



Classic Mistakes in Exit Strategy

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You've worked hard to achieve, sustain, and ensure profitability for your business. You've created jobs and opportunities for your employees, and provided valuable products and services for your customers. Now, after all these years, you may begin to think about converting your work into wealth through a potential sale of your business, or growth through acquiring another business. As you begin to focus on your business' future, you may ask yourself many questions. Who might buy my business? What should I look for in a prospective buyer? How should I go about marketing my company for an acquisition? Should I buy a company instead and continue growing? How much is my business even worth? How am I going to solve these issues while maintaining my livelihood?

Our experience as Mergers & Acquisitions (M&A) practitioners informs us that this thought process taken to its logical outcome is filled with possibilities and opportunities. However, it can also be tripped up by certain classic M&A mistakes that: (1) make the process unnecessarily long (sometimes taking 12 to 18 months instead of a focused four to six months); (2) don't result in the highest offer for your business (or you pay too much for another business); or (3) end up in a failed process in which you don't meet your objective to sell your business or buy another one.

We discuss here four of the most classic and potentially most damaging mistakes we have seen in M&A strategy for small and medium sized businesses.

1. For Sale by Owner

We don't see this happen often but every once in a while an entrepreneur will make the decision to run the process themselves. Frankly, even if the entrepreneur was an investment banker in a previous career, this is a significant classic mistake.

Even if you have the time to do this or are an expert multi-tasker, running a business and simultaneously running an M&A process is time intensive and draining. Beyond the steep learning curve of understanding the best way to run an M&A process (which contains elements of both art and science), splitting your attention between running the business and running a merger makes you less likely to be at your best at either. Should you inadequately market your company, potentially viable opportunities may vanish; and should you neglect your company's operations, your livelihood will suffer.

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M&A advisors, like accountants and lawyers, are experts that manage a business' acquisition or exit strategy. The experience of the advisor is key to the success of any M&A process. A long history of presenting companies, negotiating purchase agreements, and building relationships with people who are specifically looking to engage in M&A transactions give the advisor a significant advantage in the process and gives business owners greater certainty to close deals and accomplish their goals.

For sellers, an intermediary provides a measure of confidentiality. Typically, an investment bank solicits pre-NDA interest without revealing their client's identity. Once an NDA is in place, identities are disclosed. How can you maintain confidentiality if you are representing yourself? Ultimately, by running a process yourself, you will give away enough information that your company will be revealed as available for sale before any conversations actually begin. As soon as a buyer knows that you are representing yourself in a strategic sale, before even signing an NDA,

they can assume that you absolutely need to sell your business in the near future. Business owners who do not absolutely need to sell don't go actively soliciting buyers. This knowledge immediately devalues your business and negatively influences your negotiating position long before you even discuss purchase price. Outsourcing your exit strategy to an experienced advisor not only protects your confidentiality, but also gives you the opportunity to maximize your valuation.

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Similarly, a buy-side advisor is important for a company seeking growth through acquisition. Advisors who see M&A transactions on a daily basis have a strong sense of what is happening in the market and what type of companies can be attractive for your organization. In addition, M&A advisors can guide organizations in identifying synergistic opportunities that can properly leverage an acquisition and maximize your rate of return.

M&A advisors constantly see which qualities of a business are attractive to buyers on a day-to-day basis. While anyone can see what is happening in the public markets by checking stock tickers and reading the news, companies that are not listed on an exchange rarely give out such sensitive information. Since M&A advisors work as intermediaries between buyers and sellers, they become privy to invaluable information that business owners need in order to maximize the value of their businesses.

2. I Will Call a Banker When I Need One

Typically, business owners decide to bring in an M&A advisor when they believe “the time is right.” Too often that time is when you have an inbound call from a potential acquirer, or worse, after you have had several conversations with them. To put it simply, the time is right when you are no longer running a start-up. In today's market, you need to be planning on growing through acquisition or selling your business (especially in the technology sector). Every company encounters hurdles. Crossing them without slowing down your growth can be accomplished in one of three ways: get more funding, make a strategic acquisition, or become an acquisition for a larger business. M&A advisors help identify those hurdles early and guide business owners over them.

For sellers, exiting shouldn't just be about cashing out; it's a way to strategically reduce and diversify your personal financial risk. Small to medium sized companies have a significant amount of business risk associated with economic and market conditions that are beyond the control or influence of most individuals; these same businesses also have a significant amount of the owner's net worth tied up in the business. As we have seen in recent years, market turbulence of any variety (from the currency devaluing will have undesirable effects on your bottom line.

Moreover, the imperative to diversify your assets suggests that M&A is an important part of properly minimizing the overall risk level of your “wealth portfolio.” Stockbrokers consistently recommend individuals to diversify their risk by holding a greater variety of asset classes within an appropriate ratio. Considering that the majority of a business owner's wealth is tied up in his or her company, a highly illiquid asset, M&A is necessary in order to unlock

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a business' enterprise value and transform it into something more liquid.

Unlike investments traded on public exchanges, private companies are highly illiquid and cannot be sold quickly. A traditional M&A process could take six to nine months

to reach an agreement with up to an additional three months of due diligence before officially sealing the deal (at MergerTech we have implemented differentiated practices and processes, along with a proprietary buyer's database, that together reduce the time for the whole transaction to between four and six months). Generally,

an investment banking team will devote substantial time and resources in the initial months to understand the basics of your business. Many traditional investment bankers have a significant amount of deal experience, but lack the operational experience needed to accelerate the learning process. Developing a relationship earlier with an industry-focused M&A advisor who understands your business can eliminate such delays, giving you a faster process with greater certainty to closing a deal.

3. Arguing with the Market

At the end of the day, a business is only worth the best offer currently on the table. Occasionally, we see sellers argue that, once upon a time, they would have gotten a certain revenue or EBITDA multiple. If a valuation multiple is not being offered by the market, then the market simply will not pay you an unjustified premium. It is important to remember that companies are valued individually based on their size, business model, margins, and any unique IP or relationships inherent to the company. Sometimes buyers have overpaid, and building up an expectation based on those transactions creates goals that are unrealistic and unlikely to be met. Your business' multiple could be higher just as easily as it could be lower.

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M&A valuations have fluctuated in the past few years; however, historical multiples do not determine today's multiples. Concentrating on a lost M&A opportunity in the past or on a better valuation from yesteryear will only ignore the simple truth: today's market is what it is. Expecting valuations from the years of loose credit environments that gave rise to the popularity of the LBO (or even the dot-com era) is a recipe for disappointment. It is important to be comfortable with the current M&A environment if you intend to begin the process of selling your business.

Similarly, a buyer bidding on a company in a highly attractive space will need to pay a premium in order to beat the offers of other prospective buyers. At the end of the day, a buyer needs to weigh the economic costs of allowing a competitor to buy the prospective seller. If those costs are perceived to be high, an attractive seller will rightly demand a premium on the purchase price.

4. Waiting Too Long To Sell Your Business

Timing is the most critical aspect of M&A. Even in today's economic climate, technology M&A is strong as buyers are seeking to acquire companies to build their financial health as well as reduce their business risk by diversifying their product offerings and client bases. In addition, sellers with strong businesses are eager to exit their businesses and reinvest their capital in new ventures or enjoy their golden years. Chances are that your company has a narrow window for any specific M&A opportunity. Buyers interested in entering an attractive market must do so early, before their competitors gain a significant lead. Conversely, sellers who wait too long to exit run the risk of watching the market pass them by. As the market's interest in particular business segments begins to cool down, valuations for companies in that space will suffer. Buyers will find less value in those businesses and find themselves unmotivated to explore those markets for M&A.

Some sellers try to squeeze out one more years' worth of growth in order to drive their valuations higher. In truth, financial statements are only one small piece of the valuation puzzle. Often, the motivation is to mimic the success of other CEOs that a business owner has read about in their morning newspaper. It is important to realize that businesses warranting such media attention may simply be in right place in the right time.

One aspect of M&A that many business owners do not realize is that a significant portion of their exit value will be in an “earn-out.” Unlike a cash exchange or an issuance of stock, earn-out rewards the business owners for

continued future performance (i.e. a percentage of EBITDA for the next three years). With this in mind, it makes little sense to sell the business when it is mature as the value of your earn-out will be nil. Typically, buyers are willing to pay for growth, but require a certain level of continued growth in the business they are buying. In addition, they want a seller that maintains a stake in the well being of the business during the first few years of transition.

The right time to sell isn't just about market multiples, it's about timing in general. Whether you want to exit on a personal level or you feel that it is time for someone else with greater resources or different expertise to take the business to the next level, it is important to time your exit correctly. Waiting for a market to "pick up" may lead your business to become obsolete.

5: Negotiating with an ATM

It goes without saying that greed kills any deal. Whether it's a buyer trying to get something for free or a seller driving a price beyond a reasonable limit, deals fall apart when "more" becomes "too much." When you begin to visualize the person at the other end of the negotiating table as an ATM – a cash-filled machine – the conversation can only fizzle.

Prior sales experience may not benefit the business owner who is inexperienced in M&A. Let's assume you have a business that sells a widget for \$50 each. You have sold countless widgets at that price point. As the business owner and a salesperson, you know the value of your product every time you enter a sales situation. When a prospective buyer tells you that the value of your product is \$20, you can comfortably walk away knowing that you have succeeded at the \$50 price point before and you will again.

Now fast forward to the day you are selling your business to a prospective buyer. This is a moment where your prior sales experience may not help. Selling a business completely different from selling a product or service because each business is unique and valued on a case-by-case basis. As such, sellers often ask for "shot in the dark" valuations that may simply fit their retirement goals or egos. Likewise, buyers are naturally incentivized to grow inorganically at minimal cost. In these situations, it is important to fit your valuation expectations to market data, business fundamentals, and a strategic fit to the buyer's business rather than personal desire or an expectation of price not based on company fundamentals, industry multiples, and the strategic fit with the buyer.

An experienced M&A advisor knows that everyone who approaches the negotiating table has differing goals and breaking points. While a seller views the transaction as an opportunity to exit the business, buyers are looking for a strategic partner that they can trust and work with to grow their own business inorganically. This creates a critical disconnect between buyer and seller as their intentions and motivations can be best described as opposing dynamics. As such, unpleasant conversations regarding valuation can easily kill a deal both from a financial and personal perspective—would a buyer and seller want to work each other after arguing about money for 3 weeks?

The discussion shifts to valuation only after the strategic fit is established. At this point, the buyer has begun visualizing adding your business to his portfolio. The remaining question is how far that buyer will go to make this acquisition happen. Sellers need to play a delicate balancing act between maximizing their valuation and maintaining buyer interest. On the other hand, buyers need to balance their financing with their desires to gain market position and grow their bottom line. This is the most critical part of the process because the topic of purchase price enters the picture. Up to this point, you should only have been discussing how your company will be a strategic, financial, and operational fit within the buyer's organization and why an acquisition can be of great value to the buyer. Now that the issue of cost is discussed, it is very easy for the dynamics of the conversation to become antagonistic and ultimately break down, yielding no results for either party.

When you tell a buyer that your business fills their strategic needs and focus on his needs over your own, you create a rational and sound argument for him to pay a premium. Furthermore, a properly run M&A process with multiple buyers in play will give you the confidence to challenge a single buyer's initial offer – just like when prospective clients try to negotiate to get your widget at less than market value.



MergerTech is a specialty investment banking firm focused solely on small and mid-sized technology companies. It helps business owners realize the value of their companies through its deep domain expertise and global knowledge of buyers. As a result, it delivers three key values: fast introduction to buyers, best terms and value, and greatest certainty of deal closure. MergerTech leaders have expertise in all aspects of technology investment banking, including mergers and acquisitions, capital raises for growth or recapitalization, and a spectrum of advisory services. For more information, go to www.mergertech.com.

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