Business Succession Planning Considerations in the Era of COVID-19

Presented by:

NIAGARA UNIVERSITY FAMILY BUSINESS CENTER

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Welcome!

Today's Speakers

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Are you asking yourself these questions?

- Are the record high EBITDA multiples in 2019 and 2020 still occurring for sales of businesses today?
- Do the experts believe the “best time” to sell a business has passed?
- If my business has been impacted by COVID-19, should I forget about trying to sell my business?

The answer to these questions and more is: it depends!

What's the "right time" to sell your business?

- The "right time" to sell a business during the era of COVID-19 can be dependent on the industry the business operates within and where the leverage currently resides – with the buyer or the seller?
- Many buyers are taking a "wait and see" attitude; others are trying to deploy capital. Understanding where you business fits in is crucial to determining when to sell and how much you may be able to sell your business for.
- Emotionally ready to sell vs. operationally ready to sell:
    - Be pragmatic and willing to perform proper due diligence and address any material issues before putting your business on the market.

To maximize the selling price, be prepared to sell!

Why do you want to sell your business?

- Retirement?
- A concerning health situation?
- Downward financial trends?
- Lack of capital to reinvest in your business?
- Increased competition?
- Technology challenges?
- Supply chain issues?

Ask yourself: What are your plans for after the sale? What will your personal and financial needs be once the business is no longer consuming your time – and paying your bills? The sale price is not the price you deposit in the bank!

Will COVID-19 have a positive or negative impact?

- Does the remote workplace impact your business?
  - Scarcity of trained labor and the procurement of product and service inputs will be important to address and plan for.
- What does your financial forecast look like?
  - Your financials should be in good order – always!
- "Need to sell" and "best time to sell" may be in conflict.
- Potential buyers will likely scrutinize your financial results and try to isolate the impact of the pandemic thereon, which can have a positive or negative impact on maximizing your value, which then lends itself to accelerating or delaying the sale.

"Defend" your business and how you managed your way through the pandemic. Develop a financial road map for the buyer.

What does the future hold?

- The more wary of the future, the more a buyer will emphasize performance-based payments, pay less up front and ask for larger escrow balances.
- Are you interested in partaking in the new entity's upside or downside? This can impact the terms and conditions of the deal including, but not limited to, the purchase price.

Factors that might help the business sell

- Ability to obtain financing
  - Historically low interest rates
  - Federal government pumping trillions of dollars into the lending market
- A new group of potential business buyers/owners being created by the pandemic
  - High unemployment levels creating new entrepreneurs
- Economic recovery projected
  - Government stimulus keeping markets strong and cash reserves high

Don't go it alone! You will need experienced professionals to assist you. If done correctly, they will more than cover their fees.

How do I sell profitably in the COVID-19 era?

U.S. Businesses Today

- Average business owner age = 60 years old.
- Market for businesses valued between $2 million and $5 million remains strong.
- Private equity firms have a significant amount of investor capital that needs to be used for investments.

How do I sell profitably in the COVID-19 era?

- Get clear on your overall goals.
  - Protect loyal employees?
  - Be realistic about price; refrain from value based on revenues and/or asset values.
  - Do you want to retire? Continue to work?
  - Do you have a good management team in place?
    - Buyers will project the needs of the business and attempt to adjust for inadequate staffing levels, experience or otherwise.
  - Businesses struggling since the pandemic might be better off selling rather than investing more money into it.
    - May sacrifice maximum selling price, but have other advantages.

How do I sell profitably in the COVID-19 era, con't.

- Identify and emphasize your competitive advantages.
  - Does your brand outperform your competitors?
  - Do you have market research to substantiate your competitive advantages?
    - Your competitor and industry insights can be clues to sale timing.
  - Weigh discussing potential sale with others vs. maintaining confidentiality.
    - Potential sale options may lie with your competitors.
  - Is your intellectual property well documented and protected?
  - Have you evaluated your workforce to understand employee longevity, technical abilities and retention rates?

How do I sell profitably in the COVID-19 era, con't.

- Clean up your financials and reporting processes.
  - Understand your profitability and prioritize cash flows (working capital).
  - Financial documents should be clear, easy to read and present an accurate picture of where your business has been, is, and will be headed.
  - Normalize personal expenses running through the business; don't hide them.
  - Identify and address business challenges.
    - Call upon experts for assistance; the benefits will outweigh the cost.

A business with poorly kept financial records, outdated equipment or risky employment practices will likely yield a lower sale price than the seller desires.

How do I sell profitably in the COVID-19 era, con't.

- Upgrade your technology.
  - Is your business operating at maximum efficiency?
    - You may realize a lower sale price if the buyer has to implement sound business practices and policies post-sale.
    - Buyers will also reduce the purchase price for investments in people, processes and/or equipment that should have been made previously.

How do I sell profitably in the COVID-19 era, con't.

- Identify and mitigate risk factors.
  - Look closely at your business for red flags that may scare buyers away.
    - Slow-moving inventory
    - Uncollectible A/R
    - Vendor/customer disputes
    - Legal issues – employee or otherwise
    - Office renovation
    - Inefficient employee policies and practice
  - Identify any of these, and more, and quantify them to the extent practical. Don't hide them!

Once trust is lost, it's hard to recover.

How do I sell profitably in the COVID-19 era, con't.

- Develop a post-pandemic sustainability and growth plan.
  - How will you do business in a post-pandemic world?
  - Battle-test your operations.
  - Do you have a reliable, dedicated management team in place?
  - Create a realistic plan a buyer can relate to and see your vision.
- Help the buyer visualize the future.
  - Your passion for sharing your vision outside of wanting to monetize is key.
  - Be reasonably honest with your reasons for wanting to sell, emphasizing those that are of benefit to you.

How do I sell profitably in the COVID-19 era, con't.

- Find potential buyers and get several offers.
  - On average, it takes 6 – 9 months to sell.
  - To try to get the highest price, invoke competition among multiple potential buyers.
  - Be realistic – this will take time, a lot of work and may cause disruption to your business.
  - Don't go it alone! Experienced professionals are available to help.
  - Include relevant employees at the appropriate time.
    - Don't hide the fact that you are looking to sell. You will need their help.

Steps to Selling Your Business

- The more prepared you are, the more quickly the process should go.
- Define your goals and potential exit strategies.
  - Employee/management buy-out
    - Employee Stock Ownership Program (ESOP)
      - Good option if company's internal team is best option for future growth and success.
      - Limited by financial resources of individual management team members.

Steps to Selling Your Business, continued

        - Purchase price lower
        - Common for owner to hold a note
        - The seller emphasizes the legacy of the company
- Financial/Private Equity Buyer
    - Most popular and make up most of middle-market transactions.
        - Typically buy using debt financing for 50% to 75% of the price.
        - These buyers are also looking for sufficient cash flow to service that debt.
        - Sellers often asked to hold a note for the difference in cash down, financing and the purchase price.
        - Private equity buyers do not purchase the business to keep it long term.
        - Purchase price usually between that of the employee/management purchase price and the strategic buyer purchase price, with a multiple in the middle as well.

Steps to Selling Your Business, continued

- Strategic buyers
  - Pursue opportunities that have synergies with other businesses that work within their future plans and aligned industries and/or niches.
    - Sometimes pay a premium to get the customers/clients or expertise
    - Conversely, sellers may not want to engage with strategic buyers who are competitors. NDAs/confidentiality agreements are commonplace.
    - Exchange of shares of both parties more likely.
    - Usually highest purchase price, highest multiple
    - May not focus on retaining employees or the legacy of the seller.

All options have pros and cons. Work with your professional team!

Know the value of your business

- Valuation helps to set expectation of price
- 3 basic valuation approaches:
  - Income based
    - Discounted future benefits method
    - Capitalized economic income method
  - Market based
  - Asset based
- Discounts and capitalization rates
- Discount for lack of marketability
- Discount for lack of control

COVID-19 will have an impact on the valuation discounts and purchase price. The question is…how much?

Enhance value prior to the sale

- Develop or update your strategic plan.
  - Identify growth opportunities and financial status with the goal of improving the company's performance over a 6 to 12-month period.
- Consider reducing customer concentrations or customers with low profit margins that require additional value-add that does not benefit your company.
- Focus on core competencies, streamlining processes and reducing expenses.
- Consider working with a knowledgeable M&A advisor that has relevant transaction experience and understands your business. They can add real value during the sale process.

Gather relevant financial information

- Take time to properly evaluate and present a company’s financial and business history and future projections.
- If necessary, recast financials to prospective buyers have a good view of the company’s earning capabilities.
- Take time to properly present a company’s earnings power.

Due diligence

- Buyers will expect your business records and facts to be properly organized and documented.
- Review your incorporation records, papers, corporate governance documents, permits, licensing agreements, employee agreements, leases, etc.
- With the assistance of your professional advisor/advisory team, prepare a high-quality business summary that:
  - Tells the company’s story
  - Shares financial information
  - Describes its market niche and shares growth opportunities

Target buyers

- Lower and middle-market buyers are usually plentiful; the challenge is finding the right buyer.
  - Again, your business broker and/or M&A advisor is key.
- Your advisory team should review competitors, customers, strategic buyers, private equity firms with relevant expertise and other sources of highly suitable capital and partnership.

This is one of the most time-intensive steps of the process; but it is essential for a successful deal. If you don't find the right buyer, how can you get the best price and terms for your business?

Qualify potential buyers

- Make sure that the buyer is qualified to purchase your business.
  - Most important when considering an internal sale and/or an ESOP
- Ask the appropriate questions to screen buyers to ensure that you do not waste time talking with unqualified buyers.

Negotiate the deal

- Price generally gets the conversation started.
- As negotiations progress, the details of the transaction structure become paramount.
  - Transaction structure refers to what is being purchased – assets (tangible and intangible) or stock.
    - The differentiating factors primarily stem from legal and tax consequences
    - Buyers and sellers are typically at odds when structuring the transaction.
- In addition to purchase price, common negotiation terms include:
  - Stock sale vs. asset sale
  - Earnout terms
  - Seller financing and security
  - Employment contracts
  - Non-compete agreements
  - Current assets retained by seller
  - Equity ownership

Negotiate the deal, continued

- Buyers typically prefer an asset sale; sellers typically prefer a stock sale.
- In the case of an asset sale:
  - Each individual asset must be conveyed to the buyer.
    - Potential obstacle for contracts or licenses with “change of control” restrictions
- There is an election for a qualified stock purchase that recharacterizes a stock purchase as an asset purchase for federal tax purposes only.
  - Buyers like this because the buyer receives a tax basis in the acquired assets equal to the purchase and can depreciate at their purchased value, often times at an accelerated rate.
  - Sellers will frequently demand a higher purchase price in response to the election as additional compensation to offset the additional tax burden they will incur.

Letter of Intent/Transaction Documents

- Buyers typically express interest in a company through a series of documents:
  - LOI (Letter of Intent) includes deal terms and often gives the buyer an exclusivity period to evaluate the company. This can be non-binding but is often the first step in documenting the transaction.
  - Potential obstacle for contracts or licenses with “change of control” restrictions
  - Purchase agreement and ancillary agreements – the definitive documents outlining the terms of the sale along with other transaction documents (i.e. employment/consulting agreements, noncompete agreements, commercial leases, etc.) and must be drafted to define all the details of the transaction – legal, financial, representations, warranties, etc.

Transition the business

- The transition period typically involves a period of cooperation during which time the seller will assist the buyer in transitioning the business, including:
  - Introductions to key clients
  - Transitioning the financing and accounting functions
  - Better understanding the operations
  - Transitioning other proprietary information and trade secrets needed to operate the business optimally.

Questions?

Thank you!

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