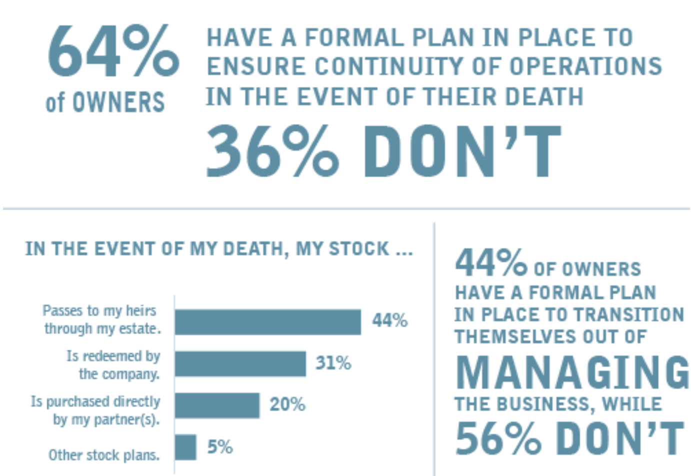
Five Pitfalls to Avoid When Selling Your Company

By Greg Powell and Mike Calder

How to successfully transition ownership while managing risk in the process.

As the famous generation of baby boomers reaches retirement age, much has been made about the tremendous wealth transfer of the largest and wealthiest generation the country has ever seen, with estimates ranging from $20 trillion to $41 trillion set to change hands in the next 50 years. Focusing on the construction industry alone and projecting estimates from FMI's Ownership Transfer and Management Succession (OTMS) survey of industry firms, a little more than 50% of companies will change ownership in the next 10 to 12 years. The question is when and how.

EXHIBIT 1 | STATISTICS FROM FMI'S OWNERSHIP TRANSFER AND MANAGEMENT SUCCESSION SURVEY



Source: FMI's 2013 OTMS Survey

Never an easy decision to make, passing the ownership baton can be particularly challenging for privately held businesses. The transition can take on various forms, from an outright sale of the business to a partial sale, a well-aligned strategic acquirer or an internal transfer to current employees.

Whatever the exit strategy, laying the groundwork for a successful sale is one of the most significant challenges a business owner will face. The wrong approach can create major financial consequences for the current owners, the future owners and the company itself. It pays to know your options and which of them is (or isn't) the right fit for your business. Unfortunately, many owners lack the expertise and guidance to identify the proper path to exit and effectively manage key challenges along the way. These risks are best addressed through long-term planning and near-term positioning, through which business owners balance the company health with their desire to maximize value upon exit.

In this article, we present five pitfalls that owners encounter when selling their companies to internal or external buyers and outline practical recommendations on how to prepare for and overcome these challenges.

1. There Isn't Enough Time

Risk: *You waited too long to properly evaluate and decide on the optimal exit strategy, and now you don't have enough time to execute your preferred plan.*

Assuming an owner does not want to simply wind the company down, he or she must decide whether to sell internally or externally and then plan accordingly. For many smaller, privately held architecture, engineering and construction (AEC) firms, an internal sale to employees is a preferred option. AEC firms are highly people-driven and are often well-suited for internal ownership transfers. In particular, engineering and architecture firms often build relatively large ownership bases—utilizing equity as an incentive and retention tool—that facilitate an internal sale. Also, some firms in this industry are not highly marketable in an external sale process and find that an internal sale can yield higher value.

Internal and external methods of selling a business present significantly different time horizons. A sale to a third party can be measured in months, while an internal transfer can take five to 10 years or longer, depending on company performance and valuation. For an internal sale to work, the seller must have sufficient time left in the business to stay involved during the transition. The buying shareholders must also fit the profile (i.e., be the right age with the right leadership qualities). If a seller waits too long to decide on an exit strategy, he or she may find that timing and circumstances can limit available options.

To mitigate the risk:

- Evaluate your selling options as early as possible, even years before you're actually considering a sale.
- Thoroughly understand the process and timing for each exit option at your disposal.
- Collaborate with experts to understand the viability of each exit option – Is there a market for your firm? Are you structurally equipped for an internal transition?
- For each option, weigh the valuation tradeoffs, the timing implications and the impact each can have on your company and employees.

2. You Don't Fully Understand the Internal and External Factors Impacting a Sale

Risk: *If you proceed without proper diligence, you limit your chances to execute a successful sale process and maximize your company's valuation.*

It's hard to time a sale perfectly. But you can manage timing risk (and seller expectations) if you understand valuation as well as the market dynamics and trends impacting your firm. Key areas to consider include the prevailing market conditions (Where is the company's market in the current cycle? Is this market expected to continue to grow for the foreseeable future or do prognosticators expect an ebb in growth or a reversion to a norm?). In turn, you should honestly assess how you are positioned (Is your pace of growth consistent with the market, or is it better or worse? Are your market share and competitive position improving?).

A seller also needs to look inwardly to identify shortcomings in operations (Is the company sufficiently staffed? Does it lack resources? Is it managing capital properly?) and any weaknesses in performance (Is revenue growing? Are margins improving? Is backlog strong? Are there any problem projects?). Think like a buyer. No one wants to admit that his or her baby is ugly, but recognizing and addressing issues early can help you get out in front of potential problems that can impair valuation or even impact your ability to sell.

To mitigate the risk:

- View your company and the prevailing market conditions with a discerning eye.
- Make sure the company is sufficiently positioned to compete and grow in the current market cycle.
- Maintain the flexibility to time the process right so you get the desired market value without compromising your company's long-term health.
- Be proactive in identifying and fixing operational issues that will surface during the process.
- Use appropriate financial controls that support scalable, ongoing growth.

3. You Lose Sight of How Best to Manage Your Business During the Sale Process

Risk: *You change the way you do business because you are distracted by the sale process or because you want to retain as much cash as possible, even at the company's expense.*

Few issues can hurt a deal more than a drop in operating performance <u>during</u> a sale process. Regardless of the preferred exit path, an owner must work to strengthen the business and make sure that it's well-positioned for sale. Potential buyers want to see a track record of success and sustainable performance during and after the sale process. The company must continue to prioritize business development, project performance and operational and financial controls. If performance begins to fall short of the forecast or backlog begins to drop off while engaging with buyers, interest will wane and pricing can suffer.

Sometimes owners reduce or shut off investment in the company while selling a business, because they want to take as much excess cash out of the business as possible, or because they simply don't want to invest for the benefit of another owner. A seller should avoid risky strategies and certainly doesn't need to make unnecessary capital investments. However, you need to continue normal hiring, operating expense and capital expenditure practices. You do not want to damage the business with short-term savings that can have broader implications. A buyer may very well factor any lack of investment into the deal price anyway. Therefore, owners must keep their eye on the ball and continue to operate the business in a manner that protects the company long term—whether an ownership transfer ultimately takes place or not.

To mitigate the risk:

- Continue to manage the business as though a sale may not go through ("business as usual").
- Avoid cutting headcount or suspending hiring if the motivation is simply to boost earnings and deal pricing.
- Maintain consistent investment and management practices (e.g., continue investing in the right equipment, people, systems and product/service development efforts).
- Avoid unnecessarily aggressive or risky strategies during this critical period.

4. You Underestimated the Difficulty of the Deal

Risk: *What seemed straightforward at the outset has since become an extremely complex selling process.*

It's easy to underestimate the complexity of the deal process, from selecting the right buyer to navigating the steps along the way to close a deal. Maybe you didn't factor in how disruptive the process or a change in ownership can be for your employees, or perhaps you overlooked the tax implications of selling your business. Value is only one piece of the puzzle. An owner needs to weigh the cultural issues, the market implications and the impact that a deal structure can present personally. In fact, assessing the cultural fit can be just as vital (if not more) to a transaction in the AEC industry than price.

An owner is taking a significant leap once he or she he or she agrees to move to the next phase with one buyer on an exclusive basis. If you don't do your homework on a prospective buyer before entering into an LOI, and don't allow the buyer to do the same, you are letting too much execution risk into the process. At a certain point, you let your employees, your customers and the market know about the pending sale. Now, more than just the purchase price is at stake, and you need to be certain that you've chosen the right buyer and that you can get a deal done.

To mitigate the risk:

- Determine your sale objectives, develop a plan and assemble the right team of advisors to understand how a process works and the commitment involved. At the outset, make sure everyone is aligned on how to maximize transaction efficiency and results.
- Consider the cultural fit of a potential merger through the eyes of the buyer, the employees and the customers.
- Enlist accounting and legal experts early in the process to understand the tax and legal implications related to your corporate structure (LLC, S-Corp., C-Corp.) or type of sale (stock vs. asset; internal vs. external).
- Demand that a buyer detail all high-priority deal terms in a comprehensive LOI so you resolve the most important issues prior to moving forward with any one buyer. This way, you minimize the major points of negotiation during the remainder of the process and increase the certainty of closing.

5. There's No One to Follow in Your Footsteps

Risk: *If you are not putting the right people in position to assume leadership, then any exit plan can be compromised.*

If you want to make a clean exit, then you'll have to prove the company can grow and succeed without you. The only way to do this is by having the right successors in place who are capable and willing to lead. Is this individual or group of future leaders prepared? Does he or she have the years of requisite experience or training to take over where you left off? Do you have the people to backfill as managers move up?

With a third-party sale, an owner must determine his or her preferred timeline not only for selling stock, but also for pulling away from the company completely, and convey that intent to the market. Even so, a buyer may not let the seller walk away until they determine he or she is no longer needed. With an internal sale, half of the equation involves transferring ownership while the other half involves transferring leadership and doing so at the right pace with the right people. Succession is an intuitive, but often neglected, issue that an owner must address before a successful transition (internal or external) can take place.

To mitigate the risk:

- As soon as the thought of selling comes to mind, evaluate who can fill your shoes.
- Carefully consider whether this person (or these people) is truly ready to take over, or if additional training, mentoring and other enrichment is needed.
- Develop a plan for transitioning these roles and responsibilities to the right people in the right time frame.
- Make sure there is a deep bench behind those leaders and that the entire business isn't reliant on one person's ability to replace the owner/founder

Conclusion

All sales require a high degree of work, sweat and due diligence to reach a successful conclusion. Regardless of whether you sell to your employees or a third party, there are some strategic moves you can make to either circumvent potential risks or effectively address them as they surface. By planning ahead with the right team, choosing successor(s) far in advance, prioritizing the company's financial health and paying attention to market dynamics, a selling owner will be well-positioned to complete a successful exit and progress to the next stage.

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