

Are You and Your Company Ready for a Liquidity Event?



While the economy may be slowing down, there is still significant merger and acquisition activity taking place. For entrepreneurs, this type of an exit is more common than an initial public offering. For most business owners, the sale of their business is a major transaction and a once in a lifetime event. Preparing for and executing a sale involves many business disciplines including accounting, tax, finance, legal, investment banking, human resources, and industry experience. While most entrepreneurs assemble a team of professionals to assist them in preparing for and managing a possible M&A transaction, they also need to be ready to move on to the next stage in their life after the transaction is completed. This could be working for the acquirer, starting a new venture, or retiring.

If an entrepreneur is serious about pursuing an M&A transaction, he or she needs to get organized and prepare for a potential transaction. Some of the main steps to be taken to prepare for a possible transaction are:

• **Accounting:** Prepare two to three years of financial statements that have been audited, or can be audited, with-

out a material adjustment

- **Tax Planning:** Organize your company to:
 - Avoid double taxation
 - Maximize the capital gains tax treatment on the gains from the sale of the company
 - Remain flexible on the sale of assets or a stock sale
- **Finance:** Identify and track the key metrics of the business
 - Utilize key metrics to prepare credible projections
 - Connect the ongoing financial results to the business plan and demonstrate the expected financial performance
 - Remove excessive owner compensation and benefits from expenses
- **Legal:** Organize the business corporate records and contracts
 - Ensure leases or property ownership are in a form that is acceptable to a buyer
 - In the case of a lease assignment, be sure to discuss this in advance with the Lessor
- **HR:** Create a plan to compensate key employees and ensure business continuity after the close
 - Avoid employee contracts that could hamper the ability to finalize a sale
 - Organize all HR documents.

Once the legal and financial houses are in order, the business can be properly valued. While most businesses are valued based on current earnings and adjusted cash flow, some businesses that have unique intellectual property rights may be valued based on future earnings. How is EBITDA (earnings before interest, taxes, depreciation, and amortization) calculated and how does it correlate to business valuation? To calculate EBITDA, start with the net income of the firm and add back the following:

- Interest expense
- Corporate income taxes
- Depreciation
- Amortization
- Any one time or non-recurring expenses
- Excess owner compensation and benefits

A privately held business can expect to be valued at 3–7 times its earnings. Faster growth companies will tend to be valued on the higher end of the scale. Companies with strong intellectual property rights, an ability to defend their competitive advantage, or of strategic interest to a buyer may be valued at higher than 7 times earnings, while companies in declining industries may be valued below 3 times earnings.

Once a seller is organized and comfortable with the projected valuation, it is recommended that he or she identify multiple interested buyers and create, if possible, an auction for the sale of the business. The creation of an auction can be facilitated by hiring an investment banker that has experience in the seller's industry. Their job is to assist in preparing the company for sale, to complete a sale package, and to identify numerous qualified and interested buyers and to manage



the sales process. Keep in mind that the sales process can be a long and grueling process which can fall apart after months of due diligence. Given that the sale is not final until the closing, the seller must continue to manage and grow the business as if a transaction will not take place. Having an investment banker will tend to keep the sales process on track while giving the business owner enough time to keep the business moving forward.

If a buyer is serious about an acquisition, they will send the seller a non-binding Letter of Intent (LOI). This LOI will summarize the proposed key terms of the potential acquisition. It is important that this LOI be reviewed by the seller's legal, financial, and tax advisors before the seller executes it. Once the LOI is executed, many of the deal terms are set and it is much more difficult to make changes. Keep in mind, the purchase price is just one of the many terms to consider when evaluating an LOI.

Some of other key terms to consider:

- How long (if at all) do you want to continue to work for the company after the sale?
- How much of the purchase price is paid at closing in cash?
- How much cash will be maintained in escrow, and for how long?
- How much of the purchase price will be based on future performance in the form of an earn-out?
- If there is an earn-out, what ability will the seller have to affect the future performance of the business post closing?
- How will the proceeds from the sale of the company be taxed?
- How will the proceeds from the sale of the company be disbursed?

The sale of a business is a complex process that requires in depth preparation, patience, and the skills of a variety of professionals. When managed correctly, this process can be the most challenging and rewarding of an entrepreneur's life.

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