CITY NATIONAL ROCHDALE
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Business Owner Advisory

Navigating the Exit: Selling to Private Equity

Choosing to sell your company is a monumental moment for any business owner and will have significant implications for the future of the enterprise and its stakeholders. One of the exit options business owners explore is selling to a private equity (PE) firm.

PE firms are sophisticated investors who seek to acquire quality businesses with the goal of increasing that company's value in anticipation of a profitable future sale. While most entrepreneurs navigate a sale process just once, PE firms are seasoned in buying and selling companies. Consequently, if you are contemplating a sale to a PE firm, these key considerations can help you be more informed as well as help you meticulously prepare ahead of formally launching the sale process.

Throughout each stage of a business sale—before, during and after—there are various issues worth your time and focus. While some sellers will wait for there to be an offer in hand before formulating a response, the most well-prepared business owners look to optimize their exit by enhancing their deal knowledge and incorporating exit planning into their overall business strategy. This proactive approach can empower you to make swift decisions and act decisively when the opportunity arises.

IN ADVANCE OF THE SALE

Pre-Sale Business Preparation is Imperative

Preparing your business to sell (regardless of the ultimate buyer) is a process that often involves numerous action items to create maximum value and attractiveness to potential acquirers.

Financial Cleanup

- Review the accuracy of company financial statements, determine whether upgrading to reviewed or audited financial statements is worthwhile, and consider obtaining a quality of earnings study.
- Identify (or preferably, remove) owner discretionary expenses from the financial statements.
- Estimate working capital to determine if there is any excess that could be removed from the business (and potentially replaced by utilizing a business line of credit).

"WHAT IS A QUALITY OF EARNINGS STUDY?"

A Quality of Earnings (QoE) study is a thorough analysis of a company's financial condition. By evaluating factors such as revenue recognition and expense classification, the study provides a detailed assessment of the company's historical financial performance and an evaluation of the sustainability of its future potential earnings.

Operational Efficiency

- Document and streamline processes to reduce inefficiencies.
- Demonstrate the business can run smoothly without reliance upon your involvement.
- Consider implementing systems that can easily be scaled as the business grows.

Capital Expenditure (CapEx) Evaluation

- Assess and prioritize current CapEx projects that enhance the business's competitive position, efficiency and profitability.
- Evaluate the return on investment (ROI) for each project to ensure these investments are generating sufficient returns.

Management Assessment

- Evaluate the capabilities and effectiveness of your management team, particularly your second tier, to ensure continued operational success after you exit.
- Invest in management development and/or find external candidates to fill any gaps (if applicable, some sellers bring on a Chief Financial Officer (CFO) or engage an outsourced/fractional CFO service to help ready the company for a sale).
- Consider implementing incentive compensation structures to retain key management team members during and after the sale, aligning their interests with yours.

Legal and Compliance Review

- Ensure all contracts, agreements and legal documents are readily available, in good order and up to date.
- Identify and mitigate any potential legal or compliance issues that could deter prospective acquirers, including environmental regulations (if applicable).

Define Your Unique Selling Proposition

- Develop detailed financial projections to demonstrate the business's future earnings.
- Identify and track key performance indicators (KPIs) that acquirers should/would assess when evaluating your business.
- Articulate the business's unique value proposition and competitive advantage against identifiable and comparable peers.

Assemble Your Deal Team and Prepare for Due Diligence

Your deal team typically includes several professionals with different, specific areas of experience. By assembling your deal team early, they can help guide you through the process, assist in preparing the company, partner with your existing management team and other advisors, and help ensure you secure the most value and best terms.

- **Certified Public Accountant:** To provide advice and support on all financial and tax matters related to the deal;
- **Mergers and Acquisitions (M&A) Attorney**: To not only negotiate deal terms but also to review other professional advisor engagement proposals and offer insights on pre-sale company entity restructuring opportunities; and
- **M&A Advisor/Intermediary (i.e., investment banker):** To help you identify and source suitable buyers and support the execution of the sale process from start to finish.

Also, do not forget your personal deal team members, which often include: a trust and estate attorney, the family's CPA, and your financial advisor. One key area these advisors can assist with before the sale is exploring tax-efficient strategies to protect the wealth you have built in your business and suggest various planning structures for the family.

As with any buyer, expect to undergo rigorous due diligence by the purchasing PE firm and its M&A professionals. Due diligence will cover all aspects of your business, including:

- Financial
- Operational
- Human Resources
- Legal
- Regulatory/Compliance
- Industry-/Company-Specific (e.g., insurance, intellectual property, environmental)

WHAT IS DUE DILIGENCE?

Due diligence is the process by which a buyer performs a comprehensive examination of the company being acquired, which begins with substantial information requests once a letter of intent (LOI) has been executed by buyer and seller. It is often the most time-consuming and difficult part of the sale process if not prepared for adequately in advance.

DURING THE SALE PROCESS

Conduct Reciprocal Due Diligence

As part of a sale process, while PE firms will analyze your company in various ways, it is equally important for you to scrutinize these potential buyers to determine which one aligns best with your company.

Strategic Alignment

- Ensure that the PE firm's investment thesis aligns with your company's strategic goals and long-term vision.
- Will they be hands-on or hands-off?
  - Some PE firms actively participate in business operations, while others are more passive and let management continue to operate the business. You may want to inquire about speaking with other companies that the PE firm has acquired over the last few years to understand their level of engagement.

   - » Decide whether you prefer a PE firm that only brings capital to the table or one who can also provide industry expertise, operational support and valuable connections to help drive growth.
- What is their methodology around the use of debt/leverage?
   - » Be prepared to have a rationale as to how much debt the business can reasonably handle.
- Will there be additional capital/dry powder available for acquisitions and/or growth capital expenditures?
   - » Will you have the ability to co-invest to maintain your pro-rata ownership?

Investment Parameters

- Are they interested in majority ownership, minority stake, or either?
   - » Some PE firms will require controlling ownership in the business, while others may be comfortable with a minority investment.
   - » Keep in mind, minority investments often come with substantial rights that give the PE firm the ability to exert some measure of control over the business and even potentially force a full business sale in the future.

Cultural Fit and Track Record

- Assess the cultural compatibility between your company and the PE firm, as this can significantly impact the success of the post-acquisition integration process.
- Look for alignment in values, corporate culture, and management style.
- Evaluate the PE firm's track record of investments in your sector.

Second Exit

- Request information on the PE firm's typical exit strategy and timeline for realizing returns on their investment.
   - » Most PE funds have a 10-year lifecycle and may be forced to exit when capital market conditions are not optimal.
- In some instances, rollover shareholders may be asked to roll proceeds into the subsequent buyer's acquisition, which creates an even longer hold period.
   - » This can create a misalignment amongst the current shareholders (e.g., the PE firm, the rollover shareholder).

Focus on Both Valuation AND Deal Terms

While the valuation or multiple you receive is important, do not overlook the deal terms.

Determination of Enterprise Value

Understand how the PE firm is valuing your company.

- Is the valuation calculated on a multiple applied to EBITDA or Revenue?
- Is the offer contingent on the PE firm independently qualifying a specific EBITDA and/or Revenue target?

Stock Sales versus Asset Purchases

- Certain deal structures can have a material impact on the after-tax consequences of the sale as well as ongoing liability.
- Most buyers want the purchase classified as an asset purchase, which has a positive impact for buyers that could result in a portion of your gain being treated as ordinary income instead of capital gains.

WHAT IS ENTERPRISE VALUE?

Total Enterprise Value (TEV, or also commonly abbreviated as EV) represents the total value of a company's operations to all stakeholders, encompassing both equity shareholders and debt capital lenders. In essence, enterprise value reflects the theoretical purchase price of a company.

TEV = Equity Value + Net Debt

   » Understand the nuances between an asset purchase and a stock sale and how they might impact the after-tax proceeds depending on your entity status (e.g., C-corp, S-Corp, Partnership).

   » This is especially important for C-corporation shareholders meeting IRC 1202 qualified small business stock (QSBS) requirements.

   » Consider working with your tax advisor to determine if there is a material difference between the two deal structures.

Purchase Terms

- While some offers for your company may be purely cash deals, those are fewer and far between when selling to a PE firm.
- PE firms typically require selling owners to roll a portion of their equity into the new company going forward (i.e., "rollover equity").
   » How much rollover equity is required? And how much are you willing to roll forward?

   » In many instances, the rollover equity can be structured to avoid being a taxable event, and therefore the seller's capital gain can be tax-deferred until the subsequent monetization event.

   » Is the rollover investment on equal footing, sometimes referred to as "pari passu," with the PE firm's equity or is the rollover investment subordinate/junior to the PE firm's equity?

WHAT IS THE DIFFERENCE BETWEEN A "PLATFORM" AND AN "ADD-ON" ACQUISITION?

"Platform" acquisitions are generally new investments into a particular business, meaning it will not be combined with another existing investment.

"Add-on" acquisitions are often smaller or similar-sized companies undertaken to complement a PE firm's existing platform business.

WHAT IS AN EARN-OUT?

An earn-out is a deal provision that ties a portion of the purchase price to the future performance of the acquired company. Earn-outs attempt to align interests between buyers and sellers as well as mitigate risk due to uncertain market conditions and/or future company performance.

Earn-outs can be structured in various ways, including binary (all or none), tiered or a sliding scale, and are typically tied to specific financial metrics (e.g., Revenue, EBITDA) of the acquired entity.

   » If your company will be an add-on:
      - How is the PE firm valuing your company, the platform company it currently owns and the pro-forma combined entity?
      - If there is rollover equity in the deal, what percentage of ownership will you have in the combined entity?

- Some deals may include an earn-out based on future performance. Often, this is due to a "valuation gap" between buyers and sellers.
   » Give careful thought to the structure of the earn-out, including the timeframe, thresholds and causes for acceleration.
- There also may be a portion of the deal that is seller-financed, which means you agree to defer a portion of the purchase price and will receive a promissory note.
   » In other words, you fund a portion of the sale, which the buyer pays back over time. Payments should rarely stretch beyond five years, and interest rates should be based upon comparable current market rates.

   » Seller financing is frequently used alongside third-party financing, although it may also be a substitute for it. Keep in mind the buyer will likely require you to subordinate its loan to any third-party lender.

- Lastly, you should make note whether there are any holdbacks as part of the deal.
  - » Frequently, there are holdbacks (also known as escrow), for the indemnification provisions/ representations and warranties as well as for other items like target working capital.
  - » With your deal team, assess whether representations and warranties insurance is feasible as part of the deal terms, which could potentially reduce any required holdbacks.

Employment Matters / Management Transition

- Clarify your post-acquisition role and responsibilities, as well as those of the existing management team.
- If the buyer is expecting you to stay on, understand the requirements, compensation and benefits of the ongoing consulting agreement (shorter term) or formal employment agreement (longer arrangement).
- Many PE firms will keep existing management running the day to day for a transition period or longer to reduce key person risk.
  - » They often require ownership, management and key employees to enter into employment and non-compete/solicitation agreements.
  - » These agreements should be thoroughly reviewed and worded to limit the scope and impact on future business opportunities, investments and other impacted activities.
  - » In addition, PE firms often seek to retain key talent and may provide incentives such as equity or equity-like incentives for current and future key employees.

Increased Leverage Environment

- The majority of PE firms utilize debt/leverage in order to minimize the amount of the PE fund's equity invested in the deal.
  - » Sellers with rollover equity as well as continued employment should evaluate the amount of leverage, interest rate, amortization schedules and covenants as part of the ongoing operations.

Don't Forget about Governance

- After the sale, be prepared for increased oversight and formalized corporate governance.
  - » If the company does not have one already, the PE firm will likely establish a formal board of directors and require a specific (typically majority) number of board seats, as well as independent board members.
  - » Expect regularly scheduled board meetings and management presentations, enhanced reporting requirements, and additional scrutiny on key operating decisions and expenses.
- In addition, sellers often neglect the fact that they may be entitled to certain governance provisions themselves (which will vary depending on the rollover equity amount and involvement of the sellers post-transaction).
  - » Are you entitled to board rights in the new company? Are those rights conditioned on continued employment?
  - » What are your rights related to future acquisitions, leverage levels, PE related-party transactions and anti-dilution?
  - » Will you receive quarterly and annual financial statements on the new company if you retain equity but are no longer employed?

IMPORTANCE OF PERSONAL PLANNING

While the focus of pre-sale planning is often solely on improving the business's readiness and attractiveness, you should not overlook the importance of personal advanced planning. There are personal considerations that could potentially enhance the net proceeds received in a sale transaction and protect the wealth you have created for generations to come. With your personal advisors, consider:

- Illustrating gross and net proceeds from the sale transaction for your personal balance sheet
- Financial planning to model post-sale family goals and long-term legacy
- Income-tax mitigation strategies
- Gift and estate wealth planning techniques
- Asset protection and risk management
- Charitable giving and philanthropy
- Customized investment management

SUMMING UP

Selling to a private equity firm presents you with an opportunity to unlock significant value within your business while often retaining some additional upside. However, navigating this complex transaction requires careful planning and expert guidance. By understanding the dynamics at play and proactively addressing these key considerations, you can be empowered to negotiate the best deal for your company.

City National Rochdale and City National Bank have dedicated specialists who can help advise you in collaboration with your professional advisors on all aspects of your business transition, from the sale itself to personal financial planning and your wealth transfer plans. We pair sophisticated financial tools and modelling techniques with a personal approach to illustrate for you the financial benefits advance planning can help deliver. We recognize the connection between your business and personal finances, and understand that each decision you make affects your entire wealth picture today and in the future.

FORMAL OFFER QUESTIONS CHECKLIST

1. What is the purchase price, or enterprise value, being offered?
2. How is that price/value being calculated?
3. Will this deal be treated as an asset purchase or a stock sale?
4. How much ____ is being offered?
   » Cash Upfront?
   » Rollover Equity?
   » Earn-Out?
   » Seller Financing?
5. What (if any) employment expectations are there?
6. What corporate governance will be provided?