Diamonds in the rough: Preparing a business for sale

This is the fourth article in our 'Diamonds in the rough' series. In this article we look at preparing a distressed business for sale. Ideally owners should avoid distressed sales but unfortunately this is not always possible.

Below we contemplate the steps business owners should go through to prepare their company for sale with the assumption the sale will not be conducted through a formal insolvency process.

It must be noted however that in some cases an acquirer may want the sale to be finalised through a formal insolvency process. This will be addressed in more detail in our fifth and final Diamonds in the rough article.

So, the decision has been made to sell the business. The drivers of this decision may be varied and include:

- Other stakeholders may be driving the decision – such as banks or creditors;
- The owner needs to step back from the business and no natural successor exists to take control; and/or
- The capital invested needs to be re-deployed or a better return can be gained by investing in other opportunities.

The first step in the process is understanding the need and desire to sell as it often dictates how much time is available to prepare the company for sale. The next step is understanding the true value of the business. Value will be heavily influenced by the efforts in preparing the business for sale. The preparation process is all about determining where the diamonds sit in a business. Discovering the true drivers of value in the business and working out how these can be maximised and separated from the underperforming parts of the business is vital. Ask, do certain parts of the business need to be cut off now in a bid to drive up the value?

Preparation is key

Preparation is everything when it comes to selling a business, distressed or not.

The analogy of buying a house is often used. A 'renovators dream' will scare a lot of buyers away and bring the bargain hunters to the fore. Whereas if a little time and money can be invested to reveal the potential value of a house, then people will likely be more open-minded to the opportunity driving the value up.

Depending on the sale motivations and objectives if you have the benefit of time on your side and have surplus capital investing effort into preparing the business for sale (along with engaging experienced professional advisors) maximises the ability to extract the highest possible price.

Above all else ensure cash flows are prepared for distressed businesses to ensure there is enough time to execute an actual transaction. If you know you only have three months of cash, then orchestrating an expedited sale process will be vital. Selling a company, outside of a formal insolvency process in less than one month is extremely unlikely.

Always consider the position of the buyer. Assess the overall business in terms of:

1. Sale readiness; and
2. Level of information to be made available to buyers during the due diligence processes.

What information would a buyer need to formulate a non-binding indicative offer for the business? You want to ensure you can generate offers which align to the sellers' price expectations and the indicative value the independent advisor ascribes to the business. Buyers will want to know what makes the business unique, what gives it a competitive advantage, its historical financial performance and its prospects for future growth and sustainable profit.

Make sure historical financial statements are reliable, accurate and current, and prepare a robust forecast or turnaround plan to present to potential buyers that clearly demonstrates future growth opportunities. Map out the process to sustainable profits. Buyers will likely pay more for a business if the growth opportunities are realistic, and clearly defined with a strategic plan in place to achieve them.

Ideally the owner will have begun to plan and implement these growth/turnaround opportunities to allow buyers to assess the financial benefits during due diligence and potentially place a higher value on the business.

Also ensure management information systems can extract meaningful management accounts and financial data to present to buyers and separate any related party transactions from that of the business.

Have a plan!

Key considerations include:

- Get an independent valuation:

What value will a buyer likely place on your business? Often, a buyer's valuation of a business can be quite different to that of the owners. Professional advisors provide an independent and objective view on indicative value to assist in decision making and to guide the ultimate deal structure. Should the company be broken up and sold in parts, or sold as a whole, or can certain divisions be sold separately?

- Review operational processes and key stakeholder agreements:

Are there any operational factors that may enhance or diminish perceived value? Having key stakeholder agreements renewed and secured (e.g. customer, licence, distribution, IP agreements) to underpin future performance prior to commencing a sale process may enable you and your advisors to negotiate a higher price for the business.

- Appraise management for post-sale suitability:

Does the company have the right management in place to take on the day-to-day running of the business and drive future growth for a new owner after a sale? If not, can appropriate management be identified before commencing the sale process?

- Evaluate revenue generating activities:

Focus on driving sustainable earnings before interest and tax ('EBIT'). Identify any profit improvement initiatives, implement them swiftly and be able to demonstrate their sustainability to potential buyers.

- Identify drivers of underperformance:

Clearly articulate the causes and identify processes and procedures to fix these drivers. Can unprofitable parts of the business be closed or hived off in to a separate entity to be dealt with post sale if need be? If a turnaround plan is not already in place, then develop such a plan and implement it.

- Seeking an independent vendor due diligence ('VDD') report:

Request a report from transaction experts to cover all areas including commercial, financial, legal and operational. It could assist with early identification, and elimination, of potential issues that often arise during a sale process. This type of VDD report is usually made available to buyers during the sale process. However, companies could benefit from engaging advisors to prepare this report ahead of beginning its preparation for sale. This allows time to action potential risks and issues.

- Review the corporate structure:

Is the corporate structure of the business simple or convoluted? Buyers are often wary of convoluted corporate structures and like to focus on the core trading entities. Therefore, consideration needs to be given as to whether the core trading entities can be easily carved out of the overall structure.

Structure

Tax consequences can vary depending on a transaction's structure so it's essential to seek expert tax advice with respect to the business and the owner's tax position. The difference between an asset sale or share sale is important when thinking about the tax implications.

Also consider if earn out provisions are an option. Many acquirers may look to the owner to assist in delivering on the future strategic plan and will pay more if they can assist in its delivery. Often earn out provisions will mean staying involved in the business for one to two years more but can deliver greater returns.

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