M&A SCIENCE

The Exit Strategy Playbook:

The Definitive Guide to Selling Your Business

Adam Coffey's Background

For 21 years, Adam was the President and CEO of three different large private equity-backed companies, two of which he built to a billion-dollar size. His military and engineering background as well as exposure as an executive at GE has led to a career in private equity-backed companies. Coffey has written two books, The Private Equity Playbook, and The Exit Strategy Playbook: The Definitive Guide to Selling Your Business, that share advice on how to sell a company for maximum value.

The Universe of Buyers

There are a multitude of places someone could sell their business to and people need to be aware of different buyer types.

- Who are they?
- What are their needs?
- How does one know if they are a good strategic fit for a business?

There are three kinds of buyers: strategic, financial, and alternative.

Strategic Buyers

Strategic buyers are following an investment strategy to either expand into a new geography, build density within their current business, or add capabilities to their business. Building density in existing markets, expanding into new territory, or adding a capability to a company are all strategic pivots. Whether a buyer is public or private, or if they are private equity owned, they are still strategic. When a company buys another company, it's a strategic buyer. For example, Morgan Stanley buys Z Trade - Morgan Stanley is the strategic buyer.

Adding capability to a business is important. When a strategic buyer buys someone else the same size as they are, strategy is less important. Sometimes, small companies cannot find a financial buyer who is interested in them and their options become limited. Strategic buyers usually don't care how big or small a company is unless they are going into new territory. Smaller companies work with strategic buyers just fine.

Types of Strategic Buyers

Strategic buyers fall into one of two categories: a “keep the lights on” buyer and a“turn the lights off” buyer. A “keep the lights on” buyer, will have the entrepreneur selling the business stay with the company after the sale. The seller will become a rollover investor in the strategic company and will keep running the business.

A “turn the lights off” buyers are not interested in buying the seller’s ideas. They are buying the customers, contracts, employees, and manufacturers and are not interested in the owner or what they bring to the table. There may be a consulting relationship that gets put into place to assist in the transition of the business from owner to owner. When the synergies are harvested and everything’s integrated, the selling entrepreneur would flip the light switch off and walk out the door.

This distinction is important to sellers when looking for a buyer. If the seller is 70 years old and just wants to retire, they probably don’t want a strategic buyer who is going to keep the lights on. As a seller, understanding the different types of buyers will help you start to think about what is important in your future.

Financial Buyers

A financial buyer is essentially one of the 6,000 private equity firms that are out there currently, with over $5 trillion in assets under management. There is roughly $1.5 trillion in capital that's committed to buying companies immediately. Private equity has grown tremendously in the last few years. So much so, that in 2022, over 50% of all companies bought and sold in the world were bought by a financial buyer.

Private equity partners will raise from limited partners and create a fund that will last about ten years. During the first three or four years, the partners are buying companies. Then for the middle of those ten years, they're building companies. At the back end of those years, they sell the company off the fund. Once the company is sold, they roll onto the next fund and start all over again. The capital usually comes from public pensions, university endowments, wealthy families, or other investment companies that are providing alternative asset investing for their customers.

These firms segregate themselves into little niche markets and invest in different verticals or in different sizes. Most commonly, they invest in certain size attributes. For example, a small private equity shop will start buying small firms. As the firm grows the companies bigger and hands them off to bigger private equity firms, those firms will continue to grow the company and hand it over once again. There are typically three flips through private equity that happens before a company hits the public market.

Financial buyers are out there, they come in all shapes and sizes, and play in every industry. From funeral homes to veterinary clinics to dentist practices, to insurance agencies… there isn't an industry that private equity doesn't play in. Because of that, leadership will stay with the company to help with the transition post-close. Leadership becomes a significant rollover investor in any new holding company (that is then going to grow). Firms will be looking to grow the business they acquire upwards of 25% to 30% within fragmented industries. There are no synergies left to harvest because the private equity people are just bringing in a checkbook. The investment is the entrepreneur rather than the company itself.

When thinking about these different classes of buyers, there are people that think about someone's life as a seller. A seller has to navigate the market and see who fits the business and will fit the needs of the seller. As a seller, there should be goals and objectives of what the buyer should look like. Trying to line up a buyer with those goals should be the number one priority. Put some time and effort into understanding who the types of buyers are, where you are at in your own life, and what you are looking to accomplish to navigate the sales process.

Financial Buyers

Alternative buyers are considered everything else. The majority of companies are bought and sold to either financial or strategic buyers, but there are a lot of other businesses or organizations out there that are also potential buyers. An advisory team can help direct a seller to these kinds of buyers. These kinds of buyers include, but are not limited to:

- Management led buyouts
- ESOPs
- IPOs
- SPACs
- Owner Operators

Owner Operator Scenario

The first kind of alternative buyer is an “Owner Operator.” Owner Operators are very popular with small service firms. Dentist offices, law offices, veterinary clinics, landscape companies, and dry cleaners, are all examples of small service firms. They are little companies that do a bunch of different things for the community. An example of an owner-operator buy-out is when a business owner is getting close to retirement age, and brings on a partner. This partner works side by side with the owner and does a handoff with the person retiring. This exchange would be common for a small business that is not large enough to cater to financial buyers.

Management Led Buyout Scenario

There may be a strategy to roll up an industry with another owner-operator in the area who could take over a business. Management led buyouts happen most commonly when there is a second generation taking over the business. A first-generation-run business needs liquidity. They have to have some type of sales transaction.

A friendly transaction could also be that the first generation is leaving and there is no second generation to take over, but management really cares for the employees and want to take care of them. So senior members of the leadership team pool together resources to make an equity investment in the company.

These are typically friendly transactions because everybody knows everybody. But there can also be issues when the seller doesn't know what the market conditions are. To avoid this, build a team of advisors, of competent counsel, to help represent the buyers and sellers to ensure good market terms are made.

ESOPs Scenario

ESOPs stands for employee-owned stock options. These are not as popular in comparison to other types of buyouts as there are only 6,717 in the United States.

ESOPS are used for a few different reasons. ESOPs are a tax shelter for a seller that can defer taxes for a long period of time. If a business is doing good but not growing very fast and is not very attractive to a financial buyer, they can use an ESOP as a path out.

If a founder loves their employees and wants their employees to own the business, they can use ESOPs as a selling mechanism.

IPOs Scenario

IPO stands for initial public offering. People will advise companies to go public when they have at least a hundred million in revenue, but Coffey advises companies to wait until there are at $500 million to a billion dollars in revenue to be successful post IPO. Relatively speaking, a small business will have thinly traded stock and will not have the same benefits of going public. But, they will have all of the downside complexities of being a public company. Another downside of IPOs is how hard it is to take a company public.

SPACs Scenario

SPAC stands for special purpose acquisition company. SPACS are all the rage currently because taking a company public is hard. If a company takes money publicly through a SPAC by raising capital but the company doesn't do anything, they aren't reliable investors. No one knows what will be bought until they buy it. One may encounter a SPAC as there have been a lot of them formed within the last few years.

Preparing to Sell

What does it mean to prepare to sell? The first thing to recognize is the correct time to sell the company. These things take time and focus. Ideally, one will start preparing to sell two to three years in advance. Coffey's book "The Exit Strategy Playbook," focuses on selling a company for maximum value, rather than selling quickly.

People do wake up and sell their companies with five minutes' notice. However, the more time one spends planning for a sale, the outcome is typically better. In order to prepare to sell, there are financial reporting, real estate, and aligning operations that must take place.

Financial Reporting

If someone is an entrepreneur who started a business, their number one objective is to not pay taxes. They are layering on all the expenses. They minimize taxes in an appropriate manner, but when it is time to sell, people focus on their EBITDA. Buyers focus on the earnings of a company. They want to see three years of normalized financial statements representing what is going on within the business. This requires an outside advisor, an accountant, and someone to help out from a tax perspective.

All buyers are going to do a quality of earnings report to determine what the true earnings are. Sellers should do a sell-side quality of earnings before they sell, so they know exactly what they are going to see. The seller should share their findings with the buyer and explain any adjustments or items added back to earnings so nothing is missed.

Real Estate

A lot of entrepreneurs own real estate as a part of their portfolio. Most buyers do not want to buy the real estate with the business. Why not? Because real estate is a different asset class, it requires a different diligence set, which creates another hurdle for buyers to go through. A buyer could love a business but hate the real estate attached. This could cost the seller potential bidders on the business if the real estate is not attractive.

Before selling, spin out the real estate. Put the real estate into a separate holding company. Make sure that there is spare market rent in pace with the company that is ultimately going to be sold. One can always sell the real estate separately. The point is, real estate adds a lot of complexity to a transaction. It is already hard enough to get top dollar from the perfect buyer, so don't make it harder than it needs to be by including real estate in the transaction.

Aligning Operations

If the potential buyer is a financial buyer, they will want to grow at a rate of 30% per year over the next five years. The seller will need to have a plan or explanation of how to achieve this growth. Tell them the story of the business they are investing in and how they will bend the curve.

The buyer will want the capital cause of the business. They will have all different kinds of things they want to view, organic versus inorganic growth, evaluate where the company is staying versus going, and how to build a team. There is no one-person company rolling out the back door with no one left to build the business. Create a team to stay after the sale.

No one wants to buy an asset that will do nothing. Everyone wants to buy an asset that they can grow. A seller needs to show the buyer the path to growth. Even better if the seller can demonstrate the increased growth potential for a few years before getting into the sale.

What is the story during recessions and pandemics? If a seller owns a chain of movie theaters and the pandemic hits and shuts down, and the business revenue hits zero - what did you learn?

- What strategic pivots did you make?
- What is the story?
- If the business was hammered during a downturn, what did you learn?
- What would one do differently?
- How does a buyer know that if there is another crisis, and the business gets hammered again, will the same thing happen to them?

All of these questions need to be answered in order to get the maximum value of the sale.

Although there are a lot of things that need to be done in order to sell, it will help the seller run a better company and ultimately increase growth rates and earnings which will make the business more valuable.

Building an Advisory Team

Everyone should build an advisory team as they are selling their team. A lot of entrepreneurs think they are an expert in running a business, and that translates to being an expert in selling their business. There are plenty of people who are looking to save themselves money by taking advantage of an inexperienced seller. Although there are good buyers, who are reasonable and customary, and help educate the sellers, there are plenty of people who don't. And those people will take advantage of any young or inexperienced seller.

To level the playing field, build a team of competent advisors.
A seller will need tax advice and accounting advice in addition to lawyers and investment bankers.

Tax Advice

When selling a business, there will undoubtedly be a need for tax advice. As a person, you are about to have a giant windfall. How one structures a deal, how one prepares to receive the windfall, and where it goes upon receipt will directly impact how much taxes you will pay and how much wealth you will preserve for yourself and future generations. Plan for this in advance of the sale!

Accounting Advice

Accountants will help normalize the books, prepare the quality of earnings on the sell side and help coordinate the diligence. The sale process can be onerous, accountants help mitigate some of it.

Legal Advice

This is not the time to rely on a good old buddy that you've known for forty years. There are a lot of lawyers out there. Equate this deal to medical. If someone has a brain tumor and needs surgery, they don't go to their dentist and ask them to perform the surgery in an attempt to save a few dollars. In medicine, there is a time and place for a generalist and a specialist. In law, it is the same thing. Selling a business is a specialty area of practice. Hire a competent business attorney that does nothing but buy and sell companies all day long. Incompetent lawyers will argue the wrong thing, not because they passed the bar and they aren't lawyers. Because they aren't business specialists and it can cost their clients millions.

Investment Bankers

When you sell a house, you hire a realtor. The realtor determines market properties and evaluates a price. The realtor deals with open houses and buyer inquiries and inspections, along with paperwork and contracts. Investment bankers are like realtors for companies. They will help a business owner prepare marketing material and get the business ready for sale. Investment bankers help negotiate prices and terms and help sellers find the right buyer. Investment bankers are an important and key part of selling a business.

Although there is a fee, that is okay. Private equity is some of the most sophisticated financial people on the planet. They never buy or sell a company without the services of an investment banker.

If private equity is always using an investment banker to sell a company, so should everyone else.

Most investment bankers and private equity firms come in different sizes and shapes and focus on different verticals and industries. A small business will probably not be big enough to get into a small boutique investment banker. In those cases, small businesses are typically sold through owner-operator scenarios. For smaller businesses, brokers are also an option. Brokers are investment bankers but only specialize in smaller companies, and typically within niche industries.

Generally, investment bankers handle larger companies, but multi-billion corporations, while brokers handle smaller stuff that isn't big enough to excite the investment bankers.

The Sales Process

All sales processes kind of look the same, they're predictable but they're effective. There is a reason why people have been doing it the same way for eons. As the seller, leverage this to get the most out of your deal. Within a typical sales process, there is a marketing flow, there are some interactions with buyers, there's a rollover investing in residual income stream, and ultimately there is a buyer chosen.

The Marketing Flow

The marketing flow starts out with a one-page teaser. This page doesn't say much about the company, it doesn't even identify the name. It just identifies a company that is coming to market within a certain industry. Those teasers go out there, and people respond by asking for more information, leading to non-disclosure agreements, leading to a "fireside chat."

It used to be typical for a hundred teasers to be sent out. Nowadays, processes are usually smaller and more targeted so only about twenty to thirty teasers are sent. In this example, let's say 15 of the 30 people who received a teaser come back asking for more information and offering to sign an NDA. At that point, the investment banker would then determine what five to ten potential buyers have the potential to pay the most money for this. They'd call up the CEO or founder and do a fireside chat and do an elevator pitch, answer some high-level questions, and kind of start the conversation.

From this point of the process, it's time for a confidential information presentation (CIP). Essentially, a CIP is a hundred-page book (typically in powerpoint form) with lots of names, org charts, bios, industry data revenue, historical data growth plans, sales stories, etc. It is the prospectus. Now the banker will ask the buyer where they are at, and bids will start coming in from people who are still interested.

Understanding Bids

Bids will be expressed as ranges, as an indication of interest. Some find it convenient to stack up indications of interest as horizontal bar charts so it is easy to see where the intersection is. If there are wide bid ranges, that means that the buyers don't know the story or understand the business. It means the seller hasn't done a good enough job of preaching what the business is all about. When there are narrow ranges, in a tight little groove, the bidders understand the story.

Interacting with Buyers

Now in this process, management meetings and dinners will now come up. At this point, the seller has to be on their A-game when they are up in front of people. Do not let a guard down at this point. A mental mistake will cost you millions.

Usually, a team flies in, in the afternoon, there is a dinner, and then the next day there is a four-hour meeting, and then the team leaves. Maybe another team will fly in that afternoon and the process repeats. This can go on for weeks. It is mentally exhausting to talk about the business for four hours at a time, with a team of people. As one gets mentally tired, they start to make mistakes.

There's always dinner at these types of meetings. And with that, there are casual drinking and side conversations that take place. Be aware of what you say in these side conversations as it may tip off a potential buyer as to how the sale process is going or how many other people are involved in the bidding.

These meetings and dinners help transition to refresh bids, and letters of intent. Through these next two steps, a potential buyer will be ahead of the others. Managing bidders and bids are where the banker really earns their money. Not just the marketing, but the strategy to navigate the process to achieve the best outcome.

Closing the Deal

Ultimately, a deal has to be financed and there has to be a closing. Like a realtor, the investment banker earns their keep upon closing a deal, which is when the commission is paid. Although there are retainers and expenses covered along the way, investment bankers make their money by getting the deal to a closing table.

Roll Over Investing

One of the best things about selling to a strategic buyer who keeps the lights on, or selling to a financial buyer as a platform, is the ability to make a rollover investment. Ride the coattails to potentially make a rollover investment to get not only liquidity today but liquidity in the future.

One of the most powerful things about selling to a strategic or financial buyer is the ability to co-invest and continue to ride the growth of your business to get a second or third payday. A lot of entrepreneurs think about selling a company as one-and-done, they want it sold and all of their money off of the table. Instead, they can have a strategic buyer keep the lights on.

Choosing a Buyer

Ultimately, a buyer has to be chosen. Price is not the only thing that matters. It is important, but not the only thing people care about. Employees are something that needs to be considered. Owners care about how employees are treated and want to make sure they go to good stewards who will be mindful of the empire they've built.

As a seller, take some time to reflect.

- What are you trying to accomplish?
- What is the legacy you are trying to leave behind?
- What do you think about your employees?
- Which category of buyer is going to treat your employees well?
- What is an ideal buyer for your situation?

All of these things should be thought about before a sales process ever really starts. Once they are answered, build a team of people who are going to help navigate the process to get the maximum value of the sale.

Changes in Selling Processes Driven by SEC Scrutiny

There are nuanced changes to the law that occur all the time. Think about Sarbanes Oxley as an example. After the financial meltdown, some laws changed and impacted their ability to finance, leverage debt and establish payback periods.

We are currently living through a time period of high inflation, which we haven't seen in decades. Ultimately, as interest rates pick up, a buyer using leverage in addition to equity, won't allow them to leverage and put as much debt into the transaction as they may have done in the past.

Interest rates matter when debt is a component of the financing. There are nuance changes all of the time. Recessionary cycles impact sales, volume and prices, and regulatory changes, and are often driven by changes in policy.

When speaking on the sheer volume of money that has to be deployed when there is a sheer amount of money that is increased, there will be more people bidding for businesses and bids will be higher. There are cycles that come and go, but generally speaking, the SEC Scrutiny has impacted deals to some degree. It causes dry periods as well as periods of rapid activity and every variation in between.

Economy scale factor into yield terms?

Typically bigger gets bigger. When there is a bunch of capital that needs to be deployed, it is hard to buy small companies, because it takes too much of it to deploy the capital.

When people are buying or selling bigger companies, they have to have inflection points that match. For example, the first real inflection point, using a very broad scale, is around 10 million. If the company is below 10 million, it will trade for a lower multiple. There are different multiples at 10 million than when a company is at two or three million. When a company is at an inflection point of 40 million, it will trade for a much higher valuation.

In terms of entrepreneurs, only 7% of entrepreneurs who start a company will get to a million in revenue. Only 4% of those entrepreneurs ever get to 10 million in revenue. Only a small portion of them ever get to a hundred million.

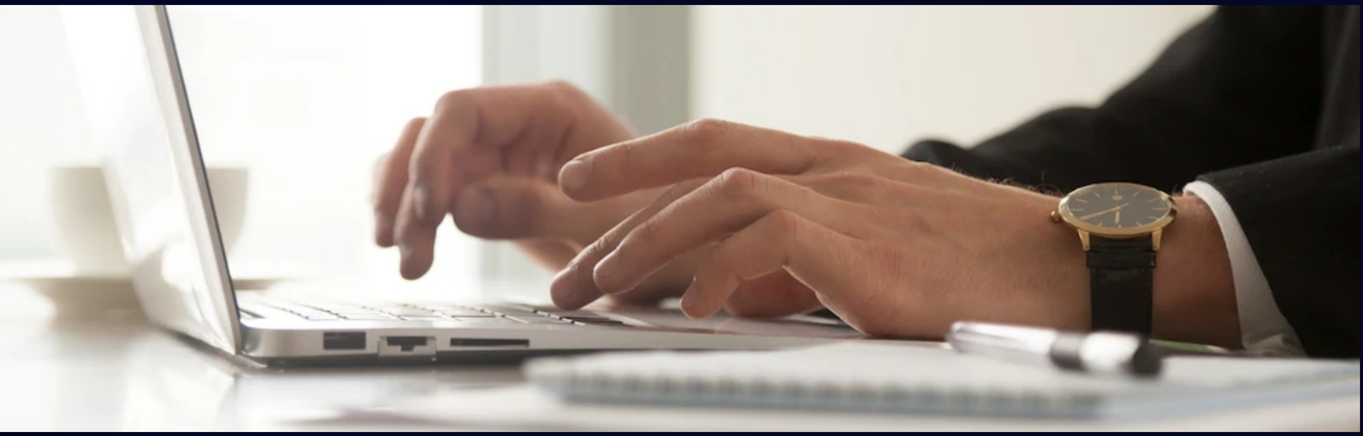
Approaching Private Equity directly versus Investment Brokers

Anyone who is selling a business should hire an investment banker. Let them do that work for you as you already have enough to do in running the business and preparing it for sale and diligence.

There are some investment conferences that are super helpful in pitching a company to investors and potential buyers. Hundreds of potential private equity firms might have partners at the conference. There are hundreds of potential private equity sponsors. Some do speed dating with them and work in a crowd. Generally speaking, first-time sellers should always bring in an investment bank to help them out and small companies should bring in a broker. These people will help you navigate the processes as there is a lot to do.

The biggest mistake people make upfront is assuming just because they are an expert in their own company, they assume they are an expert in selling their company. Be sure to build a team of specialized advisors. Even when there is a team of people, there are still a million business points that need to be negotiated. Lawyers can protect sellers with language but can't make a business decision for you.

Having a team is better than having no team, having the best team is better than having a mediocre team. Different size companies have different size problems and solutions, so there needs to be legwork to create a team that is applicable to the problems at hand.



Interested in learning about more ways to improve your M&A processes?

Check out the M&A Science Academy! The Academy is an outcome-based online workshop program, taught by the industry's leading practitioners. Members have access to **60+ courses,** networking events, educational ebooks, podcast lessons, and more.

LEARN MORE