

Oaklins
MEMBER FIRM

HERITAGE CAPITAL GROUP

Selling your business

ANSWERS TO KEY QUESTIONS



Introduction

Sooner or later, many entrepreneurs are faced with the question of succession. They must decide whether they want to sell their business and, if so, how to go about it. The sale process can be a huge challenge, both for the organization and for the owner. Therefore, it is important to plan this step in a timely manner. This booklet provides essential information on how best to prepare for the sale process, and offers answers to crucial questions which arise during the different stages of the process. Furthermore, it illustrates the obstacles which could impede the process, the aspects that the seller must focus on in particular, and how the process is dependent on his personal commitment.

What is involved in the sale process?

Should price expectations be set?

How much time will the owner and the management team need to invest in the sale process?

Does the buyer care why the business is for sale?

Does the seller have to stay in the company after the transaction?

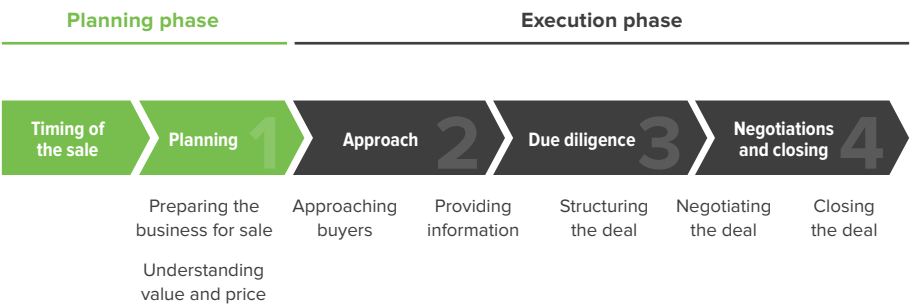
How can confidentiality be maintained?

Who should be retained to advise on the sale of the business?

What are some common mistakes owners make when selling their business?

WHAT IS INVOLVED IN THE SALE PROCESS?

Every sale process is company-specific and therefore unique. Consequently, there is no standard formula for selling a business. However, the sale process can be easily divided into a planning phase and an execution phase.



The **planning phase** is very time-consuming and is designed to prepare the company optimally for the upcoming sale process. Thorough and detailed planning increases the likelihood of receiving positive feedback from potential buyers.

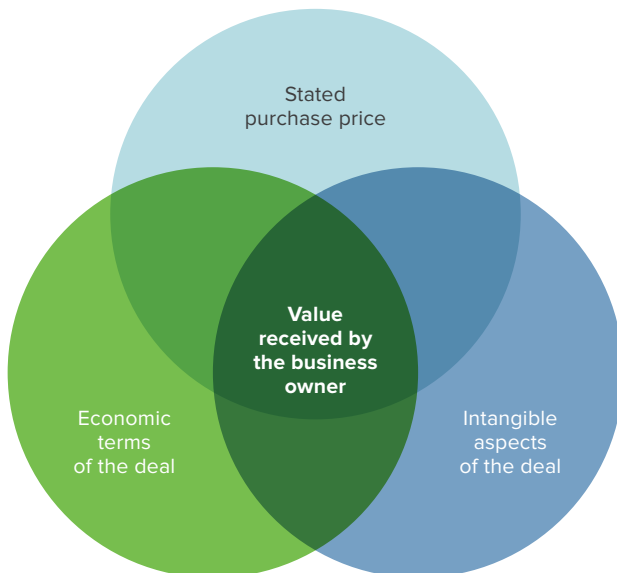
The **execution phase** usually consists of an approach phase, due diligence, and a negotiation and closing phase. This booklet will discuss the different challenges and topics at each stage of the sale process.

SHOULD PRICE EXPECTATIONS BE SET?

It is only natural to have expectations or hopes regarding the price that will be paid for the business, but many owners believe their business is worth more than it really is. Common reasons for this misperception include:

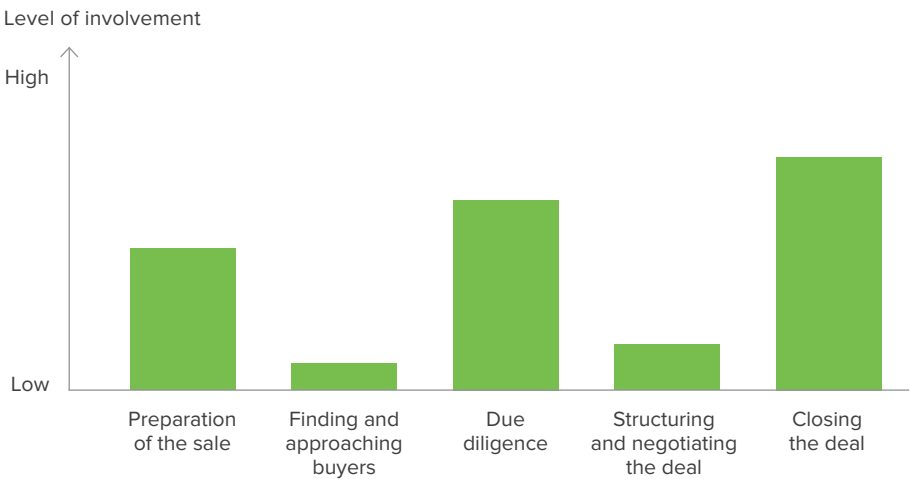
- Failing to objectively assess the strengths and weaknesses of the business
- Not recognizing that the business is dependent on their personal involvement
- Hearsay within the industry about prices and valuation multiples paid for similar businesses
- Basing their price expectations on trading multiples of large public companies
- Basing their price expectations on investments made in the past

It is important to recognize that the price paid is only one piece of a successful sale process. The terms of the deal (e.g. how, when and under what conditions the purchase price is paid), as well as intangible aspects, such as a non-competition agreement, are equally important to maximize the transaction value.



HOW MUCH TIME WILL THE OWNER AND THE MANAGEMENT TEAM NEED TO INVEST IN THE SALE PROCESS?

The time and effort needed to achieve a successful sale are often underestimated. While external advisors will do a lot of the “heavy lifting”, the input and involvement of the owner and the management team are vital to ensure the business is ready for sale and to review offers and agreements. The time requirements for each specific phase of the sale process can be depicted as follows:



DOES THE BUYER CARE WHY THE BUSINESS IS FOR SALE?

Absolutely. The reasons for selling the business are of great interest to the buyer. In fact, the buyer usually wants to know why they should invest in a business that the owner wants to sell. For example, a sale due to succession is an accepted reason. While it is important to be honest, the owner should recognize that their answers will influence their negotiating position and possibly the price or the terms of the deal. A sale due to retirement or for health reasons could concern the buyer as it raises questions about the owner’s willingness or ability to help transition the business. Similarly, a sale due to loss of interest in the business could lead the buyer to wonder what the owner intends to do after the sale, and a sale due to financial distress could be a sign that the business has been mismanaged. Therefore it is very important to elaborate on the reasons for a sale and to communicate them clearly to the buyer.

Introduction

The following table details common reasons for selling a business from the seller's perspective:

Strategic	<ul style="list-style-type: none">– Succession arrangement– Too small in a consolidating market– Too small to compete with the investment pressure– Concentration on key competencies– Outsourcing of functions
Financial	<ul style="list-style-type: none">– Attractive purchase price– Critical needs– Restructuring

DOES THE SELLER HAVE TO STAY IN THE COMPANY AFTER THE TRANSACTION?

Most buyers want the former owner to remain available for a certain period following the transaction to help facilitate the transition, anywhere from three months to five years. Their role could range from that of a part-time consultant to a full-time employee. The length and type of availability depends greatly on the business, the former business owner's function, as well as the buyer's preferences. Simply put, it is important to establish a strong management team which is independent of the owner well before the sale.

HOW CAN CONFIDENTIALITY BE MAINTAINED?

Confidentiality can usually be ensured until the closing of the transaction. However, the more people involved in the transaction process, the harder it is to ensure confidentiality. There are a few things that can be done to reduce the chances of a breach of confidentiality, including:

- Having a code name for the sale process
- Having buyers sign a non-disclosure agreement
- Clearly establishing communication protocols between the involved parties
- Preventing numerous unusual requests for information from staff
- Running the business as if you were not going to sell it

WHO SHOULD BE RETAINED TO ADVISE ON THE SALE OF THE BUSINESS?

The following three key advisors should be retained to advise on the sale:

- The **M&A advisor** or investment banker manages the sale process by helping to prepare the business for sale, providing an objective assessment of its value, finding and contacting buyers, preparing information for buyers, facilitating the due diligence process and negotiating the terms of the deal.
- The **lawyer** takes care of the legal issues during the sale process. They are mainly involved once a letter of intent has been received. Their main responsibility is to negotiate the purchase and sale agreement with the buyer, as well as related agreements, such as the management contract and the non-competition agreement. The lawyer also handles the closing of the transaction and related documentation.
- The **tax advisor** should be involved in helping to prepare the business for sale, structuring the deal and dealing with issues in connection with the closing of the transaction.

Introduction

Other advisors, such as accountants, industry experts or business consultants, can be helpful in special situations during the sale process. Their role, responsibility and incentives should be clearly defined in an engagement letter.

In most situations, the management team and key employees must also be involved. In such cases, it is important to carefully assess who needs to be involved and how this person should act towards staff who are not involved in the sale process. Moreover, these people need to be given the right incentives as possibly not everyone will view the sale in a positive light.

WHAT ARE SOME COMMON MISTAKES OWNERS MAKE WHEN SELLING THEIR BUSINESS?

- Inadequate personal reflection on the sale of the business
- Inadequate planning for the sale
- Underestimating the time and effort involved in the sale process
- Unrealistic price expectations
- Focusing on getting the highest price for their business and underestimating the importance of the terms of the deal
- Allowing or tolerating conflicts of interests of external advisors and staff involved in the sale process



Timing of the sale

When is the right time to sell the business?

When is the owner ready to sell?

What are some common mistakes owners make when timing the sale of their business?

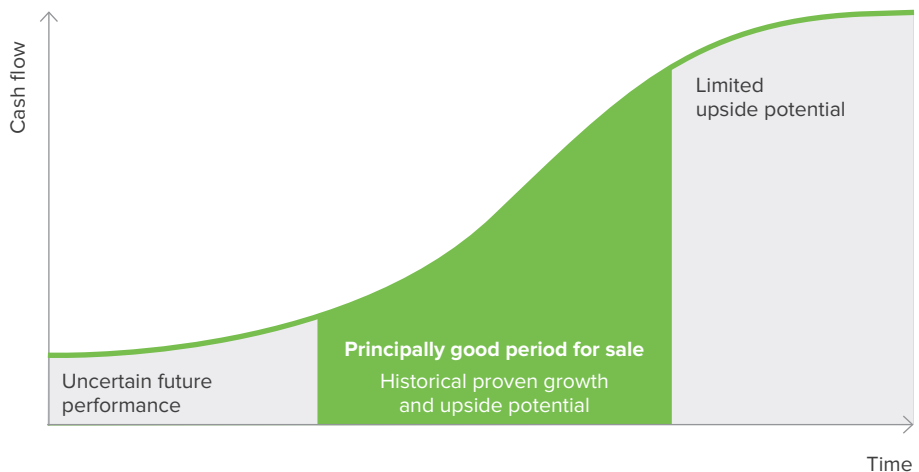
WHEN IS THE RIGHT TIME TO SELL THE BUSINESS?

It is better to look for a good period to sell rather than one specific point in time. This usually arises when the following three things are in alignment:

- The business is an attractive acquisition target
- The business is ready for sale
- The owner is ready to sell and committed to the sale process

Remember that many buyers, particularly large and well-financed companies, are inundated with solicitations from would-be sellers. The executives at these companies must determine which opportunities best meet their acquisition criteria and provide the greatest upside potential. Therefore, the business has to be positioned as an attractive acquisition opportunity from the start so that it grabs the buyer's attention. There is only one chance to make a good first impression. A profitable company is principally easier to sell than a potential turnaround case. It is easier to sell a growth story than to explain to buyers why things will turn around after a bad year. Proof is worth more than promises. Furthermore, an increasing number of unsolicited offers can also be a good sign that the market is favorable and it is the right time to sell the business. This should also be considered when making the final decision.

The following diagram illustrates the different development phases of a company. A good time to sell the business is the growth period.



WHEN IS THE OWNER READY TO SELL?

The sale of a business is both a personal and an economic decision. This means the owner's commitment is as important as the right economic conditions. It is crucial that the owner is dedicated to the sale of their business to get the most out of it. Every owner has their own preconditions for a sale which cannot be generalized. The following points should help when thinking about the willingness to sell one's business:

- What exactly is the owner's personal situation/environment, i.e. family, health, interest in the business, etc.?
- What is the owner's plan for the future? Their thoughts on this point should include not only their own availability after the transaction, but also a potential prohibition of competition.
- What is the owner's financial situation? Revenue often declines during the transaction phase compared to the normal course of business.

WHAT ARE SOME COMMON MISTAKES OWNERS MAKE WHEN TIMING THE SALE OF THEIR BUSINESS?

- Underestimating their own commitment
- Tardy initiation of the sale process
- Delaying the sale in an attempt to grow the business for another year
- Not staying in control of the process when receiving an unsolicited offer

Our clients have put extraordinary effort into making their businesses successful. When they are ready to sell, we maximize their opportunities by uncovering the most exciting potential buyers, leveraging our on-the-ground presence in 40 countries.

Timing of
the sale

Planning

1

Approach

2

Due diligence

3

Negotiations
and closing

Preparing the business for sale

When should preparation for the sale of the business begin?

How can the business be made attractive to buyers?

What has to be done from an operations standpoint?

What can be done to make financial statements look good?

When should the employees be told about the sale of the business?

What should be done to alleviate the concerns of the key employees?

What should be done in the event of a possible management buy-out (MBO)?

What are some common mistakes owners make when preparing their business for sale?

WHEN SHOULD PREPARATION FOR THE SALE OF THE BUSINESS BEGIN?

Ideally, preparations for selling the business should get underway at least two to three years before going to market. This is because many of the initiatives involved will take time to implement. Even if the owner is not planning to sell their business in the near future, adequate planning and preparation are essential in case they receive an unsolicited offer or face a sudden change in circumstances (such as health problems).



HOW CAN THE BUSINESS BE MADE ATTRACTIVE TO BUYERS?

Unique sale arguments should be developed during preparation. These usually have more to do with the competitive advantage and intangible value the business offers than its physical assets. The assets on the balance sheet are of secondary importance, particularly for service companies. Buyers are typically interested in the unique attributes of the seller's product and service offerings, customer base and the strength of its management team. The seller should therefore focus on the following points to make the business more attractive when putting it on the market:

- Promote the business name and its brands. In many cases, awareness of your business can be raised by advertising in trade magazines, newspapers and other public information channels.
- Foster customer loyalty and diversification. Demonstrating a loyal and diversified customer base increases the chance of a high value sale.
- Ensure a strong and committed management team is in place. Ideally, the owner should endeavor to become redundant so that the business can run well without him. It is also important to demonstrate that the business is not dependent on a handful of key employees, and that a strong successor has been identified for each key management position.

Buyers will assess the “transition risk” associated with the business, i.e. the risk that the company will lose major customers, key employees or other elements of value shortly after the transaction. It is important to demonstrate that things like customer retention plans and management succession plans actually exist. Ideally, buyers should be able to see that the business has a sustainable competitive advantage which can be readily transitioned following the sale transaction. Finally, it is important to investigate why the buyers wish to purchase the company so that buyer-specific arguments can be prepared.

WHAT HAS TO BE DONE FROM AN OPERATIONS STANDPOINT?

The owner should ideally strive to hand over an efficient, well-run operation that enables a buyer to readily integrate the business into their existing operations. Some initiatives that may be worth undertaking are the following:

- Providing transparent annual financial statements and financial information, e.g. on the basis of reporting systems.
- Clear separation of the business into parts which are for sale and those which are not.
- Reviewing the product and service offerings. If there are certain product lines that are unprofitable, it may be best to eliminate them.
- Ensuring that the facilities are clean and presentable. This may include minor repairs, painting, etc.
- Installing state-of-the-art IT systems based on industry-specific standard solutions (avoid in-house developments).
- Revising inventories. Removing those which are slow-moving or obsolete. Inventories should be properly organized so that they appear well managed.
- Ensuring that ongoing research and development initiatives are well documented, including costs and benefits associated with planned developments.
- Disclosure and solutions for possible “skeletons in the closet”, e.g. current or imminent court proceedings, outstanding taxes, etc.
- Ensuring that the website provides an attractive (but realistic) image of the business. The website is one of the first things a potential buyer will look at and it will influence their initial perceived value of the business and overall level of interest.

Finally, it is important to ensure that the administrative matters of the business are in order prior to soliciting buyers. This includes up-to-date books and corporate records, lease contracts, policy manuals, customer and supplier agreements, employment contracts, government filings, insurance coverage, banking agreements and similar types of documentation. If all the administrative documents are complete and available, this reduces delays and testifies that a business is well organized and well structured.

WHAT CAN BE DONE TO MAKE FINANCIAL STATEMENTS LOOK GOOD?

Buyers like to see revenue and profit growth in the years leading up to the sale. Revenue growth might be accomplished by accelerating the sale of products and services to customers and by putting short-term sales initiatives into place. However, accounting standards governing revenue recognition must be considered.

If expenses in the years leading up to the sale are carefully controlled, this can impact positively on profitability. However, it is important to be aware that most buyers will be on the lookout for reductions in operating expenditures that are required to support the long-term viability and growth of the business. For example, in the years leading up to the sale, business owners sometimes reduce costs that may not offer an immediate payback, such as advertising, R&D and equipment maintenance. When a buyer discovers that expenses such as these have been artificially reduced, they usually reduce the purchase price accordingly. This impairs their own negotiation position, especially in cases where a high correlation with the long-term operational performance can be shown.

However, owners of privately-held companies sometimes incur costs that are not essential to the operation of their business, and these can be reduced or eliminated with little or no unfavorable impact on the business' long-term operating results. This might include personal cars, trips or other discretionary expenses that are charged through the business.

In the years prior to the sale, owners might want to consider capitalizing certain expenditures rather than expensing them. Most privately-held companies are operated with the aim of minimizing tax. This explains why purchases of capital assets with relatively low monetary values are often expensed.

However, by capitalizing and depreciating some of these items (where justified), it may be possible to increase the purchase price of the company, particularly where a buyer relies on a “multiple of EBITDA” as one of its primary valuation methodologies.

Buyers also like to see a clean balance sheet. This starts with removing any redundant assets. Redundant assets are those not required in the ongoing operations of the business, such as marketable securities and vacant land. Potential buyers are not usually willing to acquire non-operational activities and assets or to pay a reasonable price for them.

Careful attention should be paid to working capital management. The lower the business’ working capital requirements are, the more cash will be generated to provide the buyer with a return on their investment, which in turn can lead to a higher purchase price. Furthermore, the owner will probably have to negotiate a target working capital amount at the closing date of the transaction. The purchase price will be adjusted upward or downward for working capital that exceeds or falls short of the target. To improve their ability to negotiate a lower working capital target (and enjoy more upside potential), the owner will need to demonstrate that their business has operated with modest working capital levels in the years leading up to the sale. As a result, the owner needs to actively manage the working capital several years before they sell as the results take time to materialize.

Finally, the owner should be conscious of under-accrued liabilities in their business, such as employee vacation pay, pension obligations, post-retirement benefits and product warranties. Buyers will closely scrutinize liabilities that will be assumed at the closing date. Any such previously unidentified liabilities can have a negative impact on the purchase price.

WHEN SHOULD THE EMPLOYEES BE TOLD ABOUT THE SALE OF THE BUSINESS?

The answer to this question depends greatly on the culture of the business. In most cases it is necessary to tell a select group of employees, such as the Chief Financial Officer, about the possibility of a sale before going to market. This is because such individuals will need to be involved in gathering information for prospective buyers.

Once a potential buyer has expressed interest, it is usually necessary to tell other key employees within the business (i.e. people in the management team) about the process. As previously stated, a strong management team is crucial to the sale process and in reaching the highest possible purchase price. It is particularly helpful when key employees attend management presentations with potential buyers to show that the business has a strong management team. If key employees are not advised of the pending sale of the business until a potential buyer begins their due diligence investigation, the owner runs the risk of jeopardizing their negotiating position if their employees react with concern or leave the business prior to the transaction.

WHAT SHOULD BE DONE TO ALLEVIATE THE CONCERNS OF THE KEY EMPLOYEES?

It is only natural for employees to feel nervous when they find out that the business is for sale as they may be concerned about the possible changes under a new buyer, or worse, losing their job. Therefore, it is important to keep key employees informed of what is happening and to address any concerns they may have.

Some owners implement an employee share ownership plan (ESOP) to help align employee interests with their own. While ESOPs can be a powerful mechanism, they should be used with caution. It is much easier to implement an ESOP than to make changes once it is in place.

A special bonus for a successful sale is an easier way to align employee interests with the owner's interests. This also serves to reward them for all the additional work that is involved in the sale process.

WHAT SHOULD BE DONE IN THE EVENT OF A POSSIBLE MANAGEMENT BUY-OUT (MBO)?

A difficult situation can occur if management itself shows interest in buying the business. This has the following two drawbacks for the seller:

- Management undermines the selling effort and process to favor its own takeover plans
- The attainable purchase price and the economic conditions in an MBO are usually less attractive from a seller's perspective compared to a transaction with a third party

Corresponding expectations from management must be avoided to prevent such situations. However, if there is evidence of a possible MBO, this should be discussed during the preparation phase of the sale. An M&A advisor can analyze whether and under what conditions an MBO may be financially viable for management and the company. This advice will help to avoid false expectations on both sides.

Despite potential difficulties, an MBO remains a possible succession option. If there are no buyers or the sale process is a failure, it may even be the best remaining option.

WHAT ARE SOME COMMON MISTAKES OWNERS MAKE WHEN PREPARING THEIR BUSINESS FOR SALE?

- Underestimating the effort needed for the preparation of the sale
- Over-investing in capital assets in the years prior to a sale rather than paying down debt
- Underestimating the importance of a clean and lean balance sheet
- Not splitting operating and non-operating assets in the accounts
- Posting private spending on business accounts
- Poor communication and missing incentives for key employees
- Lack of tax and estate planning
- Not recognizing potential MBO aspirations

Understanding value and price

How will a potential buyer determine the value of the business?

How does the multiple methodology work?

How does the discounted cash flow (DCF) methodology work?

What is the correlation between the value and price of a business?

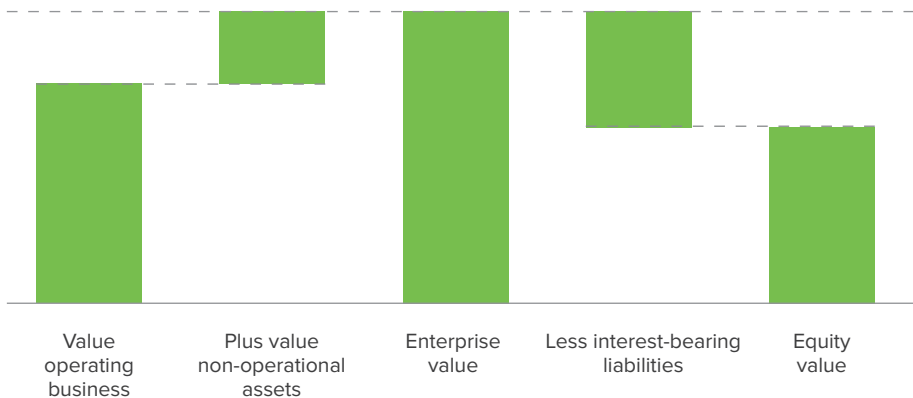
What are some common mistakes owners make when valuing their business?

HOW WILL A POTENTIAL BUYER DETERMINE THE VALUE OF THE BUSINESS?

Potential buyers commonly adopt one or more valuation methodologies, such as the EBITDA multiple (earnings before interest, taxes, depreciation and amortization), EBIT multiple (earnings before interest and taxes) and discounted cash flow. Whichever forward-looking methodology a buyer uses, they all focus on two basic variables that determine the value of the business:

- The cash flow that the business is expected to generate in the future
- The risk and growth prospects associated with the business

An important distinction must be made between the value of the business (referred to as its “enterprise value”) and the value of the equity in the business. The equity value is the result of the enterprise value less the financial liabilities. The value of the business is independent of the underlying form of financing.

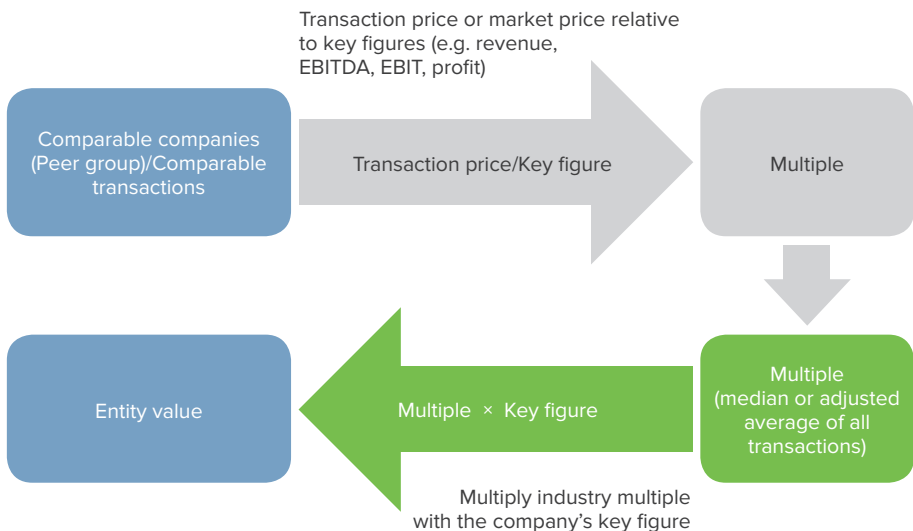


HOW DOES THE MULTIPLE METHODOLOGY WORK?

Multiples are typically applied to the classic profit measures, such as EBITDA or EBIT. The historical figures have to be normalized first before they are multiplied with a multiple of a comparable company. The resulting value is the enterprise value.

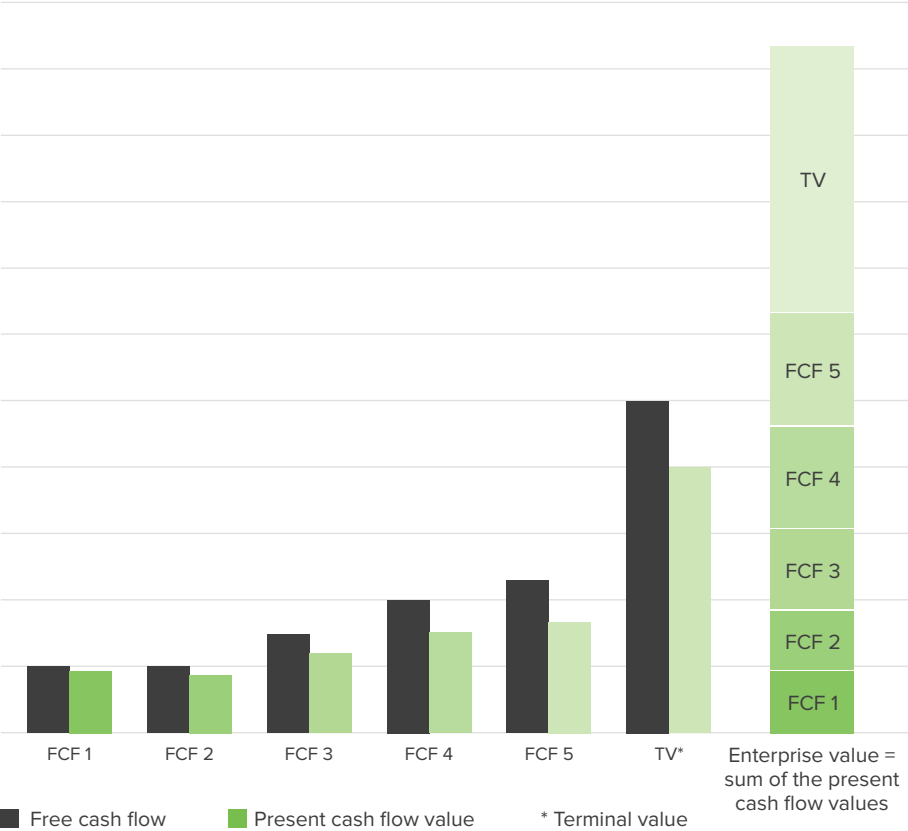
The normalization reflects the adjustment of the historical figures to sustainable cash flows that a potential buyer believes the business will generate each year in the future. Examples of such adjustments are corrections of extraordinary or singular income or spending. The normalization should be prepared by the seller and their advisors since the buyer might not recognize certain adjustments or only implement adjustments in their favor.

There are numerous factors that can influence the valuation multiple in any fact-specific situation. Valuation multiples reflect the buyer's expectations as to the future cash flow of the business given its risk profile and growth prospects. Valuation multiples can vary widely, even among companies within the same industry. As a general rule, larger, more established companies tend to fetch higher valuation multiples than smaller companies.



HOW DOES THE DISCOUNTED CASH FLOW (DCF) METHODOLOGY WORK?

The DCF methodology involves the buyer discounting the forecasted cash flow of the business by a company-specific risk-adjusted discount rate to receive the present value of the expected future cash flows. In most cases, the cash flows are projected for a five-year period. The business value after the forecast period is approximated by the terminal value. The terminal value usually has the largest share of the business value, which is why the assumptions for its calculation have to be made carefully.



WHAT IS THE CORRELATION BETWEEN THE VALUE AND PRICE OF A BUSINESS?

The potential buyer will base the price they are willing to pay on their valuation calculations. By doing so, they can value the business on a standalone basis so that it will continue as before. However, they are also very likely to make a valuation which takes into consideration the value of the business under their leadership and with some synergies. The potential buyer will, therefore, only be willing to pay this generally higher price if there is a competitive situation, which tends to cause offers to increase.

A competitive situation is therefore crucial in obtaining the highest possible purchase price. This is one of the key functions of an M&A advisor.

WHAT ARE SOME COMMON MISTAKES OWNERS MAKE WHEN VALUING THEIR BUSINESS?

- Over-estimating the valuation multiple applied to the business
- Developing overly aggressive or optimistic growth forecasts
- Incorrect derivation of equity values
- False expectations about the value of balance sheet positions from a buyer's perspective
- Over-emphasizing the replacement cost of physical assets rather than focusing on the cash flow generated by those assets
- Omitting the normalization of profit figures or inaccurate procedure
- Insufficient knowledge about the interaction between value and price



Searching for and approaching potential buyers

Where and how can potential buyers be found?

What should be done before approaching potential buyers?

How should potential buyers be approached?

What are some common mistakes business owners make when searching for and approaching potential buyers?

WHERE AND HOW CAN POTENTIAL BUYERS BE FOUND?

There are many sources for finding potential buyers. Internet and database searches or industry and competitor analyses are only two examples of common search practices. The M&A advisor has the resources and tools to identify and approach potential buyers. A strong national and international network is vital in this regard.

WHAT SHOULD BE DONE BEFORE APPROACHING POTENTIAL BUYERS?

Based on the research done, an assessment needs to be made to decide whether a company qualifies as a potential buyer or not. It is important to check whether the owner's strategy fits within the potential buyer's strategy and whether the buyer has the financial means for a possible transaction.

HOW SHOULD POTENTIAL BUYERS BE APPROACHED?

The approach process must be discussed and determined from the start. A discreet competitive process is usually preferred to avoid early disclosure of the target's identity and create a competitive bidding situation.

The approach and the evaluation of interest are usually done by the M&A advisor on an anonymous basis. This ensures that there is no untimely contact between the potential buyer and the seller or the selling company, which could have a negative impact on the bidding process or the business' performance.

Searching for and approaching buyers

	Bidding process	Competitive process	Bilateral process
Description	Broad contact with possible buyers from the seller's industry, related industries, and financial investors	Contact with carefully selected buyers	Exclusive negotiations with one bidder
Competition level	Very high	High	Low
Confidentiality	Low	Moderate	High
Flexibility of the process	Low	High	Very high
Remarks	High visibility on the market	Limited visibility, yet still competitive	High termination risk and a lack of competition between bidders

WHAT ARE SOME COMMON MISTAKES BUSINESS OWNERS MAKE WHEN SEARCHING FOR AND APPROACHING POTENTIAL BUYERS?

- Insufficient analysis of potential buyers
- Approaching direct competitors too early and not anonymously
- Inflated concerns regarding confidentiality
- Creating a teaser that is too vague to generate initial buyer interest



Providing information to potential buyers

What information should be provided to potential buyers?

What are some common mistakes owners make when providing information to potential buyers?

WHAT INFORMATION SHOULD BE PROVIDED TO POTENTIAL BUYERS?

Depending on the stage of the M&A process, certain information must be provided to interested buyers to allow them to comprehensively assess the business for sale. General information about the business and the financials of the company are provided to potential buyers in a teaser on an anonymous basis. After signing a non-disclosure agreement, the interested buyer will receive an information memorandum containing very comprehensive information about the business, markets, products, employee and customer structure, and financial figures. Further information about customer and employee contracts or other important contracts will only be revealed in a virtual data room during the due diligence.

It is important that the seller is always in control of the flow of information during the due diligence process so they can stop it once a potential buyer loses interest. Besides controlling the flow of information, it is also crucial that all relevant information – positive or negative – is revealed in the due diligence data room. Negligence in this area can reduce the achievable price or lead to expensive litigation after the transaction.

WHAT ARE SOME COMMON MISTAKES OWNERS MAKE WHEN PROVIDING INFORMATION TO POTENTIAL BUYERS?

- Not controlling the flow of information
- Untimely disclosure of relevant information
- Not including management in the provision of information
- Providing contradictory or incomplete information



Structuring the deal

What is meant by deal structuring?

Should the owner sell assets or shares?

What terms of payment should be expected?

What is an earnout?

What are some common mistakes business owners make when structuring the deal?

WHAT IS MEANT BY DEAL STRUCTURING?

The legal transaction structure will be determined when structuring the deal, i.e. whether the company will be sold as an entity (share deal) or in the form of separate assets (asset deal). In addition, the payment method and certain intangible aspects of value that are important to the seller, such as the length of time the seller has to remain actively involved in the business following the sale, must be clarified as well. Furthermore, the manner in which a deal is structured dictates when the sale proceeds are received and the income tax implications for the seller. The three basic elements of deal structuring are:

- Whether the assets or shares of the business are being sold
- The terms of payment
- Other contractual terms

Apart from securing a reasonable price, a good deal structure is a key element of a successful sale of a business.

SHOULD THE OWNER SELL ASSETS OR SHARES?

The asset deal and the share deal mainly differ from each other in terms of the legal contract design, taxation of the amount realized, and the risks and chances of the takeover in question. Sellers basically prefer a share deal, whereas buyers usually prefer an asset deal. From a tax perspective, the share deal has the advantage of obtaining tax-free private capital gains. The sale of assets, however, leads to the taxation of hidden reserves from a seller's perspective. In the event of a share deal, all the risks pass to the buyer (known as "universal succession"). The type of transaction which suits best depends on the specific characteristics of the company and the preferences of the parties involved. We recommend you take advice from legal and tax experts when making this decision.

WHAT TERMS OF PAYMENT SHOULD BE EXPECTED?

The payment terms dictate when, how and whether the purchase price will (or will not) be paid. Every business owner would like to get paid 100% cash at closing. However, this is rarely the case when selling a privately-held company. A breakdown of the payments into phases combined with certain conditions, an earnout, or other related payment methods are more common. Regardless of what is agreed, the seller must be aware that it is always risky to agree on payment after the transaction has been concluded.

WHAT IS AN EARNOUT?

An earnout is an arrangement whereby payment of some (or all) of the purchase price is conditional on the future operating results of the business or some other agreed performance measure. Earnouts are often used to bridge the price expectation gap between the buyer and seller, particularly where there is a fairly high level of uncertainty attached to the future operating results, or where the seller is having or had a major influence on the performance of the sold company during the transition phase. If the seller agrees to an earnout, they need to carefully consider whether the potential upside of the earnout adequately compensates for the risks and uncertainties involved. When negotiating an earnout, the following points should be considered:

- The earnout time period. Earnouts commonly take from one to five years. The longer the earnout period, the greater the risk that the earnout will not be fully reached.
- The basis for measuring the earnout payment. Sellers generally prefer the earnout to be calculated based on revenue measures, whereas buyers prefer profitability measures, such as EBIT or EBITDA.
- The level of control the owner will have over the earnout performance measures. In this regard, an earnout is easier to accept where the performance measure depends on the owner's active involvement rather than some action by the buyer (e.g. accounting).
- Whether or not the earnout is cumulative. If the seller falls short of the performance criteria in one year, will they be able to make up for that shortfall by over-achieving performance targets in subsequent years?

Structuring the deal

- Whether there is a minimum and/or maximum earnout level. In this regard, most earnouts are structured on a “cliff” basis, which means that if the performance is beneath a defined minimum threshold, the earnout reverts to zero.
- The tax consequences of the earnout. Depending on the payment method, there can be different tax liabilities.

WHAT ARE SOME COMMON MISTAKES BUSINESS OWNERS MAKE WHEN STRUCTURING THE DEAL?

- Focusing too much on the price and not understanding that the terms of the deal are equally important
- Not appreciating the inherent risk in receiving payment over time
- Neglecting to consider the tax consequences of different deal structures
- The tax adverse structure of the earnout, which leads to income tax





Negotiating the terms of the sale

Who should be involved in the negotiations?

When should a buyer be granted exclusivity?

What needs to be done to prepare for the negotiations?

What are some common mistakes business owners make when negotiating the letter of intent?

WHO SHOULD BE INVOLVED IN THE NEGOTIATIONS?

The buyer and seller, along with their respective advisors, take part in the negotiations. It is a good idea to commission an M&A advisor to lead the negotiations as they have sufficient experience with such situations and can therefore remain objective. However, the final decision on the negotiated deal and terms is always made by the seller.

WHEN SHOULD A BUYER BE GRANTED EXCLUSIVITY?

Exclusivity excludes negotiations with another interested buyer. This allows the buyer in question to assess the acquisition, further negotiate and prepare the integration over a certain time period. Time must be taken to decide when exclusivity is to be granted since it impacts on the seller's negotiating position. It makes sense to grant exclusivity early in the process in cases where an exceptionally high offer has been made or fast closure of the transaction is preferred. However, the seller must be aware that it can be very difficult to renew negotiations with other interested buyers after the process has been successfully concluded, and it is often linked with significant price reductions.



WHAT NEEDS TO BE DONE TO PREPARE FOR THE NEGOTIATIONS?

Before entering into negotiations, the seller needs to clearly define their needs, interests and deal parameters so that they are negotiating within a defined framework. Preparation also involves learning as much as possible about each prospective buyer. If the seller is aware of how the business fits into the buyer's long-term strategy, the synergies they may anticipate, the challenges that may be faced, their financing capabilities, etc., this can strengthen their negotiating position considerably.

WHAT ARE SOME COMMON MISTAKES BUSINESS OWNERS MAKE WHEN NEGOTIATING THE LETTER OF INTENT?

- No clear definition of the negotiation framework
- Losing credibility due to overly optimistic perceptions
- Granting a potential buyer exclusivity at an early stage
- Agreeing to a long exclusivity period, which causes the buyer to expand their due diligence investigation and exposes the seller to a higher closing risk





Closing the deal

What does it take to get the deal closed?

What goes into the purchase agreement?

What are some common mistakes business owners make when closing the deal?

WHAT DOES IT TAKE TO GET THE DEAL CLOSED?

Closing the deal involves negotiating the purchase agreement and related agreements, such as the management contract and non-competition agreement. It is very important that a seasoned M&A lawyer is part of this process. The formulation of the final contract, including the finer points of the transaction, is usually done in an iterative process between the lawyers of the two parties.

When the purchase agreement is signed, the transaction is still not complete. Only when ownership and the purchase price have been transferred is the transaction deemed closed. Signing and closing can be at different points in time when the transfer of ownership is free of any barriers. Such barriers can be competition law regulations or conditions of the buyer (disclosure of additional information, meetings with key customers or the like). The seller is generally interested in closing the transaction quickly after they have signed the purchase agreement. Conditions which delay closure increase the risk of the negotiated contract not being implemented.

The time and effort required to close the deal should not be underestimated. It takes a significant amount of time to review every aspect of the purchase agreement.

WHAT GOES INTO THE PURCHASE AGREEMENT?

The purchase agreement is the formal binding agreement to acquire the business. Unlike the letter of intent, the purchase agreement is much lengthier and covers every aspect of the deal. The major components of the purchase agreement include:

- The price and terms of payment
- Representations and warranties
- Liability and indemnification provisions (e.g. prohibition of competition)
- Details on the closing of the transaction and precedent conditions
- Numerous appendices

These days, the appendix usually contains a data storage drive containing the virtual data room which both parties relied on during the negotiations.

WHAT ARE SOME COMMON MISTAKES BUSINESS OWNERS MAKE WHEN CLOSING THE DEAL?

- Underestimating the time and effort involved
- Neglecting the operating business during the intensive negotiation and closing phase
- Insufficient focus on the representations and warranties that they provide the buyer
- Believing that they have to win on every point when negotiating the purchase agreement
- Underestimating the importance of contract details




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An overhead, high-angle photograph of four business professionals (three men and one woman) gathered in a circle on a dark floor, looking down at a smartphone held by one of the women. They are all dressed in business attire. The lighting is dramatic, with strong shadows and highlights from a window on the right. A small green horizontal line is positioned above the word 'Relationships' in the headline.

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