Value
Unleashed

Time Becomes Your Enemy

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TAKEAWAY

In every sale transaction, there is a "window of vulnerability" for the seller that starts with the initiation of sale discussions with a potential buyer and ends with the closing of the sale. Three key risks present themselves during this window: a) Completion Risk, b) Valuation Risk, and c) Damage to your business by potential bidders. Exposing your business to lengthy sale discussions with any party dramatically increases all of these risks. To ensure that this window of vulnerability is as short as possible, it's critical that you thoroughly prepare for a structured, competitive transaction process.

The Window of Vulnerability

From the moment you make initial contact with any potential bidder to the time you close a sale transaction, you and your business are at risk. As the sale process begins, you're likely concerned about ensuring:

1. an acceptable valuation for your business,
2. that utmost confidentiality is maintained, and
3. that you don't waste time, effort and money on a failed negotiation.

Should a sale negotiation fail to result in a closed transaction, in certain respects, the window of vulnerability doesn't close, prolonging these apparent risks. A key objective of any effective sale process is to shorten this window of vulnerability as much as possible.

This article discusses these risks and some effective strategies to mitigate them.

Three Key Deal Risks

1. Completion Risk

Some experts say greater than 75% of private business sale discussions fail. Completion risk, like the other key risk areas, is present in every transaction and increases the longer a business is exposed to potential bidders. During a protracted process, fatigue sets in for both the seller's and potential buyers' teams, confidence and trust erode, and expenses on all sides accumulate. Completion risk manifests in several ways, some of which are outlined here.

Market Conditions Deteriorate

While industry conditions applicable to a seller's business clearly impact completion risk, macroeconomic conditions, financing markets and market valuations have a profound impact on M&A activity. While at the time of this article market conditions remain robust, market windows can close suddenly and in unforeseen ways. I can attest to the impact that the 2008-09 financial crisis had on the M&A market. Scores of transaction negotiations were shelved indefinitely. I was involved in both an acquisition and a sale that were in the market as the crisis unfolded.

One acquirer was forced to raise exorbitantly expensive financing to close their acquisition in a debt market that had completely seized up. The result: their share price dropped from the mid-20's in June 2008 to under $3 in March 2009.

A stable business with a leading market position that was worth well in excess of $1 billion when we launched our sale process in the summer of 2008, received bids for approximately 40% less a few weeks later. The bidders in the process told us that the crisis flooded them with lower risk investment opportunities that would provide better returns than buying our client's business.

Business Performance Falls Short

Operating a business is inherently risky and there are often surprises. A key member of your team could leave, you could lose a large customer or a large order, market prices and/or demand may suddenly collapse, etc. A business sale process is intense and demanding, which makes it harder to fight fires. Of course, the longer the sale process continues, the greater the likelihood that the business will have a negative surprise. Until the transaction closes, the seller bears the full risk.

As an example, we recently saw a situation with an energy services business owner that had retained an advisor to sell their business. The owner moved very slowly to provide the advisor with the information required to launch the sale process. It took several months to provide materials that should have taken a few weeks. As the bidders neared completion of their due diligence, the oil price collapsed. Shortly thereafter, their largest customer cancelled a major project, dealing the negotiated valuation a mortal blow. The process was terminated with no prospect of revival.

Business risk is unavoidable. It's best to shift that risk to a buyer as soon as possible by facilitating a short process. If this process had moved more quickly, the project cancellation could have been the buyer's problem, not the seller's.

The Buyer's Problems Are Your Problems

As a business owner, your main concerns during negotiations are likely with your customers, vendors and other stakeholders. The buyer's objectives in pursing a sale, by contrast, are as follows:

- A low completion risk
- A low time investment
- Minimal due diligence and legal expenses
- A clean, low-risk target company

Most entrepreneurs don't concern themselves with factors that impact the buyer. Ultimately, in reaching a successful transaction with a given party, the buyer's problem is also the seller's problem. Here are a few situations we've encountered:

- **Failed processes damage careers:** Acquirers can expend significant time and resources to complete an acquisition. Their decision to engage in an acquisition process is based on their assessment of their completion risk and often results in other opportunities not being pursued. It follows then, that when a seller undermines the acquirer's confidence that they can successfully complete a transaction in a timely an efficient manner, the acquirer will likely disengage. As the seller therefore, if you conduct yourself in a manner that shows inexperience, unresponsiveness, non-market expectations or otherwise, your buyer may cut their losses.
- **The acquirer's priorities change:** Current acquisition projects being derailed by urgent, higher-priority acquisition opportunities is a common occurrence. At a prior firm, we were retained by the platform company of a private equity client to assist them with acquiring several smaller private companies in the HVAC industry. Dialogue had started with a few companies and was

subsequently put on hold for six months because the company had to shift its focus to filing for their initial public offering.

- **Financing pressures:** Like it or not, the banks are often a significant player in a deal negotiation. Credit facilities are commonly required to provide at least some of the funding needed to close the transaction. To satisfy any experienced seller, a buyer must demonstrate they have committed financing. When the banks commit this financing, that money is spoken for and cannot be committed elsewhere. As a result, the banks will resist extending these financing commitments for an extended period of time without charging standby fees to the potential acquirer, increasing their deal costs and risk of the financing being revoked.
- **Deal costs mount:** The buyer, who is also paying for financial and legal advisors, may be dissuaded from continuing to pursue a long, expensive transaction.

This is far from an exhaustive list. Suffice it to say, there are several factors that can impact a potential buyer's participation in a sale process.

2. Valuation Risk

Whether or not it is explicitly stated, a buyer's perception of the value of a business is based on the simple multiplication of [Valuation Metric] x [Valuation Multiple]. As a potential acquirer conducts their due diligence and negotiates the definitive agreement, they may adjust one, or both of these to reflect new information attained through the process, or more cynically they may engage in what is commonly referred to as the "Due Diligence Grind".

As with completion risk, changes in the business during the sale process can impact a potential buyer's perception of value. When value expectations diverge like this, there is a very real chance for the deal to ultimately fall apart. A lengthier due diligence and negotiation process increases this risk.

3. Damage to Your Business by Potential Bidders

Leaks that impact your business relationships

The longer the window of vulnerability, the greater the risk of leaks that a company is in sale discussions. Leaks and speculation about an impending sale have the potential to undermine the confidence of customers, triggering concerns about whether the same standards for service and attentiveness will be upheld during transition of ownership. Further, suppliers might take the news of an impending sale to mean that your business is in financial distress. As a result they may review whether they should continue to extend credit and revise payment terms. An information breach can also have undesirable effects on employee morale, eliciting feelings of mistrust, anxiety, vulnerability, or apathy surrounding performance.

Opportunities for competitors to use private information

Despite executing standard non-disclosure agreements, strategic acquirers and competitors may use and distribute, whether intentionally or accidentally, confidential information gained from the process for their own marketplace advantage. A lengthy sale process provides time for information to reach a wider, potentially unregulated network, especially if your documentation isn't subject to professional confidentially protocols, properly encoded, and watermarked. Competitors may use your intellectual property in their business, or take advantage of your market intelligence to gain a competitive edge.

How to Minimize Your Window of Vulnerability

There are several steps you can take in order to execute a process that exposes your business to potential bidders for the shortest length of time possible:

Ensure your business is prepared for due diligence

Whether your business will be considered by multiple bidders simultaneously or a single bidder, it's critical that you prepare comprehensive due diligence information in way that can be easily reviewed by bidders' due diligence teams. If the information provided is incomplete, incoherent, or internally inconsistent, you will quickly find yourself and your team overwhelmed with requests. As a result, the information preparation can become disorganized and reactive. Although you can't predict everything that a bidder may request a priori, take care to prepare and compile comprehensive due diligence documentation and host it with a reputable VDR provider to ensure secure and efficient dissemination of information to bidders. Attending to this in detail before the sale process is launched will accelerate due diligence and effectively minimize your window of vulnerability.

It's also important to ensure your team is equipped with the necessary "bench strength" for efficient turnaround of requested information. In spite of your best efforts, a potential acquirer will inevitably ask for information that wasn't compiled previously, so make sure your company's point of contact can provide these deliverables.

The time commitment required to exploit market inefficiencies through a competitive process is significant. We maintain a database of potential buyers and have proven systems to execute these processes, and they take us 1,500 to 2,000 hours to complete. How much extra time would your team need to efficiently access a global universe of potential buyers and create competitive tension between them? This is not the finance team's job – this is a specialized transaction and will see the best results when executed by a specialist.

Create competitive tension

Competitive tension among multiple bidders gives you leverage in the form of strategic choice, while diversifying buyer-specific completion risk. Value, after all, is in the eye of the beholder, and there are often one or two outliers in a competitive process who see more value in a business than others. A controlled, competitive process surfaces the best potential acquirers and instills a sense of urgency for them to move quickly and win the business over a competitor. The benefit is twofold: you reap a greater value for your business and enjoy an accelerated transaction process that is propelled by competitive pressure.

Set deadlines and provide clear instructions to bidders

While it is not advisable to provide bidders with a timeline that maps the process from start to close, to maintain the pace of the process and minimize wasted time due to miscommunications, it is critical to set our clear next steps for bidders a few weeks out. This includes setting realistic deadlines and enforcing them. It also means making the process requirements clear, particularly the communications protocols and providing a comprehensive “Process Letter” that clearly states what each bid must contain to be considered.

Cull the herd

A well-designed process has multiple hurdles for bidders to clear and stages the flow of information so that only the most serious parties receive your most sensitive information. This culling process also has positive effects on the speed of the most labor-intensive aspects of the due diligence process. The slowest, and potentially problematic, parties will struggle with deadlines and are eliminated from the process as a result.

Leverage expertise

Having access to someone who is experienced in the sale process, particularly in private equity transactions, will prove invaluable. Whether this is a peer, a colleague or an unaffiliated third party, a resource such as this will minimize transaction risk from the start by lending important insights about how to reach the right potential buyers while minimizing execution risks and potential information leaks. A trusted expert can also facilitate an efficient transaction process by identifying potential deal issues ahead of time and developing mitigation strategies for each.

About Valitas

Valitas Capital Partners is a relationship-focused merger & acquisition (M&A), corporate finance, and strategic advisory firm. We collaborate with ambitious owners of high-performing businesses with a potential value of at least $100 million, to discover, unleash, and realize their full business value potential.

Owners and their leadership teams rely on Valitas when they:

- Want to triple the value of their business in five years or less, but realize they lack the expertise and experience to achieve this alone.
- Want to sell their company now, assured they will look back after the transaction knowing they got the best possible outcome.
- Seek the peace of mind of taking some chips off the table now, to secure their family's financial future without giving up control or the future increased value in their business.
- Are anguished they had to say no to growth opportunities they worked so hard to create because their bank cannot keep up with the needs of their fast-growing business.
- Are frustrated at the lack of traction they are getting with their acquisition efforts, whether it is not seeing enough quality acquisition opportunities, or by wasting time and money coming up empty-handed in auctions.
- Are dispirited by the significant investments in expensive specialists, technology, systems, and financial modeling capabilities required to execute their audacious strategic goals.
- Are intrigued by the idea of selling their business to their management team over time but want to recognize the full value now, while getting their cash payments as quickly as possible.

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Paris Aden is the founding Partner of Valitas Capital Partners. Since 1994, he has been involved with more than 100 M&A transactions with an aggregate value exceeding $80 billion. He has advised clients at Morgan Stanley, Credit Suisse First Boston and RBC Capital Markets and has acted as a private equity investor at Clairvest Group where he served on portfolio company boards. Paris was also a co-founder of Alluence Capital Advisors, a mid-market M&A advisory boutique that focuses on cross-border transactions.

Paris is recognized as an expert in business strategy, M&A and corporate finance. Previous roles and speaking engagements include:

- Lecturer at the Stephen J.R. Smith School of Business at Queen's University in their Master of Finance (MFIN) program
- M&A subject matter expert for Moody's Analytics' Advanced Capital Markets Program for capital markets professionals
- Three-time expert panel moderator for the Toronto Business Transitions Forum
- TEC Canada "2018 Speaker of the Year" recipient
- Guest speaker for various industry and business leadership organizations

Paris formed Valitas to meet the unanswered needs of ambitious business owners seeking to:

- At least triple their business value in five years or less; or
- Are seeking an elite advisory boutique as their trusted advisor for their complex, mission-critical transactions.