Selling a private company — preparing for the sale

Succession planning is important, even if a sale isn't in the immediate horizon. Consider these basics first

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This article is the first in a three-part series on selling a privately-held company. Part one deals with pre-sale planning and preparation. Part two will address the business sale process and part three will cover some of the common mistakes made by business owners and their advisors when selling a private company.

The importance of pre-sale planning and preparation are frequently underemphasized. Business owners often become so engaged in the affairs of their company that they neglect to consider that succession is inevitable. Whether the business owner is contemplating a transition of their company to family members, a sale to management, or selling to a third party buyer, it's critical that appropriate planning and preparation are done to ensure that the owner's personal and financial objectives are met.

Ideally, pre-sale planning and preparation should commence two or more years prior to the time that a sale of the business is contemplated. This is because many of the initiatives take time to implement or to ensure that the benefits are fully realized. Even for those business owners who are not contemplating a sale in the near future, preparing for an eventual sale is prudent, in case an unsolicited offer or a sudden change in circumstances (e.g. health issues) dictate the need for a sale.

Timing of the sale

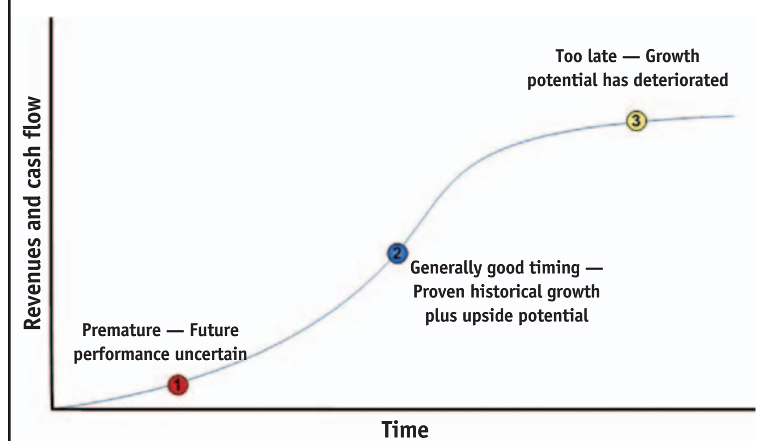
The ideal timing for selling a company can never be determined with absolute certainty. Important factors to consider include the owner's personal and financial situation, the company's recent and prospective operating performance, and general economic and industry conditions.

From a conceptual standpoint, companies normally fetch higher transaction prices and better deal terms when they have a demonstrated history of revenue and cash flow growth, and realistic expectations that growth will continue. This concept is illustrated in the chart below.

Income tax and estate planning

Three parties are implicitly involved in every business transaction — the buyer, the seller and the government. Business owners can realize considerable upside when the income tax burden on a sale of their company is reduced. In this regard, the *Canadian Income Tax Act* offers business owners legitimate ways for reducing or deferring the income tax burden on a sale of their company. For example, the lifetime capital gains exemption enables sellers to eliminate income tax on the first $500,000 of capital gains income pursuant to a sale of shares when certain criteria are met. This exemption can be multiplied when appropriate estate planning has been undertaken at least two years prior to a sale. This illustrates the importance of planning ahead.

Chart 1 — Timing the sale



Other examples of income tax and estate planning include the use of 'safe income strips' and individual pension plans (IPPs). Business owners should seek professional advice to determine which initiatives are appropriate given their specific situation.

Valuation and pricing

The ultimate price that may be paid for a company is significantly influenced by the terms of the deal, as well as the negotiating position of the buyer and seller (these factors are addressed in the next issue of *CMA Management*). However, business owners will be better able to evaluate the offers they receive by having an objective valuation of their company undertaken prior to a sale. This also helps establish realistic expectations and identifies possible buyers. In addition, a proper valuation can help identify the key value drivers within a company that business owners and their advisors should focus on in the years prior to a sale that will increase shareholder value.

Financial restructuring

Prior to exposing their company for sale, the business owners should ensure that their company's financial affairs are in order. For example, any redundant assets owned by the business (assets not required in the ongoing operations of the business) normally should be removed prior to a sale. Buyers typically aren't interested in acquiring redundant assets, so it effectively discounts the price. In most cases, redundant assets can be removed from a company on a tax-deferred basis.

As a practical matter, the price paid for a private company is often influenced by its most recent financial results, such as its trailing EBITDA (earnings before interest, taxes, depreciation and amortization). Therefore, business owners often benefit to the extent that they can increase the EBITDA of their company in the year(s) prior to a sale. However, business owners should carefully consider the potential consequences of undertaking cost reductions in an effort to increase profits. While a reduction in discretionary expenditures in the years prior to a sale can prove beneficial, most buyers aren't fooled by a seller's attempts to bolster short-term profits by sacrificing long-term value-creation initiatives such as advertising expenditures and R&D.

Appropriately managing the balance sheet in the years prior to a sale can also deliver incremental value to the business owner. This is because the convention in mid-market M&A deals is that the buyer inherits the balance sheet of the acquired company at the transaction date. However, the balance sheet that is acquired is subject to some negotiation. Specifically, target amounts for measures such as net working capital on closing must be agreed. Therefore, business owners will benefit to the extent that they manage their company's accounts receivable, inventories and other current assets and current liabilities in the years prior to a sale. Not only does better working capital management lead to improved cash flow, but the target working capital amounts to be delivered to the buyer at closing will also be more readily achievable.

Operational initiatives

A key element in maximizing shareholder value is for the business owner to structure their company as an attractive acquisition target to prospective buyers. This generally means having a sustainable competitive advantage in the market and organizing the affairs of the company to reduce transitional risk. To this latter point, buyers usually are wary of the risk that customers and employees may leave the acquired company following the transaction. The perception of this risk can be mitigated by the business owner by putting mechanisms in place to create barriers to exit for customers (e.g. service contracts, technical know-how, etc.) and employment contracts for key personnel (which may serve to decrease the risk of those employees soliciting the company's customers or divulging company secrets in the event that they do leave). Undertaking these initiatives will often improve the sale price and terms of the deal — both of which are important considerations when selling a private company.

Operational initiatives can also include relatively minor items that serve to create or enhance a buyer's perception of a company. Examples include ensuring that the company's machinery and equipment are in good working order in contemplation of a plant tour, and updating the company's website prior to exposing the business to prospective buyers. A company's website is one of the first things that a prospective buyer will examine when learning that a business is for sale. While a significant investment normally isn't required, the company's website should at least appear professional, up-to-date, and highlight the company's key strengths.

Finally, business owners should give careful consideration prior to entering into any new long-term commitments in the years preceding a sale (e.g. long-term facility leases). Buyers generally prefer acquisition targets that they believe will be relatively easy to integrate with their existing operations. Long-term commitments that are difficult or costly to undo may prove to be an impediment to that objective.

Aligning the right team

Business owners should obtain sound, objective professional advice to assist them in preparing their company for sale. This requires engaging the right individuals or firms to provide legal, income tax and financial advice, as well as experienced transaction intermediaries. The right advisors can significantly enhance shareholder value by improving the price and terms of the deal and by reducing the overall tax burden for the business owner.

Diligent preparation will help to ensure that the personal and financial objectives of the business owner are met. ■

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