

THE NEWSLETTER OF THE BDO MANUFACTURING & DISTRIBUTION PRACTICE

# BDO MANUFACTURING OUTPUT



## CONSIDERING A SALE

**M**idmarket business owners consider sales, divestitures and spinoffs for a variety of reasons, both positive and negative. Fortunate triggers for a sale include opportunities to capitalize on strong acquisition markets or an owner's planned retirement. Unhappier reasons include financial stresses (declining revenues, capital constraints or bankruptcy) or the sudden departure or demise of key leaders.

Regardless of the reasons for a sale, business owners must clearly understand *why they are selling* and craft a strategy that maximizes the sales price given those specific conditions. Why? Because while the value of M&A deals in the United States has increased to \$893.1 billion, up 3.8 percent from 2012 to 2013,<sup>1</sup> many owners walked away from years of hard work without getting the best returns on those investments. The difference between those satisfied with a sale and those who wonder why their deals went wrong depends in large part on *how* sellers prepared themselves, and their organization, for a transaction.

"Many owners have unrealistic pricing expectations for a sale," says Bob Snape, President of BDO Capital. "Savvy executives make a point of getting a realistic valuation before they contact potential buyers by evaluating similar sales in their industry or region."

Preliminary benchmarking will determine the viability of a sale; a more sophisticated review will determine if it's the right time to sell (will conditions improve in six months to a year?), whether the transaction is likely to generate the desired sales price. A thorough pricing analysis will assess the organization's "fair market value," which accounts for every asset, including capital equipment, real property and current assets such as inventory. And while accounting can differ by type of sale (e.g., assets or stock), gains or losses included in fair market value will generally be recorded based on treatment of the individual assets (e.g., capital assets result in a capital gain or loss, inventory results in ordinary income or loss).

### ***BDO Manufacturing Output***

regularly examines how manufacturers are rethinking strategies, operations, supply chains, workforces, business systems, products and markets to achieve competitive advantage. In this issue, *Time to Sell*, we will analyze the issues that face small- and midmarket manufacturers considering a divestiture or spinoff, focusing on strategies for maximizing the sale price while minimizing risk.

# PRICING AND POSITIONING THE BUSINESS FOR SALE



**S**ell-side due diligence, or valuing the company's assets and examining and documenting the health of the organization, is a fundamental component of the sale process. This procedure, even for small businesses, will help drive a selling price that satisfies ownership while reassuring a buyer of sufficient return on investment.

## ► ESTIMATE VALUE

There are many methods for valuing an organization, although the eventual selling price is always based on the value *perceived* by the buyer. Two common methods are:

### *Asset valuation*

This approach is common when a manufacturer is being sold for liquidation, as the assessment identifies the potential selling prices for used equipment, facilities, inventory and real estate. This approach also applies to businesses being transferred to new owners for operation, in which case intangible assets

can greatly impact overall corporate value. For example, a manufacturer with few physical assets might hold intellectual property that hasn't yet been commercialized, or it may have long-standing customer agreements that can be reinvigorated with new products and new sales practices.

### *Market-based valuation*

This approach looks at the value of the business from the next owner's perspective — it identifies how much value the company will continue to generate. Market valuations examine the value of similar companies and their assets, and then establish a multiplier driven common for the market or industry, such as a multiple of sales or earnings before interest and taxes. For smaller businesses, this may be a multiplier of the seller's discretionary earnings, which consists of the business' profit plus benefits to the owner (e.g., salary or non-recurring expenses).

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## ► CONTINUED FROM PAGE 1 CONSIDERING A SALE

This doesn't mean, of course, that a seller can't negotiate for a premium above fair market value. An eager acquirer can allocate a premium purchase price against the fair market value of the company, with the excess purchase price recorded as goodwill. But preparing a fair-market-value analysis offers a realistic starting point for a seller before negotiations begin.

Sound accounting analysis should be accompanied by well-documented business practices and workflows as the company's management team continues to operate and invest in the business as it always has. Meanwhile, the firm's owners, along with professional advisors including brokers, accountants and lawyers, will guide the sale process (see *Executing the Sale*).

It's important, too, that leaders be upfront with employees if a sale is rumored or confirmed. Prospective buyers may lose

interest if top talent leaves due to uncertainty. IClear internal communication of any tentative sale can help facilitate successful post-acquisition integration. A study conducted by the International Association of Business Communicators (IABC) and Mercer Human Resource Consulting asked CEOs post-merger what they would change if they had it to do over again. Their top response was the way they communicated with employees.<sup>2</sup>

"Customers and suppliers also should be alerted to a possible transaction when appropriate," suggests Howard Sosoff, Assurance partner and Manufacturing & Distribution practice leader for BDO. "Customers want to know that high-quality, on-time orders will continue as scheduled, and suppliers are eager to hear that payments will remain the norm." Apart from applicable "quiet period" restrictions during which a company and related parties cannot disclose information publicly, external communications

can actually improve the deal-making process. A strong PR strategy will get the word out about a sale to analysts and others who can influence corporate acquisition decisions, priming the pump for potential buyers. (see *Pricing and Positioning the Business for Sale*).

## M&A TIMING

U.S. 2013 total	\$893.1 billion
Q1	\$178.8 billion
Q2	\$168.4 billion
Q3	\$324.8 billion
Q4	\$221.1 billion

Source: Mergermarket M&A Trend Report, Mergermarket, Jan. 3, 2014.

- <sup>1</sup> *Mergermarket M&A Trend Report, Mergermarket, Jan. 3, 2014.*
- <sup>2</sup> *Lea Peterson and Stella Voules, Reflections on M&A: The Human Capital Dimension," Mercer Human Resource Consulting, 2007.*

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## PRICING AND POSITIONING

### ► SELL-SIDE DUE DILIGENCE

With valuations as their basis, manufacturers seek to convince potential buyers of the business' worth. Sell-side due diligence looks for both issues that negatively impact sales price, allowing the seller to counteract them to support the desired valuation, and hidden positive features that may boost sales price. "Thorough sell-side due diligence provides an opportunity for a seller to identify and correct problems before getting in front of buyers," adds Ryan Guthrie, Transaction Advisory Services partner at BDO.

Sell-side due diligence should address:

#### *Business basics*

Document the company's financial history, including earnings, cash flows, debts, and obligations.

#### *Working capital requirements*

Identify requirements to maintain current and future business performance (to drive ongoing operations) or to close down the business (to assist the liquidation).

#### *Sales forecasts*

Quantify future business demand, relying on contracts, market forecasts and realistic sales-staff expectations. This analysis should differentiate by products, markets, distribution channels and customers (e.g., a high sales forecast for a large, growing customer can offset tepid forecasts elsewhere).

#### *Business relationships*

Affirm that business is not driven by personal relationships that will end when the current owner exits. The seller will also need to reassure the buyer that favored pricing and performance levels with suppliers will survive the transaction.

#### *Accounting practices*

Detail procedures and assumptions in a manner consistent with industry standards.

#### *Risks*

Smart sellers quantify risks in anticipation of buyer concerns, e.g., "What if a competitor releases a superior product? What if the senior leadership team retires? What if a new law/regulation/tax is passed?"

## EXECUTING THE SALE

A willing and prepared seller is only one half of a transaction — and a long way from a done deal. Sellers need buyers, as well as a path to negotiate and close a deal.

### ► FINDING A BUYER

Finding the other half of a transaction (a buyer) depends on the reason for sale (transfer vs. liquidation) and the needs of buyers. Strategic acquirers look to complement their operations, expand capacity, acquire IP, etc., while financial buyers (such as private equity firms) seek stable earnings, cashflow, and/or profitability.

Some potential buyers may be executives at the company. Others are located by leaders directly through their business, industry, community, philanthropic/or personal associations and member organizations. There also are a growing number of online resources that match business sellers and buyers, such as, BizBuySell.

Most deals — even small- and midmarket manufacturers — involve a middleman (a broker or M&A expert) who assists in identifying suitors. This intermediary, in cooperation with the executive team, also manages the transaction process and presents the organization to *multiple* potential buyers to spur *multiple* bids and higher selling prices.

### ► EVALUATING OFFERS

At this stage, potential buyers submit formal letters of intent prior to discussing or negotiating any pricing.

"When offers do arrive, the executive team must analyze not only the math behind the valuation, but the intangibles that matter — or should matter — to both buyer and seller," says Sosoff. "For example, when transferring ownership, it's not unusual for owners to focus on offers that present the best path for the business going forward (i.e., retain their legacy) and that put shareholders, colleagues and employees in a position to sustain their livelihoods. Other intangibles, such as non-compete agreements for a given market or period of time, will profoundly impact the selling price."

The actual sales price also should reflect requirements on the existing owner. It's not unusual, for example, in the sale of small- and midmarket businesses to require existing owners to stay on, even if only for a transitional period. Compensation, and even part of the sales price, can depend on the current owner's continued cooperation.

Yet even an "agreed-to" value isn't quite the final selling price; *how* the sale is structured also matters. For example, a buyer may want the deal structured in a manner that has negative tax consequences for the seller; conversely, a buyer may want the seller to assume existing debts. Either issue can dramatically impact the final selling price.

### ► CLOSING THE DEAL

A buyer agreement formalizes all conditions necessary to close the sale and transfer ownership. Post-sale takeover of assets and integration of the company is driven by the buyer, and the seller may have little or no voice in these decisions, even if he stays on in a leadership capacity. This is likely the seller's last chance to change or alter the post-sale landscape.

It is not unusual for the end-to-end sales M&A process to take more than a year, even when both sides are eager to complete the process. Savvy executives will resist the urge to rush and will instead carefully review the sales agreement to ensure that it reflects all conditions agreed to by owner and buyer (purchase price, assets, contingencies, fees, closing date, etc.). When it does, the seller signs the agreement, closes the sale, and rides off into the sunset...or into the next business venture.

## ABOUT BDO

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## FOR MORE INFORMATION

For more information on these and other service offerings for the manufacturing and distribution industry, please contact one of the service leaders below:

### CONTACT:

#### HOWARD SOSOFF

Manufacturing & Distribution  
Practice Leader  
414-287-1115 / [hsosoff@bdo.com](mailto:hsosoff@bdo.com)

#### MATT BECKER

Tax Partner, Grand Rapids  
616-802-3413 / [mkbecker@bdo.com](mailto:mkbecker@bdo.com)

#### BRIAN ECCLESTON

Assurance Partner, New York  
212-885-8220 / [beccleston@bdo.com](mailto:beccleston@bdo.com)

#### SEAN HENAGHAN

Assurance Partner, Chicago  
312-233-1803 / [shenaghan@bdo.com](mailto:shenaghan@bdo.com)

#### ISSY KOTTON

Assurance Partner, Los Angeles  
310-557-8266 / [ikotton@bdo.com](mailto:ikotton@bdo.com)

#### FRED ROZELLE

Assurance Partner, Detroit  
248-244-6544 / [frozelle@bdo.com](mailto:frozelle@bdo.com)

#### RICK SCHREIBER

Assurance Partner, Nashville  
615-493-5641 / [rschreiber@bdo.com](mailto:rschreiber@bdo.com)

#### JOHN TUCCI

Assurance Partner, Woodbridge  
732-750-0900 / [jtucci@bdo.com](mailto:jtucci@bdo.com)