WITH AN EYE TO THE FUTURE: CONTINUING CONSIDERATIONS TO MAXIMIZE YOUR VALUE PRIOR TO SALE

During the current COVID-19 pandemic, selling your business may be the last thing on your mind for a variety of reasons: business or sales are trending downwards, the economy is unstable, buyers are less inclined to purchase, etc. There is also the possibility that you are in a market that has been less negatively impacted and buyers remain willing to pay a premium. In either case, now is a good time to begin taking proactive steps to position yourself for a future sale.

1 | EARLY PLANNING FOR BETTER OPPORTUNITY

As you begin taking proactive steps to position yourself for a future sale, the first step to maximize the value of your business is early planning. Ideally, we recommend that business owners considering a sale or transition transaction within the next **one to three** years begin planning and preparing the business to ensure a maximum return.

A long-term approach to selling your business allows you, as the business owner, to conduct a full evaluation of your sale goals, assemble a team of advisors, sufficiently understand the market (and allow the market to stabilize if necessary), clean-up company financials and corporate records, and work to maximize EBITDA and establish a steady or, if possible, upward trend. Given the relative complexity and cost of business transactions, the more work, information-gathering, and document compilation owners and their team can accomplish prior to sale, the more a business increases its opportunity to maximize its transaction value.

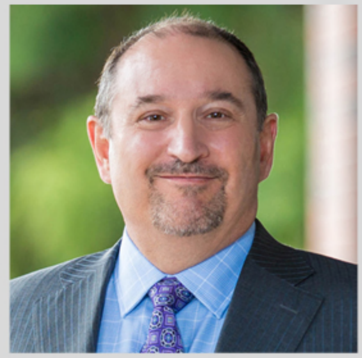
Be Introspective!

- **Understand and articulate your transaction goals.**
- **Identify and be able to articulate your value drivers. What differentiates you from your competitors?**
- **Focus on opportunities to demonstrate sustainable and quality earnings.**
- **Evaluate and understand your market. Who are your potential buyers? What is their likely motivation?**
- **Do you have any vulnerabilities? (e.g., operational weaknesses, gaps in staffing, regulatory uncertainty) Be ready to discuss with a buyer.**
- **Strategic vs. financial vs. internal buyer? Strategic and financial buyers have different goals and value companies in different ways.**

Strategic Buyer: Synergistic company (often from the same industry), looking to create bolt-on, incremental, long-term value/growth.

Financial Buyer: Firms (i.e. private equity) looking to make an investment and realize a return via future sale or IPO.

Internal Buyer: A current participant of the business (often a key employee) looking to take over the business.



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Sample of Recent Transactions:

- Assisted living and memory care facility to strategic buyer.
- Landscaping materials seller to strategic buyer.
- Manufacturing and distribution company sale to a public company as buyer.
- Data software company sale to strategic buyer.
- Accounting practice to strategic buyer.
- Proprietary pump manufacturer and distributor to financial buyer.

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2 | PRE-SALE HOUSEKEEPING

Potential buyers consider a number of factors when analyzing businesses and assessing value. Well-prepared sellers that have taken the time to evaluate and clean-up all aspects of their business, are more likely to see an increased valuation and are generally better prepared for the transaction.

- **Evaluate Ownership Structure:** How is your business organized? You may be able to significantly increase value and minimize tax impacts by converting to a different corporate structure.

- **Corporate Records:** Are your formation documents, corporate minutes, and organizational records accurate and current? Incomplete records can raise red flags and cause buyers concern.

- **Legal Concerns:** Buyers are sensitive to various legal concerns that may exist. Identifying and addressing the following matters early can have significant impact on value:
  - Clear ownership of assets
  - Long-term, transferrable leases
  - Outstanding liens and encumbrances
  - Pending litigation
  - Tax liabilities

- **Disputes**: Similar to legal concerns, Buyers are also sensitive to business disputes that may exist. These can include disputes with vendors, customers, employees, or other third parties.

- **Employment Considerations:** Consider whether or not you are properly staffed to maximize profits. Do you have any human resource or employment related concerns that need to be addressed prior to negotiating a sale? What will happen to the employees as a result of sale? Are key employees properly incentivized?

- **Financial Condition:** Buyers will require clean and consistent historical financials demonstrating the company's revenue. Establish consistent financial protocols and be prepared to evidence those protocols during sale. Buyers will seek GAAP compliant financials, which is a high threshold that your team will likely seek to negotiate down to a less cumbersome standard.

- Be prepared to evidence **value drivers**, such as: financial controls and systems, talent base (employees), product/service offerings, branding and product placement, key management.

- Review **working capital** position and how it may be improved.

- Corporate tax matters (federal, state, international) should be identified, addressed, and brought current.

- Prepare reasonable **forecasts of the financial condition** of the company.

- **Intellectual Property:** Does your business own and/or license any trademarks, copyrights, patents, or other intellectual property? Are you aware of any infringement claims? When does your intellectual property need to be renewed?

- **Contracts:** Identify the contracts that are material to your business (e.g., vendor contracts, employee contracts, customer contracts, governmental contracts, etc.…). Buyers will likely want to make sure that material contracts are assignable and that the buyer will be able to maintain the relationship going forward.

3 | NORMALIZATION & STABILIZATION

The company's historical and projected financials are key components to determining the company's value. Potential buyers want to see a solid historical track record and credible future growth and profitability projections. The COVID-19 pandemic may create an exception to your company's historical financials, but showing a long-term level of stability, a return to normalcy, and an upward projection in the future will enhance value to buyers.

- Identify **key financial metrics** and articulate their relevance. As part of being introspective, this may require understanding your weaker metrics and taking steps to strengthen them.

- Show at least **three-years of financial statements**. Be aware that buyers may request a longer history of financials.

- Consider a professional **review** of your financial statements prior to sale. Be aware that buyers may request GAAP compliant financials.

NORMALIZE EARNINGS

Buyers are interested in understanding the company's anticipated profits under new ownership. Thus, most buyers require the seller to "**normalize earnings**", or report the profits and losses as adjusted for abnormal or non-recurring events (e.g., COVID-19). Consider normalizing earnings *prior* to negotiating the sale price. Buyers are likely to apply the agreed upon multiple to the normalized EBIT, EBITDA, or other expression of value. When normalizing your earnings, look to your historical earnings and sustainable trends occurring prior to any abnormal events.

EXAMPLES OF NORMALIZING ADJUSTMENTS

- **Related Party Transactions**: Do you have contracts or agreements with related parties at prices that are lower or higher than market value? To normalize earnings, you would adjust the company's financials to reflect a market-value/arms-length transaction.

- **Owner Salaries and Bonuses**: Are the owners (or key executives) salaries/bonuses higher or lower than independent third-party executives? Owners may pay themselves a lower salary and higher end-of year bonus for tax planning purposes. Regardless of whether salaries/bonuses are higher or lower, they will need to be adjusted to reflect a likely third-party executive's salary/bonus.

- **Rent and Leases**: Many companies rent their facility from a real property holding company owned/controlled by a related party. Rent is often established without consideration for fair market value. Fair market value adjustment should be considered. Similar to related party transactions, this may result in a lower or higher market value. The purpose of this be to reflect a market-value/arms-length transaction.

- **Other Assets and Expenses:** It is common to see vehicles, homes, travel, and other items more personal in nature on the company's financial statements. Identify assets and expenses that are not necessary in the operation of the business and remove them from the normalized earnings.

STABILIZATION FROM NON-RECURRING/ABNORMAL EVENTS

Under certain economic conditions outside of a business owner's control, such as the COVID-19 pandemic, it is important to show buyers that the impact is abnormal and historically an outlier.

- **Show Revenue Recovery**: Your revenues may be down due such abnormal events, so it is important to show your historical stability, trends prior to the abnormal event, and subsequent recovery.

- **Use Government Relief to Stabilize**: In some cases, the government may offer relief and assistance to get you through the abnormal economic events. To the extent your business has been negatively impacted, utilize such assistance and relief programs not only for assistance during such event, but also to set yourself up to recover quickly.

- **Operational Normalcy**: In some cases, abnormal events may require closures due to government orders. If that is the case for your business, return to normal operations, including normalized staffing, to reflect your full operational efficiencies. This, of course, will have a direct impact on revenue recovery.

4 | MOVING FORWARD WITH THE DEAL: STRUCTURE & MANAGEMENT

STRUCTURING

The structure of a deal is determined by the seller's goals and buyer's goals. The two primary forms of deals are asset purchases or stock purchases.

As a general proposition, buyers prefer asset sales in order to take advantage of the stepped-up tax basis and ability to depreciate assets. Asset purchases, though, may require more administrative work including renegotiating certain contracts with third parties (e.g., vendors, customers, or employees), assigning certain contracts, or retitling assets.

A stock purchase can be simpler in concept than an asset purchase, specifically in relation to the administrative issues listed above. The buyer purchases the stock and the company and there may not be as much work to renegotiate and assign contracts or retitle assets. With a stock purchase, though, the buyer does not receive the tax-advantages of an asset purchase. From a tax perspective, sellers may prefer stock purchases due to the capital gains tax treatment compared to the potential double taxation certain entities face in asset sales.

Structuring a deal depends on a variety of factors, including the type of business engaged in the transaction and how the business is taxed. Sellers should be proactive and engage their CPA and attorney well in advance of any potential transaction, to appropriately understand the various tax and legal implications of each transaction type.

- ❖ Understand the **tax implications** of both an asset sale and a stock sale.

- ❖ Consider whether or not a potential buyer is likely to seek an IRC Section 338(h)(10) election, whereby a stock sale is treated as an asset sale for tax purposes. A buyer may be willing to pay a negotiated premium for such an election.

- ❖ Does your business have any pre-existing liabilities that may influence a potential buyer's deal structure determination? If there are liabilities, a potential buyer may be less likely to complete a stock sale and prefer an asset sale whereby you assume the outstanding liabilities.

- ❖ **Evaluate Ownership Structure:** How is your business organized? You may be able to maximize value and minimize tax impacts by converting to a different corporate structure.

MANAGE ROLES

When you are moving forward with your transaction, it is important to determine how the transaction will be managed. Your team may consist of an attorney, a CPA, a broker, and key employees/executives. Often, your attorney, broker, and CPA will be able to guide you through the transaction, but for efficiency you may consider what role each of the owners, executives, and employees take on. As an example, you may consider having a CFO that is responsible for preparing/gathering financials and being in contact with the CPA, while the CEO or owner is the point of contact for the attorney and broker. Similarly, you need to make sure you have team members continuing the operations of the company during the transaction without interruption or slow-down.

5 | OTHER CONSIDERATIONS

Every transaction is unique. However, in addition to the topics discussed above, we recommend considering a few additional items that we have found apply to the majority of the transactions we have completed.

- ❖ Consider utilizing a **Non-Disclosure Agreement** with potential buyers and keep the number of people that know about information about your business and the existence of a potential deal small. Disclosing a deal too early can negatively affect customer/vendor relationships, provide an advantage to your competitors, and influence negotiations with other potential buyers.

- ❖ **Keep your options open**. As discussed above, it is important to ensure your company continues to operate. Deals fall apart and the company value may fluctuate during the rigors and often extensive time constraints placed on company personnel during due-diligence. Pay close attention to your operations and remain ready to re-negotiate a better deal or find a more fitting buyer.