Business Sale Series

Time Becomes Your Enemy

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In every sale transaction there is a window of vulnerability for the seller. Three key risks present themselves during this window:

1. *Completion Risk*
2. *Valuation Risk*
3. *Disruptions to Ongoing Operations*

Greater than 75% of private business sale processes fail.

Time Becomes Your Enemy

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.

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. If you're considering selling your business, 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 three inevitable risks that a seller will encounter in an M&A transaction.

Inevitable Risk No. 1 - Completion Risk

Greater than 75% of private business sale processes 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.

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. Even if market conditions are 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 by 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 distressed selling resulting from the crisis flooded them with lower risk investment opportunities that would provide better returns than buying our client's business at a pre-crisis valuation.

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 and until the transaction closes, the seller bears the full performance 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. After the process was eventually launched and 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 quickly 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

A business owner's main concerns during negotiations are typically with their stakeholders and business performance. The buyer's objectives in pursing a sale, by contrast, are as follows:

- Minimizing completion risk
- Minimizing time investment
- Minimizing due diligence and legal expenses
- Acquiring a clean, low-risk target company

The buyer's problems are your problems too…

Negative surprises in your business can impact valuation and cause buyers to walk

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4. *Acquiring a clean, low-risk target company*

Acquirers can expend significant **time** and **resources** to complete an acquisition...

When a seller undermines the acquirer's confidence that they can successfully complete a transaction in a timely an efficient manner, the acquirer is less likely to remain engaged.

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. A private equity fund will typically spend $100,000 to $250,000 to complete the due diligence, legal work and secure the financing commitments required to table a binding bid. Their decision to engage in an acquisition process is based on their assessment of *their* completion risk and the cost of their foregone opportunities to pursue other acquisitions. 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. Sellers that conduct themselves in a manner that shows inexperience, unresponsiveness, non-market expectations or erratic behavior risk scaring otherwise qualified bidders away.

- **The acquirer's priorities change:** Current acquisition projects being derailed by urgent, higher-priority acquisition opportunities is a common occurrence. We were once 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. Such a loss of momentum is often fatal to a sale negotiation.

- **Financing pressures:** Like it or not, the bank is often a significant constituency 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 withdrawn.

- **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.

Value

=

Performance Metric

x

Valuation Multiple

A potential acquirer can grind one, or both, of these to reduce their initial price...

The longer the window of vulnerability, the greater the risk of leaks:

Leaks and speculation about an impending sale have the potential to undermine the confidence of customers, have undesirable effects on employee morale, and elicit feelings of mistrust and anxiety.

Inevitable Risk No 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. 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.

Inevitable Risk No. 3 - Disruptions to Ongoing Operations

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 a 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.

About the Author

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

Paris Aden, Partner
Valitas Capital Partners

Office: 416.556.0887
Cell: 416.931.1559
paris.aden@valitascapital.com

www.valitascapital.com
www.linkedin.com/in/parisaden

Distractions from regular business operations

Rumours surrounding a business sale may lead to undesirable consequences. Otherwise loyal customers who perceive financial distress may take their business elsewhere, and employees may fear for their job security and begin seeking other opportunities. For management, it can be challenging to maintain business operations up to standard while also navigating the demands of negotiating a sale.

Read our article that discusses various strategies that can be employed to mitigate all three of these risks.

For more information, visit us at www.valitascapital.com

Valitas Capital Partners is a corporate finance advisory firm that specializes in private market mergers and acquisitions. We collaborate with and support business owners in transition. Our clients are dedicated business owners who have built great enterprises. Valitas ensures they receive full recognition of the value they have created over many years.

The most successful transactions are those that surface the Outlier, that one acquirer or investor who sees more value in a business than does any other. Our team has been identifying and accessing these Outliers since the mid-1990s. We have learned from the best professionals at leading global investment banks, having completed greater than 200 M&A transactions and financings worth in excess of $125 billion. This formidable institutional training is balanced with our personal entrepreneurial and private equity experiences. Our team appreciates the discipline required in building successful businesses and investments.

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