Transferring Your Family or Closely Held Business – Part 2

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With more certainty creeping back into the market following the unprecedented economic downturn of the COVID-19 crisis, business owners may be wondering whether now is an opportune time to bring their company to market. While the current market has presented several unique opportunities for both buyers and sellers, there will be several changes to the deal process due to the dramatic effects COVID-19 has had on the market. However, there are several financial and strategic planning steps businesses can take before going to market in the wake of COVID-19 to maximize and protect the value of the business.

Changes to the Deal Process

Valuations are typically driven by cash flows of the business. Now, however, valuations are expected to be calculated differently because, for most businesses, the 2020 financial statements are not reflective of the business's performance. Sellers will likely require buyers to add back any income loss from the business's 2020 financial statements to get a fair estimate of the value of the business. On the other hand, buyers will want to analyze the 2020 financial statements to determine how well the business performs in difficult times, or how recession-proof the business is.

Valuations are also expected to decrease in the coming months. Prior to COVID-19, interest rates were extremely low, there was high competition between lenders, and lots of available capital. The combination of these factors increased competition between strategic buyers and private equity firms, which led to record valuations. In the current market, lenders are expected to be less aggressive and are not likely to offer high leverage debt. Valuations will decrease in the short-term due to the decreased competition between strategic buyers and private equity firms. However, as states begin to reopen and more certainty returns to the market, there will likely be more activity in the third and fourth quarter.

Preparing for Market

Typically, businesses can expect to spend anywhere from six months to two years preparing to go to market. With the expected increase in due diligence efforts surrounding the effects COVID-19 has had on a business and the associated risks, businesses thinking of selling should start preparing for a potential transaction now. Taking the time to prepare a business for sale before the deal process begins allows the business to strategize and increase its value.

Some of the areas sellers should focus on is the corporate and financial hygiene of the business. Corporate hygiene includes reviewing and cleaning up the corporate records, ownership documents and minute book. Businesses should also ensure that intellectual property rights are properly protected, business licensing and registration is compliant and up to date, and insurance policies are in place and current.

Financial hygiene entails normalizing the company's financial statements. Buyers may become wary if the financial and tax documents of a company are in disarray or incomplete. Sellers should review deductions and salaries to ensure there are no personal transactions in the financial statements. In addition, all tax filings and retirement plans should be reviewed to verify that they are up to date and compliant.

Improving Profitability and Growth

Once a seller has decided to go to market, buyers will look for ways to reduce the purchase price. There are several actions sellers can take to improve profitability, which in turn will increase the valuation of the business. Sellers should prepare to go to market by creating a good team to handle the sale. A strong team will help the seller maximize valuation and typically includes an investment banker as well as accounting and legal professionals.

A company can improve profitability by diversifying its client or customer base. Customer diversification is crucial for sellers to focus on prior to going to market because buyers may view the purchase of a business dependent on a handful of clients as risky, which in turn will decrease valuation.

Sellers should also focus on resolving any outstanding contingencies and liabilities. When valuing a business, buyers prepare for the worst-case scenario. For example, if a company is in the middle of a lawsuit, a buyer is going to reserve a lot of money for that lawsuit, which may lower the overall purchase price. Similarly, if the company has key assets, sellers must ensure any legal issues regarding those assets are resolved prior to going to market.

Prior to going to market, sellers should minimize working capital as much as possible. Buyers expect some level of working capital to come with the company and typically analyze the working capital over the past twelve months to formulate the amount expected with the transaction. If a seller can decrease working capital twelve months before a sale, the seller could potentially end up saving millions of dollars.

For the sale of any business, timing is critical. Whether now is the right time to sell your business, there are several strategic steps to start taking now to increase the value of your business and prepare for a future sale.

This content was also featured in a recent Lathrop GPM webinar put on by Steven Kutscheid and Scott Malin; visit the Lathrop GPM website to view a recorded version of Transferring Your Family or Closely Held Business: Part 2. If you're interested in exploring these transfer opportunities, please contact Steven Kutscheid; Scott Malin; Corporate & Business Practice Group Chair Mark Williamson; Trusts, Estates and Legacy Planning Chair Courtney Conrad; or your regular Lathrop GPM contact.