RKJ PARTNERS
LOWER MIDDLE-MARKET INVESTMENT BANKING

RKJ Partners, LLC is an Atlanta, Georgia based investment banking firm designed to specifically assist lower middle-market growth companies in executing transactions less than $100MM.

CYRIL JONES
Founder & Managing Partner
cyril@rkjpartners.com

GREGORY FICKLIN
Managing Partner
greg@rkjpartners.com

WILL ROSSER
Managing Director
will@rkjpartners.com

RHETT PLOTNER
Vice President
rhett@rkjpartners.com

PETER WRIGHT
Senior Associate
peter@rkjpartners.com

RKJ PARTNERS, LLC
4514 Chamblee Dunwoody Rd.
Suite 170
Atlanta, Georgia 30338
p. 404.963.8592
f. 404.920.2159
www.rkjpartners

RKJ PARTNERS
Sell Side M&A Newsletter
Volume 1; Article 6

The Sell-Side M&A Process

APRIL 2018

I. OVERVIEW

In difficult and volatile markets, many businesses will inevitably look to review their strategic options. Whether their proposed actions include a sale via a private auction, a public offering or entertaining a takeover offer, in all cases the desired outcome is the same - securing maximum return on the sale of a business.

Businesses often underestimate the importance of planning a sale, which, when combined with undue optimism around transaction readiness, can often result in value being left on the table. The underlying principle is simple: properly planned and executed sales lead to enhanced shareholder value.

The challenge is, however, how to manage a complex sales process while running a business in the current economic environment. Even in the best of times, the planning and implementation of a sale will invariably place significant pressure on your organization's internal resources. RKJ Partners' experience also has shown that most businesses do not produce financial information in a form or at level which is likely to fit the requirement of buyers, finance providers, advisers and other stakeholders. This can often lead to an owner missing or not recognizing early enough deal issues and information, which frequently prevents the successful completion of a deal or results in delay or lost value for shareholders.

At RKJ Partners, we can offer you that crucial third-party perspective:

- Helping you to identify and challenge your rationale for sale;
- Viewing your business from the standpoint of a potential purchaser; and
- Preparing for the due diligence process so that the market at large and your purchasers see your business at its best.

RKJ Partners' Readiness Review

As you consider a sale, it is essential to complete a readiness review. This will provide a framework to facilitate a robust and orderly process for selling by identifying major issues, resource requirements and work-stream priorities. A readiness review comprises a detailed review by your senior team supported by RKJ's experts, to perform an initial diagnostic of the business, providing guidance on:

- Articulation of shareholder objectives, the company and its market position, and the overall feasibility for sale.
- Extent of integration with other businesses in the portfolio and principal steps required for separation.
- Key issues impacting sale value and potential mitigating actions.
- Key priorities, timetables, information and level of required resources.

For your review, RKJ has provided a high-level summary of the sell-side process, as well as an overview of the due diligence process.

II. Preparing Your Business For Sale

Careful preparation and advanced planning can significantly increase the likelihood of a successful business sale and have a positive effect on valuation. The following are proactive steps a business owner should take prior to beginning the business sale process:

RECASTING FINANCIAL STATEMENTS. Financial statements of privately held companies typically are prepared with a view towards minimizing the tax burden. This purpose tends to be at odds with what a business owner wants to show to a potential buyer in the context of a business sale. To enable a potential buyer to "read between the lines," the financial statements must be "recast" or "adjusted" to reflect the true profitability and discretionary cash flow that would be available to a new owner. This recasting involves identifying the owner and certain family member salaries, any perquisites or fringe benefits that owners of privately held businesses customarily make available to themselves, one-time or extraordinary expenses, current expenses for future expansion that have not impacted historical sales, non-cash expenses and other expense items not likely to recur or be applicable to future ownership. An important step in this process is to thoroughly analyze the general ledger to identify all expense items that can be restated or adjusted and thereby maximize the price a seller will receive for the company.

INDEPENDENT VALUATION. An independent valuation enables a business owner to get a sense of a realistically achievable value and confirm in advance whether it makes financial sense to sell the business given current market conditions. If the lowest price that a business owner would be willing to accept for the company is well above what a potential acquirer would realistically pay, it is essential to be aware of that information in advance of trying to sell the company. This step can eliminate time wasted on the business sale process that detracts from the business owners' focus. Properly understanding valuation at the outset of a sales process will also prevent "leaving money on the table" by undervaluing the company or losing qualified acquirers by seeking an unrealistic price.

TAX IMPLICATIONS. It is crucial to understand the tax implications of a sale in advance. This will provide a realistic picture of the net after-tax yield and help to determine the most advantageous way to structure the sale for tax purposes. For example, advance recognition of the tax implications of a "C" corporation requires that negotiations be positioned toward a deal structure that would minimize a seller's tax exposure.

APPRAISALS. For equipment intensive businesses or transactions in which real property will be included in the transaction, independent appraisals of the equipment and/or the real estate prior to beginning the sale process is highly recommended. Appraising these assets will help in the valuation and planning process prior to going to market. The buyer will likely need to have these assets appraised and being prepared will foster integrity by presenting these assets with accurate market valuations.

GROWTH PLAN. A well thought out and realistic plan for growth can greatly enhance the value of a company. It serves as a road map to expansion opportunities that a new owner could exploit with additional capital or other resources that it may bring to the table. The plan should assume that significant capital resources will be available after the sale and identify areas where historic sales were constrained due to capital limitations. It is likely that the acquirer will be better capitalized than the current owner and have enhanced capabilities to act on these opportunities. Whether it is limited desire, burn out, or lack of capital resources holding the business back, it is critical to develop a well-defined plan that identifies the most realistic expansion opportunities. The more untapped expansion potential, the greater perceived value the business will have to a potential acquirer.

TACKLING "DEAL KILLERS" EARLY ON. If there are issues that may potentially jeopardize a transaction, a seller is ill served by "hiding his or her head in the sand". Eventually these issues will surface, and it is far better to be prepared and address them during the management presentation from a pro-active viewpoint, rather than have to take a defensive posture when they are independently discovered. Such "deal killers" may include a lease that needs to be negotiated, property to be cleaned up, equipment to be replaced, financials to be revised, pending litigation, key employee retention, customer retention or concentration, etc. Addressing these issues in a timely and forthright manner avoids spending months identifying qualified acquirers only to have the deal "crash and burn". There are a variety of ways to disclose, present and/or remedy these issues prior to or during the initial marketing phase. Buyers have a greater willingness to proceed with the deal if they feel the seller has been honest in disclosing the "skeletons in the closet" from the outset. The worst situation is for a potential buyer to discover these issues on its own and wonder what other negative surprises may exist.

ADDRESSING KEY DEPENDENCIES. Reducing key dependencies in a business will serve to increase the marketability and value of a company. Three key areas include customers, vendors and employees. Customer dependency exists when a high percentage of the company's revenue is derived from one or a few large customers. Vendor dependency results from difficulty finding comparable vendor replacements, if needed. Employee dependency exists when the business is highly dependent or held hostage by key employees or the existing owner, whose departure could severely impair the business. These dependencies create significant risks for an acquirer and can have a negative impact on valuation. With advanced planning and focus, the negatives associated with these dependencies can generally be mitigated.

ENVIRONMENTAL. It is the responsibility of the seller of a business to obtain required environmental clearances prior to the closing of a business sale. This generally applies to businesses subject to environmental scrutiny such as manufacturing businesses or firms routinely dealing with hazardous substances. If a company's standard industrial classification (commonly called the SIC code) triggers the need for this clearance, it is essential to understand in advance the presence of any existing issues. This can be accomplished by hiring an environmental consultant to perform a Phase One study that will identify any environmental concerns. Given that environmental due diligence is a requirement, it is best to address it early in the process. The absence of advanced planning could lead to months of unnecessary delay that can jeopardize deal momentum, financing and ultimately the deal itself.

THIRD PARTY FINANCING. It is important to ascertain the likely level of financing available to an acquirer in advance. This will help qualify potential buyers as serious prospects and determine if the necessary capital will be available to consummate a transaction. For example, assume an acquirer will need $1.5 million in available cash for the initial investment and working capital requirements. If it is determined that a bank is likely to lend a reasonably qualified buyer $600,000, then a buyer must be identified with at least $900,000 in available capital and good credit. If a bank is only willing to commit $300,000, it will be necessary to find a financially stronger potential acquirer. Not being armed with this knowledge in advance often leads to wasted time and jeopardizes confidentiality with unqualified acquirers.

CARVE OUT EXCESS ASSETS. One method of increasing a seller's total financial yield from a transaction is to identify excess assets that can be converted into cash prior to a transaction, without adversely impacting the business. For example, assuming a company has accumulated $450,000 of inventory but only requires a $250,000 level. The seller can generate an additional $200,000 by converting the "excess" inventory to cash prior to the closing.

LIKELY ACQUIRERS. Advance research within an industry can determine if it makes sense to approach companies in a related business seeking additional sales, territories, capabilities or complimentary revenue centers. These "strategic buyers" may have a strong desire to acquire a similar or related business as a means of growing through acquisition or because they may recognize the synergies that will result from the combination of the two companies. By identifying likely prospects, the search for an acquirer can be more tightly focused in a direction that can maximize the overall deal value.

TEAM OF PROFESSIONALS. Before entering the uncharted waters of selling a business, it is imperative to select the right team. This includes a qualified CPA, an attorney with a background in corporate transactional work and an experienced M&A intermediary. Ideally, all these parties should have specific experience with the business sale process and some level of familiarity with business for sale. All parties should meet in advance since their efforts will need to be coordinated later in the process. This will ensure that all team members are on the "same page" and have a clear understanding of the goals and expectations of their mutual client.

CURRENT SALES PERFORMANCE. An often-overlooked area that has a major impact on marketability of the business is the company's current financial performance. The 12-month period during which the sales process is taking place is a decisive one. If sales performance deteriorates during this period, marketability and value will be negatively impacted. Current performance often has greater significance to a potential acquirer than the previous 20-year track record. The business owner must focus his or her efforts on whatever can be done to maintain consistent (or improve) sales, margins and profits during this period. Working with a qualified M&A intermediary to manage the sale process is a vital component of the sale process because it allows the business owner to maintain focus on the business at hand. An experienced intermediary will handle the time-consuming intricacies involved in the proper packaging, presentation and negotiation of a business sale transaction.

III. Due Diligence Process

Due diligence in the context of a business sale is the process that a buyer goes through to verify that the representations about a company made by a seller are materially accurate. Buyers seek to satisfy themselves and their stakeholders as to the current condition of the business, thus reducing the chance of any post sale surprises.

It is common for a buyer to make a purchase offer based upon general financial and operational data that has been supplied during the marketing phase of the sale process. For confidentiality reasons, these representations are all that a seller should be expected to make until such time as there is a "meeting of the minds" or a business agreement between the parties. Such an agreement should include purchase price, terms and transaction structure and will generally be confirmed in a Term Sheet or Letter of Intent, signed by both buyer and seller.

Performing financial due diligence prior to a price and terms agreement would be putting the "cart before the horse". A seller should only divulge sensitive information about his or her company if it is known that there is a financially acceptable transaction in place. Buyers typically want to perform due diligence prematurely, so as to minimize their risk in proposing a deal. Allowing this process to begin before a formal offer is made is one of the most common and costly mistakes that an inexperienced seller makes. A seller's primary objective in due diligence is to emerge with the deal intact (i.e. with no revision in price or terms). A seller can maximize the probability of a successful outcome by preparing for the due diligence process. It is critical that the seller receive in advance, a due diligence checklist from the buyer, to facilitate having the information organized and ready for review. Well organized and complete information increases the seller's credibility and a buyer's confidence in the business. If a seller notices any inaccuracies during this preparation phase it is preferable to bring it to the prospective buyer's attention in advance to preserve credibility. In the event certain negative information turns up during due diligence, one of three things will happen: The buyer may be willing to follow through with the agreed upon price and terms anyway; The buyer may opt to pull out of the transaction; or the buyer may agree to proceed with the transaction conditioned upon renegotiating price, terms or deal structure. Typically, unless material information was omitted or misrepresented in the marketing phase, deals that were properly prepared emerge from due diligence relatively unscathed.

Due diligence can be classified as external or internal. External due diligence relates to industry factors such as economic conditions, demand forecasts, trends, pending legislation, industry risk factors, expansion opportunities, new technology, competition, etc. and are not company specific. External due diligence can and should be done by the buyer at an earlier stage since it is not reliant on specific company information and is not sensitive or intrusive to the company.

Internal due diligence relies on information specific to the subject company. The following are the most common areas reviewed: Financial – accuracy of financial statements and recast profit adjustments; Tax & Payroll – up to date and historical tax filings; Operational – general business structure and risks; Inventory – confirming no stock obsolescence; Legal – existence or status of any lawsuits; Regulatory – compliance with applicable agencies; Environmental – ISRA compliance; Employees – status of key employees; Customers – in good standing and likely to remain post transaction, etc. Certain aspects of due diligence are more sensitive than others. Customer and employee due diligence typically fall under this category and should be put off as an end phase of the process. It may be the final step prior to closing, perhaps after contracts are signed and all other contingencies have been satisfied, including any required financing. This affords the seller a comfort level that once this final aspect of due diligence is addressed the deal will immediately proceed to closing, assuming there are no significant unexpected findings.

Every due diligence varies depending upon the complexity of the company, size of the transaction, the specific buyer and a buyer's familiarity with the industry and company. The process can range from a few hours to several business days. If an "insider" such as an employee is buying the company, there may be little need for due diligence since he or she is already intimately familiar with the business. In summation, due diligence is an inevitable part of the business sale process. To ensure that everything will go smoothly, make sure that all representations made during the selling process are materially true and correct. Take the time to properly prepare for due diligence and keep in mind that as a seller, your goal is to survive it with your deal intact.

ABOUT RKJ PARTNERS, LLC

RKJ is an established advisor to leading lower middle-market growth companies. We provide our clients with experienced-based solutions and unbiased advice. Our comprehensive array of strategic advisory and execution capabilities allows us to meet the needs of our clients and provide an outstanding level of service in connection with a variety of transaction processes, including:

- **CAPITAL ADVISORY**: RKJ possesses substantial expertise in assisting lower middle-market clients raise capital to fund growth strategies. Whether the capital source is senior debt, mezzanine/subordinated debt, private equity, or venture capital, RKJ has both extensive and relevant relationships within the capital community to enable the deployment of optimal solutions for our clients.

- **MERGERS & ACQUISITIONS**: RKJ serves as a trusted advisor in executing merger and acquisition transactions for lower middle-market clients. In addition to our significant investment banking transactional experience, RKJ's bankers have owned businesses and have served in interim CFO roles for clients. Because of our experiences as business owners and senior level managers, RKJ's bankers are able to bring a unique perspective to the mergers and acquisitions process. RKJ's mergers and acquisitions services include:

  - Buy-side and Sell-side Advisory
  - Divestitures
  - Leveraged & Management Buyouts

- **STRATEGIC ADVISORY**: RKJ provides financial advisory services to owners, management, shareholders and their boards to assist in the evaluation strategic alternatives and options for extending and/or maximizing shareholder value. RKJ's advisory services include:

  - Business Valuations
  - Capital Structuring & Planning
  - Negotiating Joint Ventures
  - Strategic Business Development