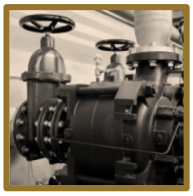
PREPARING FOR A CAPITAL EVENT

FOR PRIVATELY-OWNED COMPANIES

Industry In-Sight™





JORDAN KNAUFF & COMPANY

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Introduction

A successful transaction ... is typically the result of a systematic approach that involves thoughtful planning and solid execution.

Preparing for a capital event – whether it involves the placement of senior debt, mezzanine debt or equity capital, or the sale of all or part of a company – is far more complex and time consuming than most business owners realize. A successful transaction (one that closes and generates an acceptable outcome for the owners) is typically the result of a systematic approach that involves thoughtful planning and solid execution. With this in mind, the following best practices are being provided to private company owners for use as a blueprint in preparing for future capital events. For companies not anticipating a capital event, these best practices will be useful in maximizing the value of the company at any given time.

There are a number of junctures in the development of a private company at which an infusion of capital is needed to propel the business to the next level of success. These stages are summarized below and discussed in greater detail in our report "Life Cycle Capital Planning Industry In-Sight™" available upon request at https://www.jordanknauff.com/research-library/.

Although this report is primarily focused on the preparation stage, completing a sale or capital placement requires a number of additional steps. These steps are summarized in the figure below:

Figure 1 – Recommended Steps in Successfully Completing a Capital Event



Undertaking a thorough, disciplined preparation can help avoid numerous problems in later stages of the transaction.

After a company has been prepared for a capital event, it is necessary to identify potential capital providers or acquirers to be targeted and conduct selective pre-marketing to assess general interest in the transaction. Only then should a company move on to active marketing, which leads to identification of the best transaction partner and the final stages of negotiating and closing the transaction. We believe that preparation is the single most important phase of the capital sourcing process. Undertaking a thorough, disciplined preparation can help avoid numerous problems in later stages of the transaction. For that reason, we will concern ourselves in this report only with the preparation stage of seeking a sale or the placement of capital.

Since this report is intended to address best practices to remain prepared for sales of companies as well as the placement of debt and equity capital, it is important to establish the ways in which we will refer to these specific events. Throughout this report, when we discuss a topic that pertains mutually to sales and capital placements, we will refer to them collectively as "capital transactions" or "capital events." We will clearly distinguish between preparing for the sale of a company versus the placement of debt or equity capital wherever a given item applies to one type of capital event but not the

other. In these cases, an organization that is buying another company will be referred to as an "acquirer" or "buyer," while an organization placing debt or equity capital will be referred to as a "capital provider."

In order to undertake a thorough discussion of how to prepare for a capital event, it is necessary to first examine the various capital providers and the types of transactions in which they participate. The following sections cover the types of capital providers and the stages of a company's development at which they typically invest.

In order to undertake a thorough discussion of how to prepare for a capital event, it is necessary to first examine the various capital providers and the types of transactions in which they participate.

Stage 1 – Company Founding

Activities at this Stage

Launching a private company involves all of the activities necessary to prepare the company for operations. This includes securing machinery and equipment and a facility in which to operate, designing and configuring the operation, hiring a work force and numerous other tasks that must be completed prior to the start of business.

Rationale for these Activities

Private companies are founded to grow a profitable organization offering a product that meets a need in the market. In particular, new companies are often formed by former company executives or owners of related businesses who have sold their companies.

Providers of Capital at this Stage

In most cases, the capital to start a business is drawn from the founder's personal wealth or investments made by friends, family or business associates. In most industries, it is common for founding entrepreneurs to tap angel investors or venture capitalists – both groups that specialize in making equity investments in newly formed companies. However, these groups are usually drawn to high growth or technology based industries and are less likely to back the founding of an industrial company. In many cases, entrepreneurs start a company with their own capital and use the initial cash flow to continue to fund the capital needs of the company in its earliest stage, a practice called "bootstrapping."

Stage 2 – Early Expansion

Activities at this Stage

As a company's sales increase, there comes a point at which the company outgrows the facilities in which it initiated operations. In other cases, a company that began manufacturing one product may need to introduce an additional product line in order to continue its sales growth. Any of these reasons can lead a company to pursue the acquisition of new machinery and equipment or new facilities.

Rationale for these Activities

A company will undertake an early stage expansion as long as it believes that market demand for its products is sufficient to provide its desired return above the cost of the capital needed to expand the company's facilities.

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Working Capital Requirements – Private companies face working capital requirements at various times because of the need to ramp up production in anticipation of their busy season. This busy season comes at different times of the year, depending on product type, geography and other factors. At other times, extra working capital is needed in order to accommodate a company's unique cash flow cycle. Working capital requirements are typically met using bank lines of credit of less than one year in duration.

Bridge Capital – Companies turn to bridge capital when the need arises to finance specific projects or long-term assets, such as new plants or machinery. This might include a new production line or other equipment. Bridge capital usually consists of bank financing or institutional debt. In order to avoid interfering with the company's operations, servicing and repayment of the debt should be matched to the cash flow generated by the project requiring funding.

Providers of Capital at this Stage

Internal Cash Flow – Many companies manage capital needs with internal cash flow. This report is intended to address capital needs that cannot be met with internal cash flow.

Debt Placement – The most common type of external capital pursued by private companies is debt, typically provided by a bank. Larger companies have also accessed the capital markets by offering publicly traded bonds. These bonds and bank loans typically take the form of senior debt, which has a priority claim on the assets of a company in the event of liquidation. Some forms of debt, such as mezzanine or subordinated debt, also have equity-like characteristics and are often more expensive than senior debt. This allows their use for projects that cannot be financed with senior debt because of their risk profile.

Stage 3 – Later Stage Expansion

Companies preparing for or involved in later stage expansion represent the majority of companies ...

Activities at this Stage

Companies preparing for or involved in later stage expansion represent the majority of companies during times when the market is functioning normally. The typical company in the later stage expansion phase has prospered sufficiently to upgrade its facilities and has built a strong base of sales. Also, it has recognized and acted on the need to develop its management team and adopt professional management techniques. This phase of growth represents the longest period of a company's development and can last for several decades or, in some cases, seemingly into perpetuity. At some point in this stage of growth, many companies will make the decision to upgrade to a state-of-the-art facility. This allows for a quantum leap in productivity and eliminates many of the product defects and worker injuries that are caused by the manual handling of products.

Rationale for these Activities

Company in Transition – Securing a source of capital can be critical for companies involved in an important transition, whether it revolves around a change in ownership, the construction of a new facility or a change in the direction of the company. The company may need to create financial liquidity

for a certain group of shareholders or pursue a completely new market involving the addition of machinery and equipment or the acquisition of another company.

Strategic Initiatives – Capital is often needed to support a company's long-term strategic development. This could include expanding into a new geographic area that requires taking on a local partner. Other uses of strategic capital would include buying out a large portion of the founding family. Many companies today have a strong balance sheet and are looking for companies to acquire. Typically, the strategic partner in these transactions comes to the table with its own source of financing, whether internal or external to the company.

Providers of Capital at this Stage

Equity – An equity investment at this stage typically involves the sale of a non-controlling portion of the equity of a company. The sale may be undertaken to provide the owner with partial liquidity of his investment in the company or to provide the company with capital needed for growth. Ideally, the capital provider also brings expertise in the industry or other useful operational knowledge, increasing the value of the partnership.

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Mezzanine / Subordinated Debt – Some projects do not have the appropriate risk and return characteristics to attract an investment of equity capital. Mezzanine, or subordinated, debt may be an appropriate tool in situations such as these. As mentioned previously, mezzanine/subordinated debt falls just after senior debt and just before equity with regard to the priority of its claim on the company. Mezzanine debt is typically structured with a current pay portion and an equity enhancement, such as warrants to purchase stock of the company.

Stage 4 – Early Liquidity

Activities at this Stage

As the founding owners of a company near retirement, they become interested in monetizing a portion of the value they have created. Many company owners' personal wealth is primarily in the value of their business. Owners often seek to make their personal holdings more diverse and liquid, however, the reluctance to sell all or a portion of their business or to give up control restrains many owners from seeking liquidity.

Rationale for these Activities

A recapitalization, commonly known as a "recap," is a two-step process whereby, in the first step, a company takes on debt capital that, in the second step, is used to buy out a portion of the owner's interest in the company. Under current market conditions, companies can usually expect to be able to take on such a loan in the amount of two and a half to four and a half times their trailing 12 months earnings before interest, taxes, depreciation and amortization ("EBITDA"). A recapitalization creates liquidity without selling all of the ownership of a company, making it an ideal strategy for business owners who wish to maintain control of their companies while generating partial liquidity of their investment. Such owners typically believe their businesses will be much more valuable in the future, so they do not wish to sell their entire ownership.

... a "recap," is a two-step process whereby ... a company takes on debt capital ... that is used to buy out a portion of the owner's interest in the company.

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By selling a portion of their company, owners have the opportunity to redistribute their personal wealth into any number of liquid and diversified investment options. Also, an owner may seek liquidity because of personal debts or obligations that must be satisfied. Others require liquidity in order to provide for retirement, divorce or estate planning needs.

By selling a portion of their company, owners have the opportunity to redistribute their personal wealth into any number of liquid and diversified investment options.

Providers of Capital at this Stage

Mezzanine Debt Providers – Providers of mezzanine, or subordinated, debt are commonly involved in the recapitalization of companies. Mezzanine debt was discussed in detail in the earlier section entitled, "Stage 3 – Later Stage Expansion."

Private Equity Funds (Non-control Type) – While most private equity funds prefer to acquire controlling or 100% ownership of a company, there are funds that make non-control investments. These types of funds can be a good fit for companies seeking to achieve partial liquidity or complete a recapitalization.

Management Team – Sometimes, the owner of a company has created a plan whereby the management team will purchase the company at the owner's retirement. These plans may also take place in stages, rather than in a single purchase. In these cases, the management team purchases an interest in the company to initiate the process of an eventual buyout of the owner's remaining interests. Having invested their own capital in the company, the management team typically assumes a portion of the owner's duties, allowing the owner to work on a less than full-time basis.

Employee Stock Ownership Plans ("ESOP") – Employee Stock Ownership Plans, which are discussed in greater detail in the next section, are another potential source of capital for the partial buyout of a company owner's equity position.

Stage 5 – Final Liquidity

Activities at this Stage

The sale of a company is a natural final step in the company's life cycle. Most owners come to a point at which they realize that they wish to exit their business and they understand the advantages of orchestrating an orderly sale of the company while they still control it. Allowing the transition of a business to take place as a result of the often slow and plodding estate settlement process is an extremely risky strategy. It is likely the company will be vulnerable to inroads by competitors for a long period of time during the settlement process. Competitors may even use the estate resolution process to cast doubt on whether the company is a dependable, ongoing entity.

Rationale for these Activities

The reasons that company owners move through the earliest stages of the company life cycle are relatively simple. Companies are founded because owners wish to enter a given line of business. They are expanded because

owners believe they can earn a return within their business that exceeds the cost of the capital used in the expansion. Owners take early liquidity because that liquidity satisfies a financial need without triggering the sale of the entire company. When it comes to the final stage of the company life cycle, though, there are myriad reasons that entrepreneurs decide to sell their companies. The following list represents the majority of reasons usually given by entrepreneurs for seeking a sale.

Fatigue – By the time they near retirement, most entrepreneurs have spent the majority of their working lives building their companies. Despite an enduring fondness for the company, its customers and its products, owners often feel that despite their best efforts to delegate responsibilities they are still typically responsible for all the most stressful decisions that need to be made. They seek to be able to devote more time to other interests and begin the next chapter of their lives. This is usually reported as the predominant factor in the decision to sell a business.

The Business is at an Inflection Point – The growth of a company is a non-linear process. There occur, along the way, inflection points at which it becomes clear that growing the company to the next level will involve additional risk, time and capital investments. It is often at inflection points such as these that owners pause to consider selling the company rather than accepting the risk and the financial burden needed to move to the next level. In particular, some entrepreneurs are adept at starting companies but prefer to sell them once the business is established and represents an attractive opportunity to an acquirer.

Succession Issues – Many business owners find themselves with sons or daughters who have successful careers of their own and no desire to assume management of the family business. In other cases, the successor chosen by a company's owner may have left for unforeseen reasons or ultimately lacks all of the necessary skills and abilities. In any case, there is no one to carry on the business at the time of the owner's desired retirement.

Changing Technology / Product Obsolescence – In most industries technological change and product obsolescence often require capital investment in the business. Companies whose product line has become somewhat outdated may not be willing to make the investment of time and energy needed to correct the deficiency. Selling the company may be viewed as being preferable.

... owners that decide to sell to a larger organization often do so ... to gain access to the resources of the larger organization.

Joining a Larger Organization – Company owners that decide to sell to a larger organization often do so, in part, to gain access to the resources of the larger organization. This expanded access to capital can make a recently acquired company a formidable competitor in its segment of the market.

A Buyer has Approached the Company – Often, a company is approached by a potential buyer at a time when the company was not actively seeking to be acquired. The approach is typically made by a competitor or a financial group, such as a private equity fund. In some cases, the offers tied to such unsolicited approaches are lucrative enough to lead to the sale of the company.

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Changes in the Competitive Environment – After spending many years in the industry, business owners frequently find that operating the business is not as much fun as it once was. Owners often lack the desire to tackle these challenges and would prefer to transition to new ownership who will face the task of choosing the correct path for the company to take in the future.

Personal Matters – Other reasons for a company to be sold include the ill health or death of the owner. In these cases, the death or infirmity of the owner is likely to have a negative impact on the valuation of the company. Buyers may simply seek to take advantage of a "forced sale" situation or they may genuinely perceive increased risk in the acquisition because of the unavailability of the owner to assist in the transition. Another reason that an owner may need to sell a business is to generate sufficient liquidity to fund a settlement in a divorce proceeding. This type of forced sale may also have a dampening effect on valuation, although the owner is likely to be available for a transition period.

... the public markets remain accessible to most of the larger companies in any industry.

Providers of Capital at this Stage

Public Markets – The public markets remain accessible to most of the larger companies in any industry. The sale to the public of shares that were previously privately held is accomplished through an initial public offering ("IPO"). In an IPO, all or a portion of the shares in the company are offered for sale to the public by an investment bank or other underwriter. Another less common way to access the public market is to do a reverse merger into an existing publicly traded company.

Private Equity Fund – Private equity funds purchase the stock or assets of companies on a regular basis.

Management Buyout – A management buyout is a particular type of equity buyout that hinges on the participation of the management team of a company. In these situations, it is typical for a buyout fund to provide the majority of the capital needed to complete the transaction, while the management team provides sufficient capital to purchase a minority interest in the company. In this way, the management team enjoys the benefits of ownership of the company and the buyout fund perceives the investment as more attractive because the management team has "skin in the game." The management team stands to gain or lose in proportion to the buyout fund, based on the performance of the company they have been charged with managing.

Employee Stock Ownership Plan – Under the terms of an ESOP, a trust is created to purchase all or a portion of the equity of the company on behalf of its employees. The purchase may be funded using bank debt borrowed on behalf of the employees of the company, employee contributions or a combination of both. Owners often view ESOPs as a means of rewarding employees for their efforts in the success of the company over time. Also, a partial sale of a company to an ESOP can allow the owner a partial liquidity event without some of the complications of having to work with a purely external capital provider. Finally, ESOPs enjoy favorable tax treatment on their earnings, allowing them to be very competitive in the marketplace.

Pre-transaction Considerations

Establishing Objectives

Understanding the exact reasons for selling a company or raising capital will significantly impact the company's strategy and the best approach to the market. An owner's assessment should include consideration of the outcome that the owner desires following the event, as well as various other issues such as tax, estate planning and liquidity considerations (discussed below). Social issues, such as concerns regarding the way employees or customers will be treated following the transaction, should also be addressed. These factors will shape the objectives and desired outcome of the capital event and are key in determining which prospective transaction partners are contacted and the type and nature of information provided to them.

Understanding the exact reasons for selling a company or raising capital will significantly impact the company's strategy and the best approach to the market.

Explore the Owner's Intentions and Priorities

The amount of stock, if a stock versus asset sale, that an owner wishes to sell must be determined early in the process. The portion of the company being sold has an impact on the number of potential capital providers or buyers who will be willing to look at the company. Some transaction partners will only entertain transactions in which they are able to purchase 100% of a company's stock, while other buyers prefer that shareholders that are active in the management of the company retain a portion of ownership to remain invested in the company's success after a transaction.

Another important area to consider is the natural trade-off between the various terms of a deal and the minimum purchase price or implied valuation an owner will accept for their company. Selling owners must understand the difference between the portion of the purchase price to be received immediately, versus that to be received over time. The latter portion includes payments that are usually based on the future performance of the company, referred to as an earnout, as well as any portion of the purchase price that is financed with a seller note that is due from the buyer of the company. Such a seller note is typically unsecured. Financing a portion of the transaction creates unique risks and opportunities for the selling owner that must be considered.

Along with determining the portion of the company that will be sold, an owner must prepare mentally for the concept of having to report to another individual or group, even if only during a transition period. Also, if less than 100% of the company is being sold, the company's owners should make an assessment of their need for a right of first refusal if or when the capital provider decides to sell their portion of the company in the future. Otherwise, the former owner may find themselves with a partner that is not of his or her choosing. Finally, owners must prepare themselves for the activities they will pursue once they have completely transitioned out of their company. Many business owners report feeling very unfulfilled following the sale of a company because insufficient plans were made to provide a sense of purpose in the post-transaction period. Of course, not all buyers or capital providers will agree to grant such a right. In fact, there are cases where a buyer of even a minority stake in the company may demand super majority rights with regard to certain events. Such events could include the ability to force a sale of the company, even though the buyer does not own a controlling number of shares.

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It is also important at the outset to determine the post-transaction liquidity needs of the existing shareholders. Companies must make sure to select a transaction partner whose investment parameters are consistent with providing the existing shareholders with the liquidity they need. Some capital providers, for example, will be less comfortable than others with placing capital in a company in a non-controlling stake and seeing that capital immediately transferred out of the company to existing shareholders. Finally, it is also necessary to obtain the agreement of all shareholders that the company will seek a capital event. Initiating the process without a full consensus carries the risk of having to stop mid-process to resolve shareholder issues and arrive at an agreement to move forward.

Companies must make sure to select a transaction partner whose investment parameters are consistent with providing the existing shareholders with the liquidity they need.

Consider Strengths and Weaknesses

It is important to engage in a frank and honest assessment of the company's strengths and weaknesses prior to a transaction. Owners must determine what makes the company unique versus its competitors. It is critical to assess what sets the company apart and what drives repeat business. At the same time, companies must assess their shortcomings and, importantly, correct those that can be addressed prior to a sale or capital raise. The aspect of the company about which the owner hopes he or she is not asked is probably the best place to start.

Before seeking a transaction partner, companies should confirm that their existing corporate governance structure is sufficient to meet the needs of the company at the present and during any transition period. Introducing an external transaction partner into the picture will only exacerbate any current shortcomings in the areas of governance and corporate control.

Timing the Decision to Raise Debt or Equity Capital

If a source of external capital will be vital to a company's success in the coming years, it is critical that the company allow enough time to perform a thorough search for the appropriate capital provider. While a company may have a relationship with a local bank that would allow it to secure senior bank debt with relative ease, securing other forms of capital – equity and subordinated debt, in particular – involves a longer process. It may take six months to a year to secure these types of capital. The important thing to remember is that companies should approach the capital markets with plenty of time to spare before a capital need becomes urgent. Capital providers always perform due diligence, a detailed analysis of the books, records and operations of a company, as part of the process of deciding whether to participate in a given transaction. In their due diligence process, they will determine whether a company is "running on fumes" or has planned prudently in advance of its capital needs. Discovering that a company's financial situation is somewhat desperate will cause some transaction partners to walk away. Others will try to take advantage of the company's situation with onerous terms or low valuations.

... companies should approach the capital markets with plenty of time to spare before a capital need becomes urgent.

Also, it is important for companies to take account of financial covenants that may be required by various types of lenders. This would include, for example, limitations on the debt-to-equity ratio, minimum debt service levels or requirements to maintain a minimum net worth. These requirements are a function of the risk that various capital providers are willing to accept.

Companies must be careful not to seek capital for an expansion, acquisition or other purpose that will cause it to run afoul of the covenants and requirements of its capital provider. For example, while most owners avoid selling equity in their company if possible, some projects will only be pursued by an equity capital provider willing to accept the full risks of ownership.

Timing the Decision to Sell a Company

The timing surrounding the sale of a company is perhaps more critical than the timing of the decision to raise external capital. Owners wishing to sell must not only allow sufficient time for the 6- to 12-month process of selling their company but also for a transition period after the company is sold. Very few company owners are able to transfer their responsibilities to others so completely that they can turn over the keys and walk out of the business after a sale with no negative ramifications for the company. Even if an owner has actually come close to that situation, a buyer will assume that this is not the case. Thus, most buyers insist on an appropriate transition period following the purchase of a company. This can vary from several months to two years depending on how critical the owner is to the daily operations of the company and the depth of the next layer of management. In many cases, buyers and sellers have a different assessment of the value of the owner. Failing to allow enough time for a reasonable transition can limit the number of potential buyers or reduce the price paid for the company.

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Assemble a Team of Experts

For most owners, seeking external capital or selling a company is a challenge they will face, at most, only a few times in their entire career. The groups that might place capital in or acquire a company, however, most likely enter into such transactions several times each year. This gives these groups a distinct advantage when it comes to structuring and negotiating transactions. We believe that, at a minimum, the team of experts should include an attorney, a tax advisor/accountant and a mergers and acquisitions specialist, such as an investment banker.

Failing to allow enough time for a reasonable transition can limit the number of potential buyers or reduce the price paid for the company.

Importantly, the attorney and the tax advisor/accountant must have significant past experience with sale and capital transactions. The outside CPA that has prepared the company's taxes for many years but has not worked on transaction specific assignments most likely is not the right person for the job. In our experience, if these professionals are asked whether they are qualified to render advice regarding tax and other implications stemming from the possible sale of the company, they will confirm that they are not. Often, though, they are able to give a recommendation to appropriate tax counsel. If that tax advisor is within their same firm, it will likely save time and money, since they will have access to a large amount of historical tax and financial information regarding the company seeking a capital event.

With regard to the attorney who will advise on the transaction or capital event, owners seeking a capital provider or a buyer would be equally well advised to make sure the attorney has experience with mergers and acquisitions transactions. Again, the company's existing attorney may or may not be the proper person to fill that role. There can also be an important advantage to retaining an attorney from a large law firm. Not only is it more likely that the attorneys at a larger law firm have worked on a larger number of deals, the firm will probably have multiple practice areas beyond corporate

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transactions. Having access, within the same firm, to attorneys that work in human resources, tax, environmental, patent or real estate law can be a significant advantage if issues in these areas arise in the process of pursuing a transaction. Even if an attorney is hired for such an event, existing counsel will often work in cooperation adding existing company knowledge and background.

While they are not needed in order to complete a transaction, it may also be advisable for owners to retain the services of an estate planning expert and/or a financial advisor. These individuals will be able to provide advice concerning the optimal structure of a transaction relative to the owner's personal financial status. A financial advisor, in particular, is able to help an owner selling his company determine whether varying levels of proceeds, when combined with the owner's existing assets, would be sufficient to provide for the owner's comfortable retirement. The strategies such advisors utilize often require a meaningful time investment to implement. It is a good idea to begin talking with them in the early stages of preparing for a transaction.

Constituents

An action plan regarding how and when external and internal constituents are made aware of the transaction should be formulated. External constituents include key customers, vendors, joint venture partners and any other groups similarly connected to the company. Internal constituents are primarily employees, shareholders and board members. Of these, employees are the most sensitive group with regard to sharing information. Companies must strike a balance between tight or loose information policies regarding the transaction. If the company tells too many employees too soon, there is a greater likelihood that knowledge of the transaction will find its way into the market. This allows competitors the opportunity to capitalize on the uncertainty created by a sale. On the other hand, if trusted key employees are not made aware of the sale until the time of closing, they may feel insulted and decide to leave the company. Another aspect to consider is that the input of key employees will be needed in order to prepare the company for a capital event. It is usually not possible to restrict knowledge of a transaction to one or two key executives. In most cases, however, rank and file employees do not need to be made party to transaction discussions.

Companies pursuing a capital event will typically be required to explain their strategic plan in detail to potential transaction partners.

Strategic Planning

Purpose of a Strategic Plan

Companies pursuing a capital event will typically be required to explain their strategic plan in detail to potential transaction partners. Exploring the best way to draft a strategic plan could be the subject of an entire research report, so we will confine our discussion in this report to the highlights of drafting such a plan. It is important that companies that seek to attract debt or equity capital or that wish to be acquired have drafted a strategic plan covering the next three to five years. The plan should address the opportunities open to the company as well as details surrounding the cash the company requires to achieve its goals. The strategic plan should consider the return that will be generated on the investment. This will ensure that an investment in the company is capable of generating sufficient returns to attract a capital provider.

Another important benefit of drafting a strategic plan is that it allows a company to clearly delineate between opportunities that already exist within the business and potentially attractive areas that can be pursued in the future. The critical distinction is that opportunities are attributes that have already been created by the owner, who should expect to be paid for them. Examples would include having fully developed and commercialized an interesting new product, the widespread sale of which has not yet begun. Potentially attractive areas, on the other hand, are only available to a transaction partner that is willing to invest the work needed to turn the potential into a reality. While these situations may make a company more attractive, owners should not expect to be paid for potential value that the new transaction partner must create. An example would include a company's knowledge that demand exists among its customers for a product that it has not yet begun to develop.

... transaction partners will place a higher value on a business with a well-articulated growth story, strong margins and a great track record.

In general, transaction partners will place a higher value on a business with a well-articulated growth story, strong margins and a great track record. They also seek companies that are experiencing positive trends, have high inventory turnover and stable, consistent performance over time. It is a good idea, as part of a strategic plan, to demonstrate that the company enjoys the possibility of strong performance even in soft market environments. In particular, it is important to show that the company's gross margins do not deteriorate each time the market passes through the down stroke of its cycle. Such deterioration is indicative of a company that is producing a more commoditized product and competing mostly based on price.

Common Mistakes in Strategic Plans

There are a number of common mistakes that are made in drafting strategic plans. The first type of mistake is not clearly identifying the primary opportunity that is open to the company. In the case of a company seeking external capital, this would be the opportunity that will be funded with the capital that is being placed. Another common mistake is making unrealistic financial projections. Nothing in a strategic plan is met with greater skepticism than financial projections that show a company with years of tepid earnings growth suddenly exploding into a growth phase following the sale of the company or the placement of debt or equity capital (often called "hockey stick" projections).

Another common mistake is making unrealistic financial projections.

In other cases, companies use overly simplified assumptions in creating financial projections. For instance, it shows far less work and depth of thought for a company to assume that costs will be a constant percentage of revenues, which will increase by 10% annually, than for a company to perform a detailed growth analysis by product line, combined with a line by line examination of the behavior of cost items. A final common mistake that is made in strategic plans is not identifying and taking account of the competitors in the industry. Very seldom does a company enjoy a total lack of competition in a given area. In a mature industry it is almost impossible for a company not to face competitors in each of its major product areas. Even if a company has a superior or very unique product, there will always be substitute products at lower price points that serve as competition.

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Financial Preparation

Assess the Quality of Financial Statements

The first critical aspect of financial preparation is an assessment of the quality of financial statements. In this way, owners can avoid problems associated with the financial areas of greatest concern to transaction partners.

Ongoing Profitability – The first step in preparing the financial statements of a company seeking a capital event is to confirm the profitability of the company. Capital providers prefer to work with companies that have been consistently profitable over time and that are experiencing growing revenues and cash flow. While not an absolute requirement, it is greatly preferable for companies to be able to demonstrate their profitability at the division and product levels. Also, if the company's revenues have increased, it is important to determine whether this has been the result of an increase in the number of units being sold or simply a price increase that has been implemented. Potential capital providers will also examine gross margins to confirm that they have been stable over time and that the company is able to pass along to customers increases in the prices of its raw materials.

Revenue Recognition – Another important aspect of preparing financial statements for review by a potential transaction partner is determining whether sales are being recorded properly. Revenue recognition that is not in accordance with generally accepted accounting principles ("GAAP") will cause transaction partners to invest significant resources in restating financial statements or could simply cause them to walk away from a transaction altogether.

Preparing Monthly Financial Statements – It is strongly recommended, in order to facilitate a transaction partner's analysis of a company's financial statements, that companies prepare their financial statements on a monthly basis. In addition to showing that the company is well organized, monthly financial statements allow transaction partners to assess seasonality of revenues, the general consistency of a company and the performance of the management team. Companies not currently preparing monthly financial statements that anticipate a significant capital event in the near future may benefit from adopting monthly statement preparation now.

Companies not currently preparing monthly financial statements ... may benefit from adopting monthly statement preparation now.

Continuous Inventory – Companies that maintain a continuous inventory system are generally better able to discuss their cost of goods sold at the product level at various points throughout the year. Transaction partners do not look favorably on a company that only knows its true cost of goods sold once per year. Companies not already using a continuous inventory system should consider switching to such a system. It is likely the company will benefit from a more accurate knowledge of its cost of goods sold in addition to being more attractive to transaction partners.

External Oversight of Financials – It is important that companies that may complete a capital event have an independent external assessment performed of their financial statements. Preferably, this would take the form of an annual audit by a regional or national accounting firm. If a company is unwilling to bear the expense of a full annual audit, the next best option is to

have the company's financials reviewed. It should be noted that a review is not the same as the informal review that may be conducted by one's accountant after the financials have been prepared. An official review of financial statements results in the preparation of a financial package of the same type generated following an audit. There is a distinct possibility that a potential capital provider may require a full audit before proceeding with a transaction. If this is the case, owners may face the unpleasant choice of eliminating from consideration a strong potential capital provider or enduring a significant delay while the audit is being completed. While financial audits and reviews involve additional expense, the value they create for owners in a transaction can be significant. Some buyers will use a lack of external financial oversight as a lever in seeking price reductions because the company's profitability and performance have never been verified independently.

While financial audits and reviews involve additional expense, the value they create for owners in a transaction can be significant.

Recasting Financial Statements

A company's internal financial statements and the annual financial statements prepared by third party accounting firms do not portray the true economic value or earnings potential of a business in the hands of a new owner. Such statements are designed to report historical results and make no attempt to adjust the earnings of the business for non-recurring items, unusual items or other expenses that may cause the financial statements to differ from the true economic picture of the company.

In many cases, owners attempt to manage the company's earnings in order to avoid taxes wherever possible. Owners may also process certain personal expenses through the company, such as country club dues, personal vehicles, travel, entertainment expenses, etc. In some cases, owners have family members on the payroll that are not active in the business in order to provide for their medical insurance or for other reasons. While companies must avoid committing tax fraud in their pursuit of the lowest tax bill, these are examples of costs that would not be borne by a new owner. In many cases, the owner draws compensation that would be excessive for the non-owning president or chief executive officer of a similarly sized company. Particularly in the case of a sale, a prospective buyer needs to see financial statements that demonstrate the maximum verifiable earnings and cash flow potential of the business.

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If a buyer or capital provider looks solely at historical financial reports, they will not understand the true economic potential of the business or properly pay the owner for it. In preparing financial statements that reflect adjustments – referred to as "addbacks" – to the GAAP financial statements, it is important that every adjustment be completely justified and documented. The easiest way to ensure that addbacks for items such as excess compensation and personal expenses will be fully realized is to actually change the way the company handles these expenses. If it is possible to eliminate such expenses two to three years in advance of a transaction, it will not be necessary to prove to capital providers that they are not vital to the ongoing operation of the company. Thus, the owners will receive a full valuation of these earnings. If it is not possible or desired to eliminate these expenses in advance of a transaction, it is vital that owners at least be able to quantify these expenses in full detail, including receipts. Owners sometimes work to obscure these expenses, fearing an IRS audit, so they cannot be adequately documented in recasting financial statements.

If a buyer or capital provider looks solely at historical financial reports, they will not understand the true economic potential of the business or properly pay the owner for it.

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It is also important to analyze any "sweetheart" relationships with parent companies that will not exist under new ownership. If the business is one member within a group of companies, adjusted expenses should reflect the business on a stand-alone, going-forward basis. Allocated expenses should be restated to reflect a realistic estimate of stand-alone future costs. Importantly, this may result in a "negative addback" in the recast financials. Transaction partners evaluating a company that is part of a larger parent company will perform a painstaking analysis of the economic implications of separating the company from the parent entity.

The buyer of a business may or may not purchase the underlying real estate used in the business ...

The buyer of a business may or may not purchase the underlying real estate used in the business (assuming that it is owned by the principals). With this in mind, the business should be presented to a buyer as if no real estate were included in the transaction (e.g., demonstrated financial results should include a charge for rent expense stated at fair market value). By doing so, the proposed sale of the business is separated from the proposed sale of the real estate. Such handling can result in greater aggregate value for the sellers (if both the business and the real estate are sold). Other selling owners prefer to use the real estate as a source of income after the sale.

Financial Housekeeping

It is important to ensure that all financial matters of the company are conducted in a way that is conducive to seeking a transaction partner. If, over the years, the company has experienced a proliferation of corporate entities, it may make sense to combine these entities into a single organization. Companies often create such entities to more accurately capture the profitability of a newly created product line or similar venture. To the extent that such a corporate structure will distract a potential transaction partner, it may be better for the company to fold those entities back into the primary entity. Having to purchase multiple entities will increase the difficulty of completing a transaction and may drive up legal costs. Transaction partners may also be wary, in situations in which numerous corporations are present, that assets may be funneled to the selling owner via other such corporate bodies.

There are a number of other transactions that should be addressed prior to a capital event. Any shareholder or employee loans that are still on the books should be repaid. Companies must also determine whether all of their accruals are up to date. If a transaction partner discovers that accruals are not being calculated correctly, they may request that past financials be restated to reflect accruals as they should have been made. Companies must also determine whether depreciation is being calculated correctly and if the inventory is up to date.

In the early years of a company, it is common for owners to offer personal guarantees on the company's debts. Owners sometimes neglect to have these guarantees removed as the company matures. If possible, this should be corrected before undertaking a transaction. Also, it is important to determine whether there are any prepayment penalties on any of the company's existing loans. These can sometimes be onerous and may impact the decision of how to use proceeds from the company's capital event. Finally, companies should assess the quality of their accounts receivable. Any

receivables older than sixty days are considered doubtful and any older than ninety days will likely be considered worthless in calculating the company's working capital.

Non-core Assets – A company seeking to undertake a sale should consider divesting non-core assets or unrelated businesses that may hamper a sale. Examples of non-core assets would include boats, planes, personal vehicles and machinery and equipment used in unrelated businesses. At the very least, companies should make it as easy as possible to lift these assets out of the company or leave them behind at the completion of a sale.

Facilities Rent – If the intention is to increase the below-market rent on a facility owned by the company's principals following a sale, it is better to enact this change prior to the sale. This should smooth the process of negotiating the lease rate during the completion of a transaction. However, buyers will refuse to accept lease rates that are higher than those for comparable properties in the local market. Commercial realtors will often provide information regarding the market lease rates in the area surrounding a company. This lease pricing information should be retained for use in later due diligence by a potential buyer.

The buyer of a business will expect a normal level of working capital to accompany the business when it is purchased.

Maintenance Capital Expenditures – A common area of discussion in the sale of a manufacturing business surrounds the magnitude of capital expenditures that are required on an annual basis to maintain the business (referred to as maintenance capital expenditures). Accordingly, the company's history of capital expenditures should be evaluated in order to determine a realistic annual requirement. Also, if the company is presenting forecasts of future financial performance, it is important to disclose whether additional capital expenditures will be required in order to fund the steps needed to achieve the future growth and to quantify the amounts needed. Transaction partners will view additional capital expenditures as a reduction of the cash flow to be generated by the company.

Working Capital – A company's working capital is the amount of cash that is tied up in the company because of the difference between the time at which a company pays for its inputs (materials, labor, etc.) and the time at which it is paid for its finished products. Working capital is calculated as the excess of a company's current assets over its current liabilities. The buyer of a business will expect a normal level of working capital to accompany the business when it is purchased. With this in mind, historical levels of working capital should be analyzed to identify an acceptable and appropriate amount that a prospective buyer can expect to receive with the business at closing. Particular attention should be paid to the cyclicality of volume and the related effect on capital requirements. Companies frequently maintain higher inventories than necessary because they prefer to maintain a large safety inventory. This causes a higher than optimal level of working capital. Companies anticipating a sale may wish to carefully and gradually wind down their excess inventory levels a year or two in advance of a sale. It is critical, though, to establish as long a track record as possible at the lower working capital level. This will demonstrate to a potential acquirer that the company can operate effectively at the reduced level of working capital.

Companies anticipating a sale may wish to carefully and gradually wind down their excess inventory levels a year or two in advance ...

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Take Steps to Improve Earnings

Considering that sale transactions are typically priced based on a multiple of cash flow, it makes sense to capture every possible dollar of earnings.

There are no quick fixes to improving the fundamental profitability of a company in anticipation of a capital event. There may be, however, a number of examples of "low-hanging fruit" that company owners do not pursue because they are satisfied with the present level of the company's earnings. Considering that sale transactions are typically priced based on a multiple of cash flow, it makes sense to capture every possible dollar of earnings.

Companies seeking areas of earnings improvement should begin by analyzing all of the company's leases. If there are assets that are being leased, it may be more economical for the company to own these assets. Making such an adjustment a year or more before a prospective transaction may provide a positive return on the cost of investing in the assets if the leased asset can be bought for a reasonable price. Another way to improve earnings is to evaluate a company's current service providers and materials contracts. There may be contracts that can be renegotiated or eliminated without negatively affecting the company's operations. Workers' compensation insurance is an area in which companies often have significant room for improvement. By identifying and focusing on the most problematic injury areas (cuts, lifting injuries, etc.), it is possible for companies to dramatically lower their loss experience. While it takes two to three years for these savings to be realized, their impact can be significant.

Another potential area of improving earnings and the fundamental health of the company is to conduct an in-depth analysis of the company's various product areas and business segments. To the extent that the company is able to calculate the profitability of each of these individual areas, the decision can be made to exit product or market segments that are unprofitable. Needless to say, this is not a decision to be made lightly. However, if a company determines that a given product or segment is unprofitable and the company is unable to create a plan to rectify that situation, an elimination of such persistently unprofitable areas may be in order. Every dollar of losses avoided in such a move is multiplied by the EBITDA multiple and contributes to the sale price.

Cost Cutting Methods to Avoid

While it is generally a good idea to trim expenses wherever possible, there are a number of cost cutting measures that should be avoided. Because they are seen as harmful to the company, owners will not receive credit for them in a valuation.

Reducing Employee Benefits – One such measure to avoid is reducing employee benefits. In the short term, reducing benefits has the effect of increasing profitability. However, it puts a potential acquirer in the unenviable position of taking the reins of a company with an unhappy work force.

Scaling Back Service to Customers – Another expense item where cost reductions have great potential to cause problems is the decision to scale back service to customers. Changing the level of service that customers receive brings with it an unacceptable risk of causing the flight of valuable, long-time customers.

Decreasing Advertising and Marketing – Reducing advertising and marketing shortly before a transaction is a measure that will likely be viewed negatively by potential transaction partners. Since they will probably perceive the need to increase marketing and advertising back to their pre-transaction levels, they will not pay for that portion of the earnings increase.

Reducing Development Expenses – Another area that most likely should not be reduced in order to increase earnings is employee training. Potential transaction partners will view such changes as being short-sighted in much the same way as decreasing advertising and marketing. Also, companies should not seek to increase earnings by reducing spending on research and development.

Financial Documents to Gather

There are numerous financial documents to gather in anticipation of a transaction and a sample Due Diligence Checklist is available from Jordan Knauff & Company upon request. The most important items include three to five years of annual income statements and balance sheets. These should also be available on a monthly basis if the transaction partner desires. Having monthly financials allows a transaction partner to assess the seasonality of the company's revenues. Monthly financials are particularly important when a company that receives a majority of its revenues in the latter part of the year is being sold mid-year. Demonstrating the past seasonality of the business will provide comfort to transaction partners that the company is not underperforming on a year-over-year basis. Three to five years of state, local and federal tax returns will be used by transaction partners as another way to verify the earnings of the company. Finally, companies must be prepared to show a full inventory of all property, plant and equipment, as well as the current and anticipated depreciation expense for these items.

Having monthly financials allows a transaction partner to assess the seasonality of the company's revenues.

Three to five years of state, local and federal tax returns will be used by transaction partners as another way to verify the earnings of the company.

Sales & Marketing Preparation

Marketing Materials

When considering the sale of a company or an infusion of external capital, it is important to look at one's marketing materials (website, brochures, pamphlets, print advertisements, videos, etc.) with a fresh and objective eye. How would transaction partners view these materials? If they are old or outdated, they will raise questions regarding the rest of the company's operations. It is critical that all marketing materials are aligned with the image the company projects to the marketplace.

Company Video

It is typically our recommendation to clients seeking a capital event that they prepare a video presentation about the company and what sets it apart from competitors. Unique product features should be discussed, along with an overview of how the company manufactures its products. Such a video is an excellent opportunity for capital providers and acquirers to make an initial assessment of whether it makes sense for them to pursue a transaction with the company. However, the content of the video should be directed at potential customers, not acquirers or capital providers. In this way, the preparation of the video can involve all members of the executive team and can include filming the production area without raising suspicion. Also, a link to the video can be posted to the company's website or sent to potential customers.

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Diversify the Customer Base

Making an attempt to improve the diversity of the customer base is not a measure that can be completed in a short period of time. However, if the owner of a company anticipates a capital event one or more years in the future, there may be sufficient time to improve the impression capital providers or buyers will have of the customer base. Capital providers are very hesitant to enter into a transaction with a company with an excessive concentration of its revenues among a small number of customers. Their fear is that, if the company loses one or two key customers, the value of the business will vanish. There is no pre-established rule for the concentration that a provider will or will not accept and all providers have levels with which they are comfortable. As a general rule, though, capital providers become more comfortable with a company's revenue streams as the number of customers served increases.

Benefits of a Public Relations Campaign

Companies that know they will initiate a capital transaction at some point in the future would be advised to work actively on public relations on an ongoing basis. This will attract the attention of potential strategic buyers who will be interested in stories regarding a growing or innovating company in their market segment. Also, when potential capital providers conduct their initial due diligence regarding a company in which they are interested, an important step in that process is an internet search for places where the company has been mentioned in the media. Companies can measure the success of their public relations campaign by the number of unsolicited inquiries they receive regarding acquiring the company.

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Operations Preparation

Unwritten Company Policies

Companies often operate with a large body of unwritten policies, procedures and corporate knowledge. In the event that a company is considering a capital event, it is important to codify all of this unwritten information. If necessary, companies should consider drafting procedure manuals or employee handbooks.

Vendor Dependency

Companies considering a capital event should assess their suppliers and determine the likely replacement suppliers that would be utilized in the event of a supply disruption or a disagreement with the current suppliers. It is not necessary to actually add vendors and diversify purchases among competing suppliers, but buyers will want to determine during due diligence whether it would be easy to do so.

Eliminate Idiosyncrasies

It is important that all of a company's relationships be palatable to potential transaction partners, particularly in the event of a sale of the company. Often, in winning and continuing to service a given customer's business, companies come to offer that customer special treatment. Sometimes this means accepting verbal orders where typically orders must be written or offering special delivery terms. To the extent that it is possible without damaging the customer relationship, it is a good idea to standardize such special arrangements. Standardized businesses are easier to assume control of and no acquirer will want to be viewed as having eliminated preferential treatment as their first act after taking the helm.

Intellectual Property

In the case of the sale of a company, a buyer will want to know about all of the intellectual property they are acquiring, among the other assets of a company. Regardless of whether a given patent, copyright, trademark or service mark is being utilized commercially, it is important to catalogue every item of intellectual property included in the sale. Acquirers will want to know that they are purchasing the unencumbered right to utilize all of the company's intellectual property following an acquisition. The buyer may also view the failure to sell all intellectual property as an indication of the selling owner's intent to re-enter the industry under the banner of a new company.

... it is important to catalogue every item of intellectual property included in the sale.

Facilities Preparation

Dealing with Real Estate

If a company considering a capital event owns the real estate on which it operates, it may be beneficial to consider separating the real estate from the business or selling the property before the company is brought to market. Real estate can complicate a company's financials. Maintaining its ownership within the company can, in effect, force potential acquirers to invest in real estate when they may not wish to do so. The countervailing view of real estate, however, is that having significant real estate in the situation may make it easier for some buyers to finance the transaction using an asset-based loan. In short, the optimal treatment of real estate must be decided on a case by case basis.

... the optimal treatment of real estate must be decided on a case by case basis.

Condition of the Manufacturing Facility

It is important that a company's facilities be in prime condition before a tour by potential transaction partners. This means that they are well-maintained, painted, clean and generally make a good first impression. Transaction partners confronted with a facility that appears dilapidated will likely assume that the owners have not been careful about taking care of other aspects of the company as well. We recommend that owners give a tour to a business contact from another company to provide a fresh set of eyes on the facility. It is also important that tooling is properly inventoried, along with the contact information of the vendors that provided the tooling. Production documentation, such as drawings, machine routings and others, should be well-organized and easily accessible.

On the other hand, it is important not to rely too heavily on the outward appearance of facilities. A fresh coat of paint will not disguise the fact that a plant has been configured incorrectly or that a company's machinery is antiquated. It is important that the surface appearance and the fundamental condition of the company both indicate a top notch organization.

Operational Documents to Gather

In preparing for a capital event, it is important to gather documentation regarding the status and condition of the company's facilities. This includes consent decrees, injunctions or similar governmental notifications from the Occupational Safety and Health Administration ("OSHA"), the Environmental Protection Agency ("EPA"), the National Labor Relations Board ("NLRB"), the Federal Trade Commission ("FTC") or similar government agencies. If a

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company has received an adverse notification from any of these agencies, it does not mean that the company will not be successful in completing a capital event. The company's capital provider, however, will require a thorough explanation of the adverse situation and the steps the company has taken to resolve it and prevent a recurrence. Wherever possible, companies that have received these types of notifications should obtain no further action letters from the applicable authorities.

Environmental Considerations

Companies seeking a capital event should expect to provide a recent environmental assessment of the real estate used by the company.

Companies seeking a capital event should expect to provide a recent environmental assessment of the real estate used by the company. With this in mind, data, reports and other file documentation on hand should be refreshed to place the company in a position to provide current status information and documentation to a prospective buyer. Assessment efforts should include soil sampling (if appropriate), and ideally the work should be performed by a consultant or firm that has previous knowledge of the property. Our experience suggests that a prospective buyer is more comfortable when a property is monitored on an ongoing basis by the same environmental experts. At a minimum, most transaction partners will require at least a Phase I report indicating that there are no potential environmental concerns.

Equipment Appraisal

As previously noted, the prospective buyer's ability to obtain acquisition financing can greatly influence transaction value. With that in mind, an upfront appraisal (or at least an abbreviated "desktop" appraisal) of the underlying hard assets may be appropriate.

Human Resources Preparation

Management Team Assessment

When a prospective buyer looks at an acquisition candidate, they seek to purchase a set of assets that can and will continue to generate the earnings that have occurred in the past. In assessing the acquisition of a company, buyers will attempt to determine whether the company will function well once the owner of the company transitions out of the business after a transaction. The critical ingredient that will give an acquirer comfort that this is the case is the presence of a superior management team. No company should be allowed to exist as a "one-man show" or to be overly dependent on a small number of key employees. Businesses such as this are very difficult to sell. We have even recommended to past clients that the founder of the company should transition from chief executive officer to a chairman role in anticipation of a transaction. This sends a very clear signal to the market that the president of the company, who will likely remain after the sale, is truly in charge of the company on an ongoing basis.

In any case, it is important to determine that the executive team in place is the proper one to ensure that the company will continue to perform the way it has in the past. If there are executives that any prudent buyer would need to replace, these changes should be made prior to a sale transaction. Any required change in key management following the sale will only create uncertainty in the eyes of the buyer, which will negatively affect the valuation of the business. To combat this situation, companies should maintain an ongoing recruiting effort that ensures that they will continually be considering top talent for all positions within the company.

Awareness of an Upcoming Transaction

Most companies would not be overly concerned with their employees knowing that they are seeking capital to expand or make an acquisition. This is seen as a sign that the company is doing well and is optimistic about its future and the health of the industry. These same companies, however, will take great pains to restrict the knowledge of an impending sale to a small number of key executives. It is important, in preparing for a sale transaction, to determine exactly whom this group will include. As with any sensitive information, it is always possible later to decide to include an executive who was not aware of the original round of discussions. It is not possible to retract information once it has been circulated, though, so great care is needed.

In general, it is optimal to inform only those employees whose direct input will be needed to prepare financial projections and a detailed description of the company and its future prospects. It is vital not to exclude any executives whose input will be needed because that would reduce the effectiveness of the materials prepared about the company. In communicating that the owners are seeking a sale, it is important to stress confidentiality with executives. If word of a potential sale reaches the rank and file employees, it will likely create disruptions and a decrease in productivity. Competitors of a company known to be for sale will often take advantage of the uncertainty surrounding a sale to position themselves to the selling company's customers as the safer and more reliable company from whom to buy products.

Employee Compensation

In preparing for a capital event, particularly the sale of a company, it is important to document all aspects of employee compensation. This includes salaries, benefits, bonuses and stock options. In addition to documenting current practices, it is important to rationalize the company's compensation systems to market levels. If key employees are being underpaid or overpaid, this can have important implications in a sale transaction. Overpaying employees helps retention in the short-term, but it will impair the profitability of the company, decreasing the valuation of the company upon sale. It is not advisable, in particular, to give large raises just before a sale as a farewell gesture. This will put the buyer in the difficult position of possibly rolling back raises or laying off staff to bring payroll expense back under control.

In preparing for a capital event, particularly the sale of a company, it is important to document all aspects of employee compensation.

On the other hand, if employees are underpaid and they tolerate it only because of their relationship with the owner, there may be wholesale defections in the event of a sale. This will make the business less attractive to a buyer. There are a number of websites that can provide, free of charge, a rough benchmark of the average salary and bonus levels for various positions in different geographic regions of the country. While the salary levels they provide are not precise, they can help highlight flagrant variations from market compensation levels.

Finally, it may be a good idea, in the case of critical employees, to secure non-competition agreements. It may be necessary to entice employees to sign such agreements by offering stay bonuses in the event of a change of control. The cost of such bonuses may be justified, however, since they will give potential buyers comfort that key employees will remain after the acquisition is completed.

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Policies and Procedures

Given the potential for litigation in the human resources area, it is necessary for companies considering a sale to limit, as much as possible, problems arising from employee issues. In order to do so, companies should keep detailed records of hiring and ongoing employee performance, as well as employee departures and terminations. When employees leave the company, conducting exit interviews will help detect employee grievances that may lead to lawsuits later. Requiring all new employees to sign confidentiality and non-competition agreements can also reduce the issues that arise when an employee leaves the company. Problem employees should be terminated in advance of a transaction so an acquirer will not inherit the company's problems with the employee.

... companies should keep detailed records of hiring and ongoing employee performance, as well as employee departures and terminations.

Undocumented Workers

Another aspect of employment law that is of concern to employers and capital providers alike is the hiring of undocumented workers. In most metropolitan areas of the country, there are numerous undocumented or improperly documented workers making every effort to blend in with the legal working population. These workers often provide false documents to employers, triggering a letter from the Social Security Administration regarding a mismatched Social Security number. Companies that find themselves in this position should consult with a competent labor attorney regarding their best course of action. By doing so, it is far less likely that employers will run afoul of the ever evolving employment laws in this area. Companies with concerns regarding their practices in this area would be well advised to seek legal counsel from an attorney specializing in employment law.

Collective Bargaining Units

If the hourly employees of a company seeking to be sold are covered by a collective bargaining agreement with a labor union, additional planning considerations are required. The union will need to be notified of the impending sale even if it is not required under the existing contract. As this is a complicated area of the law, it is advisable for companies in this situation to consult with a labor attorney. Furthermore, if the business contributes to any multi-employer benefit plans (which are fairly common with a unionized workforce), a sale of the business may trigger an employer withdrawal liability depending on the circumstances.

Human Resources Documents to Gather

It is advisable for all companies, regardless of whether they are interested in a capital transaction, to maintain ready access to complete details on all staff and employees. This includes employment agreements or employee contracts, consulting, confidentiality and non-competition agreements. It is also important to maintain a detailed history of any past attempts to unionize the work force. Companies should maintain an accurate employee count and an employee occupational profile by subsidiary or business segment.

Other human resources documents that should be gathered include details regarding pending Equal Employment Opportunity Commission ("EEOC") or similar labor disputes. Also important are the plan documents governing all employee benefit plans, whether pensions or employee-funded plans. These plan documents include the Form 5500 for the most recent plan year, the most recent actuarial report and the qualification letter from the IRS. Any correspondence regarding reportable events should be maintained,

along with the identity and address of each plan trustee and information regarding any terminated plans. Finally, companies should maintain their employee records in such a way that it is not difficult, at any given time, to prepare a list of all full-time and part-time employees during the prior two years, including their job function, start date and quality grade. It is important to also maintain a list of employees that have left the company in the prior three years, as well as the reason for their departure. This will ensure a transaction partner that they are not inheriting any wrongful termination, discrimination or similar legal issues.

Organizational Preparation

Organizational Documents to Gather

Since a company's organizational documents are drafted at the time of its inception, there is typically not a lot of work that must be done to prepare a company for a transaction from an organizational documentation standpoint. Documents regarding the founding of the company, such as articles of incorporation, the corporate charter and company by-laws and amendments should be gathered prior to a transaction. In some cases, the company will discover that it has not taken the time over the years to draft certain documents, such as the minutes of board meetings. In these cases, it is usually necessary for the company's corporate counsel to draft these documents for at least the prior three years. Companies must also compile all records regarding common and preferred stock held in the company and all of its subsidiaries, along with any agreements creating liens or restrictions on company stock. Agreements regarding stock rights in the company must be presented, as they could impact the capital structure following a transaction. Any partnerships or joint venture agreements should also be documented. If the company has made any acquisitions or divestitures in the last five years, potential acquirers will want to examine the documentation for those transactions as well.

Any partnerships or joint venture agreements should also be documented.

Legal Preparation

Supplier and Customer Contracts

Companies considering a capital event, particularly a sale, should make an assessment of all supplier and customer contracts. It is important to ensure that these contracts will not expire, requiring their renegotiation shortly after the sale. Few buyers will be comfortable with the prospect of renegotiating such critical contracts before they are properly oriented in the business. Companies should terminate or renegotiate, where possible, any contracts that would trouble a buyer because of onerous terms or because they are uneconomical. Also, companies should analyze equipment leases and other material contracts from the buyer's perspective to assess whether they are properly structured. Finally, the company should formalize all loose or verbal contracts and agreements that are important to the operation of the company.

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Real Estate Leases

A review of real estate leases in anticipation of the sale of a company is particularly important if the company relies heavily on its location or if relocation would be expensive. As with supplier and vendor contracts, it is important to ensure that real estate leases will not expire shortly after the consummation of a transaction. This does not mean, however, that leases about to expire should be renewed for an extended period of time. Several years of protection from having to renegotiate a key real estate lease should provide most acquirers with comfort as they assume control of a company. If, on the other hand, the company's current location is a negative aspect of the business, it is advisable to consider moving prior to undertaking a transaction. A buyer is unlikely to want to add the risk of changing locations to the unavoidable risks inherent in acquiring a company. Finally, it is important to assess whether the lease contains any special requirements regarding transferability of the lease in the event of a change in control.

Litigation

Any pending litigation should be resolved in advance of an upcoming transaction ...

Companies with significant, unresolved litigation will find it difficult, if not impossible, to complete a sale or the placement of external capital. Any pending litigation should be resolved in advance of an upcoming transaction and the company should be prepared to document that the situation has been resolved and is not likely to resurface in the future. If the company is aware of any threatened litigation, this will likely be uncovered by a potential capital provider's due diligence. Issues such as these should be disclosed in full detail. Failure to do so will only expose the company to liability following the completion of a transaction if any problems stemming from the litigation arise.

Right of First Refusal

If, in its agreements with any employee, shareholder, investor or outside party, the company has granted the right of first refusal to place additional capital or to acquire the company, this fact can have a negative impact on the company's ability to undertake a transaction. Few, if any, transaction partners will proceed very far in a transaction if they know the company must give another party a right of first refusal. It is important for a company seeking a sale to secure a written waiver of the right of first refusal from any parties to whom that right has been granted. It is particularly important to address such rights that have been granted to a key member of the management team. Transaction partners will not proceed if they perceive that any managers' interests are at conflict with their own.

Legal Documents to Gather

There are numerous legal documents that should always be maintained in an organized manner and that should be gathered in anticipation of a capital event. These include signed copies of real estate and equipment leases or the deeds for company owned properties. Companies should also maintain an organized file of all standard forms used in interactions with customers, vendors and employees. It is also important to have access to the company's insurance policies that are currently in place. Any agreements relating to franchises, distributorships, dealers, royalties or sales agency agreements will be required, along with copies of contracts with suppliers and vendors and retainer agreements with professional service providers. Also important are copies of any permits, consents or authorizations received from governmental bodies.

Companies must also compile any confidentiality and non-competition agreements into which the company has entered, along with any contracts or other agreements or guarantees provided by the company. If the company has purchased another company in the past, potential capital partners will request full documentation regarding Purchase Agreements and Letters of Intent submitted in the process of acquiring these companies. Similar details will be requested regarding any divisions or subsidiaries which have been divested by the company.

Another aspect of the legal preparation for a business sale involves confirming that a company's vital contracts with suppliers and customers can be transferred in the event of a sale and whether permission is needed prior to completing a sale. These contracts will typically contain language regarding their transferability and companies are advised to review all contracts well in advance of a business sale. This will help determine the optimal time to make a supplier or customer aware of a pending transaction and will avoid delaying the pending closing of a transaction in order to secure needed permissions. If the company has entered into any security agreements, mortgages, pledges or factoring agreements involving its stock or assets, these must be documented and disclosed as well. In general, companies that desire a transaction should consider whether there are any factors encumbering the company's ability to deliver its stock or assets to a buyer in a sale transaction or external equity investment.

Tax Preparation

Scope of Discussion

The tax impact of the sale of a company's stock or assets deserves a great deal of consideration. Inasmuch as this report concerns itself only with preparation for a capital event, it exceeds the scope of this report to delve into the tax consequences of the completion of a transaction. Accordingly, we will limit our tax discussion to a key issue that should be addressed in the preparation phase – the decision of operating as a C corporation or an S corporation.

C Corporations and S Corporations

In the past, it was common for small and medium businesses to operate as C corporations. However, if many of these companies were formed today, they would likely be founded as limited liability corporations ("LLCs"), which are S corporations. This is because C corporations are subject to double taxation, since their earnings are taxed at the corporate level and then again at the individual level when earnings are paid out as dividends. The advantage of S corporations is that they have only a single layer of taxation. Earnings are untaxed at the corporate level and are passed through to the owners to be taxed only at the individual level.

There are important differences between selling the stock of a C corporation and selling the stock of an S corporation.

There are important differences between selling the stock of a C corporation and selling the stock of an S corporation. When C corporation stock is sold, the selling owners face taxation on the gains built into the business. When S corporation stock is sold, however, there is no capital gains tax because the earnings of the company have been taxed at the individual level over the years, regardless of whether they were retained in the business. For this reason, and because of the avoidance of double

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taxation on an annual basis, many owners that founded their businesses as C corporations elect to convert to S corporation status. If a company is converted to an S corporation and then sold during the subsequent ten years, the transaction is subject to gains tax, ratable throughout the ten-year term, at the S corporation rate, and the net amount after that tax is taxed again at the individual level.

If a company is converted to an S corporation and then sold during the subsequent ten years, the transaction is subject to gains tax ...

For companies that are near the end of the ten-year look back that occurs after converting a C corporation to an S corporation, it may make sense to wait to sell the company until the ten-year period has elapsed. Needless to say, this strategy brings with it the risk of continuing to operate the company while the waiting period lapses. If the earnings of the company decrease during the remaining waiting period, the accompanying loss of value may outweigh the tax savings to the selling owners.

Another important factor to consider in the sale of the assets of a C corporation is the resulting depreciation recapture, which is a taxable event for the selling corporation. When the proceeds of the sale are later paid to the selling shareholders as a dividend, a second taxable event occurs. These two taxes combined can represent as much as 50% of the purchase price. Careful planning and structuring are needed in order to reduce this problem. One way of avoiding this taxation is to sell stock, but it is sometimes difficult for small companies to sell stock because of the assumption of potential liabilities by the buyer. However, a stock sale is usually advantageous for a selling owner because of the preferential tax treatment and because, by selling stock, the seller can dispose of the ongoing liabilities of the corporation.

Other Tax Considerations

In the section covering financial preparation, we discussed in detail the implications on valuation of managing a company's profitability to minimize taxes. If this strategy is employed, it is important to at least keep track of expenses that are managed in this way to allow for recasting financial statements. Another important consideration with regard to preparedness is to make sure the company is in compliance with tax laws at the local, state and federal levels.

Tax Documents to Gather

Key tax documents to gather in anticipation of a transaction include the last five years of local, state and federal tax returns, along with documentation of any real estate or payroll taxes paid. If there have been any IRS or state audit reports, inquiries or other special reports in the last five years, these will need to be disclosed and documented.

The structure of the sale of a business is equally as important as the value to be received in the sale.

Transaction Structure

The structure of the sale of a business is equally as important as the value to be received in the sale. What really matters is the magnitude of the net after tax proceeds to be received. While a comprehensive discussion of structuring strategies is beyond the scope of this report, it is important to remember that a great deal of flexibility is possible. Not only are there the traditional differences between asset sales and stock sales, there are many sub-categories of both types that should be evaluated. In addition, depending upon the circumstances and desired outcome, other more complex strategies may be applicable.

If a company is organized as a C corporation for income tax purposes, transaction structuring ability for sale purposes is limited. In our experience, we often see many businesses that retain "C corporation" status when they do not need to do so. It is important to understand the current tax status of a corporation and options that may be available.

Final Considerations

Stay Focused Until the End

The mantra for a company preparing for a capital event should be "business as usual" up until the moment that the transaction is consummated. It is important to continue to drive the sales effort and to invest in necessary capital equipment. This makes it clear that transaction partners are working with a well-run company. It is also critical that the company's earnings remain solid until the time of the capital event. In general, the nearer a buyer or capital provider gets to closing a transaction, the more closely they will watch the company's financial statements. This ongoing monitoring makes the preparation of monthly financial statements particularly important.

The mantra for a company preparing for a capital event should be "business as usual" up until the moment that the transaction is consummated.

Annual Preparedness Review

It is advisable for companies to conduct a "life boat drill" on an annual basis to assess whether the company would be prepared in the event that it needed to take in external capital. An annual assessment such as this will help ensure that the company is being managed in an organized way, maximizing its value. Fortunately, the steps companies need to take to prepare for a capital event are steps that all well-run companies should perform as part of their ongoing operation. Another aspect of being well-organized is maintaining an electronic copy of critical documents that is backed up to a server located away from the company's current facilities. In the event of the destruction of the company's facilities, it would be a significant advantage in resuming operations to know that the management team could quickly access all of the company's books, records and important documents in an electronic format.

Increasing the Interest of Potential Buyers

In general, transaction partners will place more value on growing companies that offer products with a long life cycle, meaning that they will not become obsolete quickly. They also seek companies with stable and profitable relationships with vendors and customers and room for growth or excess capacity in their manufacturing facilities. Issues that decrease the potential interest of capital providers include unresolved issues or problems within the company, requirements or restrictions imposed on the transaction by the selling owner, unrealistically high valuation expectations and the desire for an unusually short transition period following the sale of a company.

The involvement of key owners in the business following its sale will vary based on a number of factors.

Transition

The involvement of key owners in the business following its sale will vary based on a number of factors. At a minimum, owners should expect to participate for a short period of time (three to six months) simply to facilitate the new owner's transition into the business. However, key participants in day-to-day operations or executives that are critical to maintaining important customer relationships may be required to remain with the company longer, possibly one or two years. The type of buyer involved also impacts the required transition period. If a prospective buyer is a financial entity (a

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buyout group or a private equity firm), they are more likely to be interested in having the selling owners remain with the business following its sale. On the other hand, a company currently operating in the industry may have a team or key manager ready to put in place, which will dramatically shorten the owner's required transition period.

It is unrealistic to think that a selling owner can walk away immediately after a sale transaction, no matter how great their desire to retire or pursue other activities. That is why the sale process must be planned well in advance. Particularly in cases where the owner's involvement is critical to the ongoing success of a company, their willingness to stay on for an appropriate transition period will be a key determinant in receiving full value for the company.

Who is Jordan Knauff & Company?

Jordan Knauff & Company ("JKC") was founded in 2001 to undertake a distinct mission: to assemble and maintain a staff of top-notch investment banking personnel and offer their knowledge and experience to provide the best available investment banking services to middle-market companies, the entrepreneurs who lead them and the financial entities that transact with them. On a combined basis, over the course of their careers our employees have completed over 200 transactions as investors, owners, operators, buyers, sellers and investment bankers of middle-market businesses across a variety of industries. The majority of our firm's broad transaction experience has been with private companies owned by one shareholder, a partnership, a family or private equity investors.

The Middle-Market Entrepreneur and JKC

Experience has taught us that the owners and executives of middle-market businesses tend to have very different needs and goals in capital transactions from those that are common to capital events related to larger companies. Our personnel apply their considerable expertise to accomplish important goals: delivery of successful outcomes to our clients. Pursuant to that, we direct and manage all aspects of the capital transaction process, assist our clients with the management of important constituents (employees, customers, vendors and lenders), act as a teammate to other important client advisors (legal counsel, accountant, tax advisor) and collaborate with transaction counsel in the negotiations with the parties on the other side of the transaction.

Should you desire more information about our firm and its mission, please contact any member of our team shown on the back cover. Our website is www.jordanknauff.com and our main telephone number is (312) 254-5900.

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Jordan Knauff & Company is a knowledgeable and experienced provider of a comprehensive line of investment banking services to private companies. Our services include selling companies, raising debt and equity capital, acquisition advisory services, and strategic business services to companies in a variety of industries, including among others, energy logistics and distribution, flow control (pumps, valves, filtration), real estate, and building products and services. Typical transaction sizes range from $10 million to $300 million in total consideration.

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