Selling Your Company:
Understanding the Discussions

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Now that you are ready to sell your company you may run into terms, options and discussions that need to be translated. The following is an assembly of items you may need to know or understand that will impact the transaction or may be a part of the discussion. These descriptions are meant to be an initial primer to help you understand the discussions, but it is highly recommended that you consult with an attorney that has significant experience with company mergers and sales to help structure the best deal for you.

Cash purchase

In a cash transaction the company is purchased with cash by the buyer. The purchase may be in the form of purchasing your stock or as an asset purchase, both of these items are outlined below. It is advisable that you consult with your accountant to understand the tax implications of a cash purchase compared to a purchase by a buyer providing you the acquiring company's stock.

Sale to another company in exchange for stock

A buyer that is purchasing your company in exchange for their stock will provide the acquiring company's stock in exchange for your company. In this transaction there may be some time limitations as to your ability to liquidate the company stock and there may also be some tax benefits or limitations in this form of sale. Consult with your accountant to understand the tax implications related to a stock transaction.

Stock purchase

A stock purchase is a transaction where the buying company purchases your company stock to purchase the company. This has them purchasing all assets and liabilities and is usually in the best interest of the seller to structure as a stock purchase. Since this form of transaction has your company's liabilities included as a part of the sale the purchase price may be lower reflecting the liabilities on the books at the

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time of purchase. You should also be prepared for some reconciliation at the time of closing. This is because is usually takes a number of months between initial discussions, setting a price for the company and the actual closing date. The buyer wants to be assured that there have not been any material changes in assets or liabilities that negatively impact the value of the company. This discussion may take place during the stock purchase agreement or letter of intent negotiation discussions. During those discussions your attorney should also request from the buyer that if there is a positive impact due to the position of assets and liabilities at the time of closing that the seller should see some positive impact on the purchase price. Most reasonable buyers will accept the reciprocity of this discussion.

Asset purchase

In an asset purchase the buyer is purchasing only the assets of the business and is not taking responsibility for the liabilities on your company's books. Since the buyer assumes no liabilities the purchase price is typically higher than in a stock transaction, but the seller is responsible for settling all company liabilities.

Consolidation

A consolidation is a transaction that has your company consolidating with other companies that will benefit the buyer based on the synergies between the consolidating companies. This type of transaction, also referred to as a roll-up, has a platform company that acquired companies will be integrated into. The platform company typically has the infrastructure to support additional volume that can be leveraged with any additional companies that may be acquired. While you will not be involved with the consolidation, it is important to understand the implications of a consolidation with your company. If your company is identified as the platform company, then you can expect the existing employees and infrastructure to remain intact or be enhanced. If, on the other hand, your company is being integrated into a platform company then you can expect all but the unique value-add of your company to be eliminated. The business model of a consolidation is one where the redundancies are eliminated making a more profitable company through integration.

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Private Equity purchase

A private equity firm may be interested in purchasing your company because of a unique niche you serve, or they see the ability to drastically improve operations in the short term. Private equity firms typically invest in companies for a 3-5 year time horizon, although there are firms that invest for the long term return of a company. This 3-5 year time horizon means, in many cases, drastic changes to the company to make it appealing for their exit. The changes may include more investment by the private equity firm to increase new product development, sales channels or infrastructure. The private equity firm is interested in their exit and the activities needed to maximize their finanical results during exit. While you will be out of the picture, it is important to know that the company will most likely be run differently than when you owned the company and there may be several changes to the employee base. It is only important if you are concerned with the eventual outcome of what was once your company. Remember that you are selling your company and you should focus on maximizing your financial outcome at the time of the sale.

Earn-out

In some cases an earn-out will be proposed by the purchaser as a part of the negotiation on price for your company. In an earn-out scenario you will receive a base amount for your company up front and some amount will be held out based on company performance over some future. An earn-out is a good way to get the price you want for the company, or in some cases they can be structured as upside possibilities based on over achievement of these goals. The downsides for the seller include the delay in receiving the additional funds for the company, and it may be a concern for you if you are no longer involved with the business that a part of your cash settlement for the business is dependent on future operating results of the company. If the earn-out is tied to future results of the company and you are no longer involved with the company, then you do not have any ability to impact the results or your earn-out.

Non-Disclosure Agreement (NDA)

A Non-Disclosure Agreement (NDA) is an agreement that provides you protection that information shared with potential buyers will be kept confidential. In many cases the buyer will request that the NDA be reciprocal since they will be sharing their plans with you as a part of the negotiation. This is a reasonable request. You should have your attorney draft the NDA for the buyer to sign, as opposed to

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using the buyer's NDA – you want to be certain that your confidential information is protected. This is a simple document that your attorney should be able to turnaround quickly.

Letter of Interest

A letter of interest by an individual or company is normally a non-binding document that formally announces their intention to purchase your company and is usually a short one-page document. It will usually have some indication of a price range based on some preliminary information and should have a time-frame indicated for their evaluation that may lead up to a letter of intent.

Letter of Intent (LoI)

A Letter of Intent (LoI) is a binding document that distinctly spells out the purchase price for the company, estimated closing date, due diligence timing, and some of the terms of the purchase agreement. In many cases the buyer will want an exclusivity period to protect them from another buyer coming in during the due diligence and potentially stealing the deal or increasing the purchase price for your company. If an exclusivity, or no-shop, clause is included in the LoI then you should negotiate something in return for essentially taking the company off the market. This could be in the form of some earnest money in escrow that could be applied to the purchase, but forfeited by the buyer if they back out before closing on the company. Your attorney can help you with the best structure of the LoI and in most cases it is wise to discuss the key terms with the buyer prior to an actual LoI draft being created. This will eliminate a lot of the time involved with sending marked up drafts of an LoI between your attorney and the buyer's attorney. These early discussions can result in a bullet list that will become the key points in the LoI and will shorten the overall process.

Due Diligence

Due diligence is a process where the buyer validates his understanding of the key areas of the company that impact the value of what they may be purchasing. It will include looking at any intellectual property, sales channels, contracts, IT infrastructure, manufacturing documentation, software licenses, software revision control, and many other items related to the value of your company. The buyer is only validating what has already been presented as the company they are purchasing, and looking for any items that may be additional risks or costs to them in the near term. In many cases items are found that the buyer

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will try to negotiate as a price concession, and you will need to work with your attorney and accountant to manage through this process to maximize our final position.

Warranties and Representations

Warranties and representations is a list of items that are assurance by the seller and management team that the items presented as a part of the transaction and during due diligence are in fact true and correct. This is the buyer's additional assurance that the company they are buying is the same as that represented by the seller. There is a financial impact associated with items that turn out in the near future as not being correctly represented by the company. It is your attorney's job to help negotiate the best solution for you as it relates to how the items are handled at the time of settlement. In many cases there may be a holdback, described below, that creates a reconciliation account that at the end of some period – usually 1 full accounting period and not longer than 18 months.

Holdback

A holdback is a part of the purchase that is held back by the buyer to be released to the seller at some point in the future after a reconciliation of Warranties and Representations. The time period and amount is negotiable, but in most cases the amount is less than 10% of total purchase price for the company and the length is no longer than 18-24 months. Your attorney can help you negotiate this amount down, and in most cases there are only a few items the buyer is really concerned with. If you and your attorney can quantify these concerns then the amount of the holdback can be carved out based on the items of their concern and reduce the overall amount of the holdback.

Multiples

You will hear the term multiples primarily during the early stages of the negotiation as it relates to the price of your company. The buyer in most cases is basing a pricing decision on some multiple of historical free cash flow of your company as it compares to other companies in your industry or type of business. For example, if your average annual free cash flow is $ 1 million and you are a manufacturing company (typical manufacturing multiple is three to five times free cash flow) then the buyer may be looking at a purchase price of between $3 million and $5 million. The multiple by industry and business type can differ and will change over time. It is wise to get some outside guidance about the value of your

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company prior to putting your company on the market or as an outside reference point if you are evaluating an unsolicited offer for your company.

Selling your company is much different than running your business and it is suggested that you have outside support during the process. A company that specializes in helping owners exit can provide you with areas that you can work on prior to putting your company on the market to help structure your company to provide you with a better financial return once you do sell. These firms will suggest areas to change that could allow you to manage the due diligence process better, improve results in the short term, or position your company differently than it is perceived today through a marketing communication program. It is also very important to work with an attorney familiar with merger and acquisition work before you get to the LoI stage, as well as working with your accountant so you understand all potential opportunities to maximize your final financial result.

Larry Turner is the CEO of Roundhouse Advisors and has more than 25 years of high-technology business experience growing, starting up, repositioning, and revitalizing organizations. He has successfully supported owners in their exit strategy, worked in business development capacities, improved customer service, and streamlined organizations. Mr. Turner has experience in a wide range of vertical markets and industries, while improving operations and sales at companies like Bell & Howell, Canon, and BancTec. He holds a BS in Marketing from DePaul University and an MBA from Northern Illinois University.

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