Planning Your Exit Strategy

Who Is the Optimal Buyer

Part Three in a Series

A series for owners of privately-held businesses

Introduction: Finding the right buyer

Finding the right buyer for you and your company is a complicated process which will require you not only to evaluate what your "ideal exit" looks like but how exactly that vision will match up with potential buyers and their "ideal entry." To achieve success when exiting you will need to clearly define what "exiting" means to you, understand how a successful search process is conducted, and understand the different types of buyers and how they view you and your company.

It is important to note there are several methods a business owner may turn to when considering exiting their business including selling (divesting) or transferring to family members, selling to their employees (ESOP), selling to private investors, or even an initial public offering (IPO), to name a few. Statistics show that the vast majority (more than 90%) of business owners will sell to an outside third party. As such, for the purposes of this discussion, we will focus on that assumption.

The best choice for you will depend on a series of factors and include, but not be limited to, your personal goals, your financial needs, your age, the state of your specific industry, and the state of the M&A market at the time you decide to divest.

Simply stated, your clearly defined goals and objectives, to a large extent, will determine the optimum exit strategy for you and lead you to the right type of buyer. This article will give you a brief look at the following:

1. *Identifying your desired post-closing objectives*
2. *What types of buyers may be interested in your business*
3. *The search process*

About Private Company Exit Strategies

First Part

- ***The Decision to Sell***, discusses how maximizing of the value at exit begins with a process of understanding the owner's objectives—and how those objectives influence who the optimal Buyer is, and the best exit strategy.

Second Part

- ***Preparing the Business for Sale***, suggests some tactics to consider as well as mistakes to avoid in preparing for the sale of a private business.

Third Part

- ***Who is the Optimal Buyer,*** focuses on seeing the business through the eyes of potential Buyers and Buyer types and on understanding how their various objectives and value drivers fit with the Seller's personal and financial goals.

Fouth Part

- ***The Deal Process***, discusses the process of getting from negotiation to closing and explores techniques to avoid pitfalls along the way.

Fifth Part

- ***Life After the Deal***, discusses how to preserve and transfer the wealth generated by the exit from your business.

Identify your post-closing objectives

Arguably the most important and yet most overlooked aspect of this phase of the process is clearly defining what you want your life to look like after the closing in the short term (let's say 6-12 months) and in the long term (up to, let's say, 5-7 years). This becomes critical for many reasons as it will affect not only the number and types of buyers interested in your company but the value and structure of the deal as well.

All too often in the first phase of a divestiture process when the business owner is asked, "Exactly how long are you willing to work and in what capacity?" the business owner has not given this enough in-depth thought and reflection on the topic. Typically the impact of such decisions is not fully understood and therefore is too often glossed over only to come back later in the process as an obstacle. An experienced investment banker will make sure you explore this question in great detail very early on in the process and will educate you on the impact of your choices or lack thereof.

Different types of buyers (discussed later) will certainly have different demands when it comes to your participation and role with the company post-closing. For example, a strategic-type buyer may pay you a significant amount of cash at closing of the total value and require you to "work" for just a few months until they feel confident your largest customers and top employees are comfortable with the transition before asking you to leave and paying you the balance. A financial-type buyer may pay you much less up front in cash, require you to own a minority interest of the company, and require you to "work" for a longer period perhaps up to 7 more years, until the business is sold again at which time you would then receive your proportionate share of the proceeds. In both cases you are likely now an employee of the company and no longer the boss; for many this can become a serious issue.

Prior to beginning the divestiture process with your investment banking firm it is highly recommended you spend time thinking about the following:

- How much money will I need to live my current life style? Do I want to work again someday or ride off into the sunset?
- When and how will I receive the proceeds? Do I need all the money in cash at closing? Do I want to continue to have skin in the game after closing and if so how much? Am I willing to have an earn out component to the deal?
- How long am I willing to work for someone else after closing? Will I work full time or part time? In what capacity? Will I have any influence? Do I want a second bite at the apple at some point? Do I want to walk away and never look back after closing? How long after closing am I willing to participate?

You may be asking, "What does this have to do with finding your buyer?" The answer is as you will see shortly, different types of buyers will structure deals certain ways based on their overall objectives and as such may require certain commitments from you as a part of the deal. The bottom line is you (and frankly, your family) must take a long look at your objectives moving forward which will ultimately determine the best buyer fit for you.

What types of buyers may be interested in your business?

In order to both accomplish your post-closing goals and maximize your value, you must understand the two primary types of buyers and the advantages and disadvantages of each. For all intents and purposes there are two primary categories of buyers (although there are several subsets of each):

1. **The Strategic Buyer:** One which seeks synergies with the seller's business. This can include competitors or companies looking to enter your industry. This category can include a vertical market… that is, companies up or down the supply chain in the same or similar industry.

2. **The Financial Buyer:** One which seeks short term returns for its investors. This category can include private equity groups, venture capital firms, or investment funds. Your acquisition may be their entry into your industry (platform purchase) or you may be an addition to their existing portfolio (bolt-on purchase) in the industry.

Because of synergies or operational efficiencies, strategic buyers are almost always willing to pay more for your company than a financial buyer.

The Strategic Buyer

A strategic buyer will look to find a good fit with at least one aspect, department, or division of your business. They are most often in the same industry or line of business and are embarking upon this endeavor in hopes of gaining access to a new market or product line, acquiring intellectual property, increasing their overall market share, or looking to a solution for the ever expanding problem of achieving organic growth. It is often less complicated and expensive to acquire this growth than to develop it. They will look at you and your company as a vehicle to acquire one or more of the above elements. In fact, they may be considering a number of targets just like you as a part of their strategy. Other filters considered may include access to your best people, operational efficiencies through consolidation, and access to new technology or distribution channels, to name a few.

Because of these synergies or operational efficiencies, strategic buyers are almost always willing to pay more for your company than a financial buyer, especially when integration is relatively quick and painless. It is important to note that often these operational efficiencies will result in the termination of some of the people who have helped you and your company reach the level of success it currently enjoys.

In general, strategic buyers will be experts in your industry and have a great working knowledge of the operations and well as the financial measures including turnover, liquidity, and profitability ratios as well as typical capital structures. They will typically be in a position to finance the acquisition utilizing primarily cash and perhaps equities as opposed to debt.

Typical Advantages

- Provide higher valuation , higher multiple of EBITDA (earnings before interest, taxes, depreciation, and amortization) or Revenues, than financial buyers
- Provide higher amounts of cash at close while liquidating your equity position
- Potential operating efficiencies can improve profitability of the business
- Expertise of strategic buyer can improve overall performance of the business
- Business will continue to exist for some time to come
- The divestiture process is shorter as strategic buyers not required to deal with financing issues

Typical Disadvantages

- Management may lose jobs or autonomy
- Integrating the culture of the two companies can be problematic
- Clients relationships developed over time may be at risk
- If earn outs are involved, risk they may never be achieved
- If deal falls through, competitive information has exchanged hands

The Financial Buyer

In general, financial buyers are not as focused on operational efficiencies or synergies, however may consider those factors as a part of their analysis of a potential acquisition. Financial buyers by nature are searching for opportunities to provide financial support to undervalued companies with the end goal being a short term exit after turning a desired profit range for their investors. At the outset, they are not primarily focused on entry into a certain industry or market; rather they are targeting opportunities which will generate the greatest return with a secondary focus on the market of industry.

As discussed previously, they will look for a solid, stable platform company to become the foundation of their entry into a particular market or industry. Once the platform is established, financial buyers will look to add bolt-on acquisitions to build the portfolio. It is important to know whether you are being viewed as a platform or bolt-on acquisition as the analysis and valuation from the financial buyer's perspective will likely be very different in terms of what they are evaluating. Having said that, they will target companies with strong cash flows, a strong market position, lower capital expenditure requirements, and all within a growing market.

Financial buyers are highly sophisticated in deal structure and diligence, however are not typically well versed in owning and operating in your industry and will be counting on you to provide that expertise. They will generally finance the acquisition using a significant amount of leverage or debt and consequently are much more focused on measurements such as free cash flow and EBITDA.

It is important to know whether a financial buyer is viewing you as a platform or bolt-on acquisition as the analysis and valuation will likely be very different in terms of what they are evaluating.

Typical Advantages

- You and other shareholders may retain a minority position in the company and have the opportunity for a second bite at the apple
- You will remain actively involved as they will count on your expertise to guide, and perhaps, lead the company
- Not as disruptive to clients and employees as a strategic purchase (fewer jobs/clients lost)
- May provide you an opportunity to share in the future growth and profitability over and above its current value

Typical Disadvantages

- Provide lower valuation (lower multiple of EBITDA or Revenues) than strategic buyers
- Provide lower amounts of cash at close
- Will require your involvement and delay you "riding off into the sunset"
- No longer the chief executive of your company and you have not fully liquidated as of yet
- Heavy oversight and financial reporting requirements
- With highly leveraged purchase, capital available for growth is limited and reduces margin for error

The search process

The process of identifying the potential buyers interested in your company is more complex than one might imagine. There are a number of steps involved and as the process evolves it can become increasingly more difficult to manage the expectations of your client and all interested parties. Keeping the group in sync throughout the process is key. It is definitely part science and part art, and a reputable investment banking firm will help you navigate between the two.

First, your investment banker will 1) collect and analyze an incredible amount of data, 2) conduct a series of interviews, meetings, and tours, and 3) research everything there is to know about you, your objectives, company, operations, competition, market, industry, etc. They will come to know all in the ins and outs of your business in a very short timeframe. This process will provide the basis for which they will begin to search for potential buyers.

Next, they will take all that they have learned above and, utilizing a series of proprietary research tools and databases, will create an initial list of potential buyers for your business. This list will include a variety of types of buyers including strategic and financial buyers, as discussed above, from all over the world. It is not uncommon for buyers to non-U.S. buyers. This list will be scoured vigorously to ensure it is complete. It will then be presented to you for your approval to approach everyone on the list. Adjustments are made based on your input and a final target list is decided upon.

A 1-2 page "teaser" is sent to everyone on the list to gauge initial interest in proceeding to the next level. The teaser is designed to disclose enough information (i.e. size, performance, industry, owner's objectives, etc.) without disclosing any confidential information (i.e. company name, locations, etc.).

Those intrigued by the teaser will contact your investment banker and be required to sign a non-disclosure agreement (NDA) prior to any further discussions. Once the NDA has been executed and your confidentiality is protected, the interested parties are provided a confidential information memorandum (CIM). The CIM is a 30-60 page document which is a result of the research completed above and in essence highlights all the pertinent information regarding your company that a buyer may want to see.

At this point, while the majority of parties will look to move forward, there will be a minority who will no longer be interested in moving forward. Those moving forward will require conversations with your investment banker, and perhaps you, to clarify information, request a significant amount of additional information, require conversations with your other trusted advisors (such as your accounting firm), and request a tour of your facilities. This phase of the process in typically the longest; but have no fear, your investment banker is an experts in this area and will manage the process for you.

Once completed, your investment banker will provide each remaining interested party a deadline to submit an indication of interest (IOI) which is a non-binding indication of the interested party's desire to move forward. The IOI will give a preliminary indication as to their view of value and how they would propose to structure the deal.

From this list, you and your investment banker will narrow the list down to a smaller number of interested parties who appear to be within the range of your expectations. They will be invited to submit a letter of intent (LOI), a legally-binding document which will provide the details of their offer. Again, you and your investment banker may go back and forth with the LOI submitters looking for adjustments in certain areas until you reach the point where there is one clear party you wish to hopefully make a deal with. The attorneys from both sides will now work together (each advocating for their client, of course) to draft and finalize a definitive agreement which will explain the terms and conditions of the sale. Once this is completed and the details regarding how the divestiture will be financed are finalized, you move to the closing.

It is important to note that although this process is the most common, there are certainly other buyer selection processes which may take place. For example, you may have one specific buyer who has approached you and you do not wish to expand your search. In this case, the process may change dramatically. As you can see, the process of identifying a large pool of potential buyers and narrowing it down to one is no easy task.

In summary, the decision to accept a buyer's offer to purchase your company is not always an easy one. Only you can decide what is important to you as you decide how and when to exit. It is the area of overlap between what you want and what potential buyers are willing to offer, based on all the factors and criteria considered, where deals are made and lost.