TRANSACTION ADVISORY

Be prepared
10 things to do to facilitate a transition

Some day you will sell your business. Before you start the process, there is a lot you can do to prepare your business for the transition and so ease the process and improve your potential return. Whether you are transitioning to inside management, another company in your industry or a financial partner, preparation is critically important.

Regardless of the type of transition, you will need to showcase your business in its best light. Even in the case of an internal transition—where you transition ownership to an individual or team who understands the business well—you will still need to deal with other parties, like banks. Any outside party is going to want to know as much about your business as possible prior to the transition.

Having a well-organized business, a clear business plan and a strong management team can help with this process. If you consider the following 10 activities before you sell, you will be well positioned to achieve your transition goals.

1. Document your business planning and forecasting

> "If you don't know where you are going, it doesn't matter how you get there."

When it comes to a transaction, investors want reassurance that they are investing in a company with a cogent and well thought out plan for the future. If you don't have a history of clear business planning, budgeting, monitoring and reporting, investors may have trouble buying into the business.

A rigorous planning processes can greatly add to the value of your business and improve buyer confidence in your management team. Even if investors have a different objective or plan for the business, they are likely to value your planning process.

Think about when you lease a car. You probably know how you expect to use the car for the next three years. Shouldn't the same be true for your business?

While having a strong business plan is worthwhile even if you aren't considering a sale, demonstrated business planning and forecasting is essential if you are. This means putting business objectives, plans and forecasts into words and documenting results. Measuring results is also important, which is why you need to make sure you are rewarding your people, whether financially or non-financially, when their behaviours align with your objectives.

Be Prepared

- Can you demonstrate a history of planning, forecasting and comparing results to plan?
- Are your performance incentives, explicit and implicit, aligned with your business plan?

2. Identify the primary attributes of your business

> "If you can't show investors why your business is valuable, they won't value it."

Oftentimes, sellers believe that investors have their own reasons for buying a business and will bring their own plans. As a result, sellers don't place enough emphasis on understanding the attributes of their business that would be the most valuable in the eyes of potential buyers. Imagine that you are helping the investor "sell" the opportunity to someone who knows nothing about your business.

Consider if you were to write a book on entrepreneurship. To some buyers, you might suggest they buy it in order to help them get a business off the ground. To other buyers, you might suggest the book provides insights on how to apply entrepreneurship principles within a traditional business. With each prospective buyer, you might showcase different attributes of the book based on their needs and desires.

Before you hang a 'For Sale' sign on your business, it is important to understand all the valuable attributes of the business and which buyers might be most interested in particular attributes. Some buyers might be interested in your intellectual property; others might be interested in your distribution or sales channels. Regardless of the buyer, you should understand what attributes of your business are important so that you can showcase the value when you need to.

If you can show potential investors the specific business attributes, they will value your business to a higher degree and the transition will likely go more smoothly.

Be prepared

- What attributes would investors value about your business?
- How can you communicate the value of your business to different prospective investors?

3. Maximize and stabilize profits

> "Don't believe hockey stick projections."

When it comes to evaluating potential business, investors heavily discount earnings when they are volatile. Even if your business's average earning are the same, you will not get the same multiple for earnings that go up and down as you will if growth occurs more steadily.

There's a term used in business: "Hockey stick projections." This means all of the growth (usually substantial) and good news will happen in the next year—but not this one. Most investors don't want hockey stick projections. They look for businesses that have a history of steady revenue growth and increasing profitability.

Before you consider selling a business, undertake the actions you need to maximize and stabilize your profits. This will help increase the value of the business in the minds of prospective investors. At the same time, you should not look to improve profitability by reducing marketing or Capex expenditures, because you will be dinged heavily if an investor believes that a higher than normal level of investment will be required in those or other key activities.

Make a target to achieve three years of steady growth and consistent accounting treatment prior to selling a business. This consistency will put you in a better sales position and increase the perceived value of the business.

Be prepared

- Has your growth been steady and consistent for 3 years or more?
- How can you avoid major fluctuations in profitability that might be seen as negative?
- What can you do to maximize your profitability without harming perceptions of your business? For example, can you implement operational efficiencies?

4. Clean up the balance sheet

> "It's better to clean your house before you put it up for sale."

If you were to put your house up for sale, you wouldn't leave your garage full of junk—you'd clean it out. The same should be done when you plan to transition your business. Too often, the storage room of a company is a shrine to every piece of outdated equipment it has ever purchased.

Prior to putting a business up for sale, you should take a good look at its balance sheet and clean it up. Dispose of any surplus assets that would not be part of the business being sold (e.g. land purchased for a possible future expansion). Clean up your liabilities by writing off bad debts. You should also work to resolve any disputes or litigation. While these activities can be carved out, most investors don't want 'hair' on a transaction—and will value potential businesses accordingly.

Before entering a transition process, you should also look to identify and address any problems that might not be obvious. If an investor identifies a problem during or after the transition process, you can be caught by an indemnification claim or a purchase price reduction. Make sure you know everything about your business so that you can be transparent about any potential issues and their resolution if required. For example, you should make sure that the business does not have any environmental liabilities and have the report to prove it.

Be prepared

- How clean is your balance sheet? Can you write off any bad debts or sell any surplus assets?
- Can you resolve any litigation prior to putting the business up for sale?
- What hidden issues might come up during the transition process? How can you address them in advance?

5. Document Contracts

> "A handshake might be nice, but investors value contracts."

It's great when you have such good relationships with your employees, clients or suppliers that you can make deals with a handshake. But treating people like family doesn't negate the need for some formality—especially when you want to sell a business.

Investors can't put value on a handshake. As a result, if you don't have any business arrangements documented, investors are not going to give you the value you think your business deserves.

Before you put a business up for sale, make an effort to document all of your important contracts, whether with family members, customers or suppliers. For example, if you lease space from a non-arms' length party, make sure that you have a lease agreement in place at current market rates.

The lack of formal contracts can be a major barrier to investors and, as a result, will negatively affect your potential purchase price. You can typically avoid this issue all together by making sure that any oral deals are documented prior to putting your business up for sale.

Be prepared

- Are all your contracts, purchase orders, deals well documented?
- If you lease space, is your leasing agreement documented and does it reflect market rates?

6. Make your accounting is as rigorous and transparent as possible

> "Investors only trust what you can prove is true."

It's easy for the owner of a bakery chain to say, "If our store runs out of rye bread by 4:00 PM and the next day returns from other stores are less than 500 loaves, I know we're doing okay." The challenge is that while the owner might have the experience to know this is true, investors still aren't likely to take his or her word for it.

When investors consider a business transaction, they want assurance that the information they are receiving is accurate. The best kind of assurance you can provide is that of an external third party.

If you're looking to sell a business, you should get your annual financial statements audited for at least the past three years. An audit can help you prove that your accounting treatment has been consistent from year-to-year, while also providing credibility to the numbers being reported. Having your financial statements audited prior to a sale can simplify negotiations with potential investor by confirming valuation around key assets. This can, in turn, put you in a stronger sales position for your business.

If you already get your statements audited, talk to your auditor about the proposed transition. If they are familiar with your company, they will be in a good position to give you potential insights and input into your sale process.

Complementary to having your financial statements audited, you should also make sure that you have up to date
IT systems so that you can produce reports on key metrics, including standard metrics in your industry. Providing proof of operational performance can help alleviate investor concerns, especially when paired with audited financial statements.

Be prepared

- Do you have audited financial statements for the past three years?
- Have you spoke with your auditor about the proposed transaction and taken action on any advice they have provided?
- Can you upgrade your IT systems to improve your performance reporting?

7. Develop a management succession plan

> "The sellers said to us: 'We want to sell the business and retire to the Okanagan, but we have to make this a fast meeting because we can't be away from the business for more than two hours.'…and they wondered why we turned down the opportunity."

Only a small number of investors are willing to buy a business knowing that they have to replace management. That's because purchasers are concerned that without management, they will lose access to the "special sauce" that makes the business a success (e.g. key customer relationships, technical expertise).

Depending on the nature of the business being sold—the skills, relationships and expertise of key people can be where the majority of the value of a business resides. This is why having a professional management team well in

place and structured to provide for succession will help you create a more compelling business case for potential investors. If you document how the key skills, capabilities and relationships will be retained within the business, you will be better able to attract the value you target.

As a business owner, you should be prepared to involve your key management in the sales process and transition. An investor is going to want to meet them and to hear them articulate the business strategy and how they contribute to it. If family members are part of your management team, you may need to provide them with training so they are better able to prepare for the transition.

Before you put a business up for sale, consider management succession and come up with a plan that makes sense and that will answer potential investor concerns.

Be prepared

- How are you going to transition your relationships and expertise when you sell the business?
- How can you better prepare your management team for the transition so that they can contribute more to the sales process?
- What can you do to make any family members more prepared for the transition?
- What is your plan if the investor wants you around for another 2, 3 or 5 years?

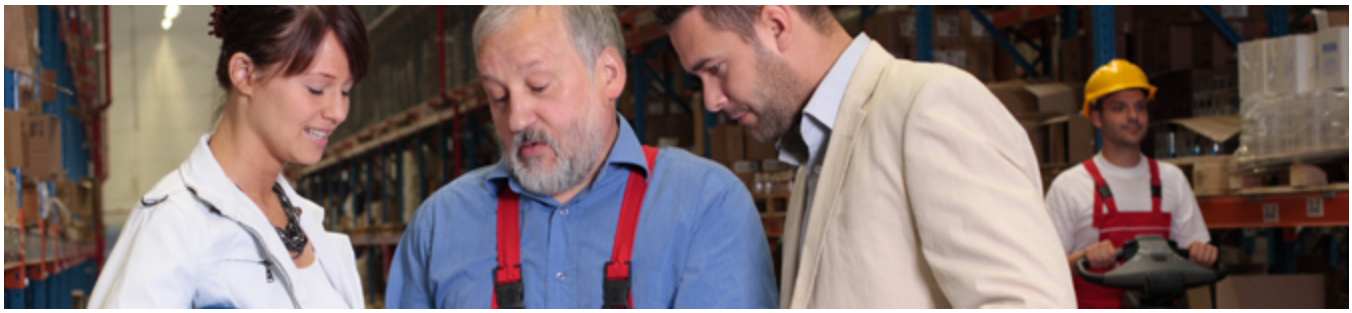
8. Update agreements among shareholders and with key stakeholders (e.g. management employees)

> "When it comes to ownership, document everything."

When it comes to ownership in a business or intellectual property (IP) related to a business, it is utterly essential to document who is contributing what and how profits generated (i.e. financial or otherwise) will be shared. While it may not seem important in the early years of a company where shareholders are all on the same page, documentation becomes critical when it comes to transitioning a business. Every shareholder should understand their role in the transition and what they will get out of it.

While it is easy for a seller to say that IP in "Bob's" name will remain with the company, if there's no intellectual property agreement in place, investors will likely assume the opposite. In the case of IP critical to the business, investors will be leery of any and all uncertainty around ownership. As a result, the business itself will become less attractive.

Before putting a business up for sale, owners should make sure appropriate agreements are in place and well documented, especially around issues like IP and other business-defining capabilities. Addressing these issues in the middle of a transition process can create stress, decrease investor confidence and negatively affect the value of a business.



Be prepared

- Are shareholder agreements up to date?
- Are employment agreements current and reflective of go-forward arrangements?
- Have intellectual property agreements been properly drafted and executed?

9. Make sure appropriate tax planning is in place

> "Tax planning takes time. To get the most out of it, you need to think about it early."

Some business owners are concerned that if they set up a family trust, family members will squander the money in it. As a result, they decide to hold off on tax planning until they are ready to fully transition a business.

The problem with this belief is that if you don't plan early—there may be significant tax implications should you need to transition a business earlier than planned. Here in Canada, many tax structures require time to season.
For example, family trusts must be in place for two years before a transaction occurs.

Tax planning can be critical to transitioning a business in the most cost effective and easy manner possible, especially when the transition involves family members. Well before you contemplate a sale, you should make sure that you, your family and the business have implemented tax plans—and that the transition timing recognizes and maximizes any tax benefits or decreases any tax penalties.

To develop a successful tax plan, start by having honest discussions with your family members about their roles and involvement in the business, its future and mutual expectations. This clarity early on in the process can help you minimize potential family conflicts and smooth the transition process.

Be prepared

- Are appropriate tax plans in place for you, your family and your business?
- Have you had conversations with your family members about their roles and involvement in the business and its future?
- Have you gotten key family members on-side with respect to transition plans?

10. Clean up your corporate records

> "It's difficult to sell a business if it doesn't actually exist."

Before putting a business up for sale, you should make sure that your corporate records are completely in order so that no information you provide can be called into question by potential investors.

Imagine that you bought out a minority partner a few years ago, but you never documented it in your share register or minute book. The lack of documentation could create numerous problems during a transition process and degrade investor confidence as you work to execute the necessary documents.

Investors will be more confident if all of your paperwork is clear, accurate and in order. Before entering a transition process, you should work with a lawyer to make sure that your records and minute books are

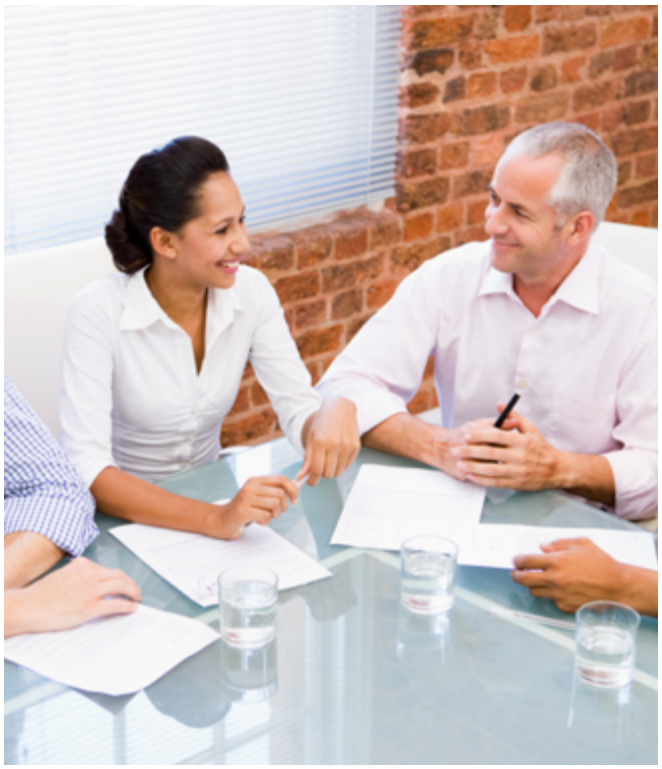
up to date and accurate, your corporate returns and registration documents are current, and any share transfers have been properly documented. It will be very difficult to sell your business if it doesn't actually exist on paper.

Be prepared

- Are your minute books and corporate records up to date?
- Have any share purchases been appropriately documented?
- Are your corporate returns and registration documents current?

Conclusion

Some day you are going to sell your business. Even if that day seems a long time in the future, undertaking certain activities now can give you the peace of mind that you will be fully prepared for the transition when the time comes. You've put a lot into your business. Now make sure you are in the best position to get the most out of it.



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