), conditions of closing and timing. The letters, although non-binding for the most part, provide the basis for choosing the final bidder. Often the bidders are provided with a draft purchase agreement that they are asked to "mark up." This can often provide the attorney on the deal team with a sense for the key legal issues that the buyer has identified. Choosing the final buyer based solely on value without considering legal structures is a mistake many sellers come to regret later.

If all has gone well and there is a sense of excitement among the bidders, this is when the clout of the seller is at its maximum level. This is when that last morsel of value can be extracted through the competitive auction process when bidders are asked: "Which one of you wants to buy this company more than anyone else?"

NEGOTIATIONS AND CLOSING

Once the buyer is chosen, the push and pull of the final negotiations begins. The LOI is

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signed and final negotiations and due diligence commence. This is the stage when the investment banker moves to the background, passing the lead role of process manager to the deal attorney. Following execution of the final purchase agreement, ownership changes hands and funds are transferred.

PROCESS MAXIMIZES VALUE

The primary thesis of this article is that a carefully managed and organized process, designed to reap the benefits of the competitive auction, should be conducted to maximize the value shareholders realize through a sale of the company. You may have a great company with tremendous perceived value, but if the sale process is botched, that value will not be realized. Worse yet, you may inflict damage on the business if, for example, trade secrets make their way to competitors or if employees, frightened by the prospects of a sale, choose to seek employment elsewhere.

Selling a company using a hit and miss approach without a road map and a professional deal team will rarely result in the realization of the potential value of a company in the marketplace. A well-executed process that will unlock a company's value should be comprehensive so that once the deal is completed the seller can rest assured that all potential buyers were involved. Equally important, the process should be competitive to ensure that all the bidders stepped forward with their best deal. Careful execution of these elements remains the best way to find the best buyer and cultivate the best deal.

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JIM LISY, CFA, MBA
jlisy@cohenconsulting.com
216.774.1153