Henshaw/Vierra Management Counsel, L.L.C.

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Are You Qualified?

As an advisor to family businesses over the last 20 years I have found that after we have worked with a company to make it safer and more efficient and profitable, we will get around to the question "What's next?" Well, that's pretty simple. Every owner has three choices over what's next: 1. Continue to do what you are doing, 2. Grow faster, or 3. Sell the Company. Each of these choices requires a separate and different business plan.

We have written a lot about Plan 1 – Continue to do what you are doing. Hopefully the Plan includes delivering an accurate and reliable service to your customers at a competitive price. And, that you run your company safely and efficiently at 15 to 20% EBIT or better to provide you with a return on capital which allows you to re-invest in people, products, technology, and give you a reasonable return on your investment. If you are not there, you need to focus on Plan 1 to be able to do Plans 2 and/or 3 well.

When clients come to us and want to talk about Plan 2 or Plan 3, the first question we ask is "are you qualified"? For Plan 2: are you and your team qualified to run a larger organization, and are you qualified to be a buyer and close a transaction? For Plan 3: what are you going to do when the company is sold, have you thought through the financial impact, is your company ready to meet the requirements buyers will insist upon, are you experienced enough to close a deal, and are you ready for the emotional experience you will go through when you sell "your baby"?

Qualified Buyers

Plan 2: Grow faster requires you to take an inventory of your company's competencies, capacities, and capital. First determine why you want to grow, particularly why you want to grow by acquisition. Good reasons to buy: market opportunities are strong; your company has good leadership throughout the organization; your technology and systems are in place and have the capacity to assimilate the target company; your planning and execution with your team has been tested and works well; the target company brings in market share and expertise which can quickly contribute to free cash flow; and, you have the capital, or access to the capital, to close a cash deal. Bad reasons to buy: you have tried several times but you can't get your sales team to produce; you need to grow at any price; your current system will not support your customers' current and future needs, the target has great new technology; and, the best one, I was at a conference and it sounds like everyone is buying companies so I should too.

The best buyers are the ones who know why they are buying a company; have a business plan for the first three years after the acquisition complete with organization charts with clear lines of authority and responsibility; and, they may or may not use the same operating system as the target but they have a conversion plan which is aimed at retaining customers and enhancing customer service. The best buyers have an experienced team of managers and advisors, who have done deals before, to help them identify targets, assist in structuring proposals and letters of interest, organizing due diligence, creating the documents, working through bumps in the road which will always come up, getting a deal closed, and helping to integrate the two organizations. The buyer's team prepares the legal documents in a vast majority of cases. The instructions the buyer gives the team are very important, because those instructions set the tone for the negotiations and due diligence. Buyers should be clear, not cavalier. Clear instructions should come from reading the potential seller and understanding what is important. Unclear instructions at least cause costly re-drafting and could lead to costly litigation after the fact.

The buyer's team conducts the due diligence. Buyers should have a firm idea of key areas in risk management that they know will give them the best quick look at how the seller ran their business. No risk management strategy, few controls, little documentation, and the buyer should back away. There is not enough due diligence you can do, enough funds/hold-backs in escrow accounts, representations, warranties, and/or indemnifications that a buyer could get to make up for the lack of trust the above red flags present.

Much of the due diligence will take place after a letter of interest and a standstill agreement have been put in place, and normally not until a rough draft of the definitive agreement is at least in outline form. Sellers will want to know that a deal is possible before they reveal a lot of private and sensitive information about their company. The buyer will drive the due diligence check list, even though there will be items on the list which the seller will add to learn about the buyer and their ability to manage their customer base after the close and until the last dollar comes out of the last escrow account.

The final qualification for a buyer, is patience. Patience in looking for targets that will enhance their growth plans. Patience in dealing with sellers who may have never sold a company before. Patience with the speed of answering questions, overcoming objections, and with the stress of the deal.

Qualified Sellers

Plan 3: Sell the Company Selling a company requires a complete and well thought out business plan. It requires an understanding of how valuations are determined, a realistic analysis of the company in view of those determining factors, and finding a qualified buyer.

Sellers of well-run payroll/HR/workforce management companies have important market forces working for them. Their business generates **strong repetitive cash flows**, provide customers with an important and fundamental service, and have an asset many qualified buyers are willing to bid for throughout the business cycle. Few, if any, legal companies have these attributes. Interestingly, these great attributes tend to create many unqualified sellers who have not prepared themselves well to find the right buyer who will pay the best price.

Too often we see sellers enter the markets for the wrong reason or unprepared. They get a call from a national company or a private equity group and they want to know what they will take for their company. They have one crisis too many – key person quits, loss of key customers, IT is not keeping up with the market, a competitor is buying the market, a partner dies…suddenly they want to sell. **They haven't really prepared their company, assembled their team, or even shopped the market to know what a fair valuation is**. They are not prepared for what we know will be one of the most emotional and stressful things that they will do in their business lives. Outlined above we described the activities that are undertaken to make a buyer qualified. A seller should also be as prepared as the buyers they will encounter. I will repeat now that selling your company is an emotional thing. It is far less emotional for the buyer. The seller therefore needs to be even better prepared than the buyer.

Selling a company needs a reality check, a business plan, and a qualified team.

We are firm believers that a company is worth what a willing qualified buyer will pay and a seller will accept. There are many reasons why a buyer will make the bid and extend the offer they do. If they pay cash, and they make few demands on a seller, the seller can close, cash the check and move on without having to understand much about the buyer. Unfortunately for the seller, that does not happen very often. There is time and money required by the seller to find a qualified buyer (more than one is helpful), There is more time and money for preparing for due diligence, reviewing documents, closing, then fulfilling the requirements to free escrowed funds, complete earn outs, and make good on representations and warrantees. The seller is tied to the buyer for extended periods of time. It is mandatory that the seller get to know and trust the buyer, and that takes time and energy. **Getting to know and understand a buyer is the first reality check. The second is to understand the net value of an offer.**

In a past Payroll Tribune (see our website: www.henshawvierra.com May 2012 "Where Does Value Come From?") we described that there is a big difference between a gross bid and a net bid. Deal terms further change the effective net proceeds. Deal points, like representations and warrantees, effect the net bid. How the seller prepares for a sale also has an important effect. Above I stated that one advantage that payroll/HR/workforce managements are highly sought after is that they have strong repeatable cash flows. When a seller prepares for sale, they need to clearly demonstrate that their company has, does, and will produce those cash flows whether or not the current owner is there. A good way to show that is to have budgets and income statements that go back three years. Clearly show what happens to income drivers during that period. Be able to explain variances between years, and between budgets and actual performance. Be able to explain multiple pricing tables and the differences between mean product prices, marginal prices, and list prices. Be able to walk a buyer through bundled pricing strategies, if you use them.

Sellers should be prepared to explain risk management practices around tax and trust accounts and ACH flows of funds. Customer files should be defined and available. Company records should exist and be current.

Many sellers are faced with dealing with the darker side of giving customers flexibility when it comes time to sell. Prior to going to market therefore, sellers not only need to understand the effects of customer price discounts on cash flows but also need to be able to show where they are and which customers are effected. In addition, do some homework around is in the documentation and ongoing changes for custom reports. The valuation discounts for not being prepared for these questions can vary from 10% from buyers using the same operating system to 25% or more from buyers who just will not bother with the differences and force customers to convert to their own operating systems, with the seller taking a reduction in the deal value for cash flow lost in the process.

Qualified sellers should not only undergo a reality check on what the market is buying and at what price and have a firm grip on their past three years of financial and operational performance, but they should also assemble their team to guide them through the process. The buyers have their team. Often buyers are serial buyers. They and their team have bought more than one company, done more than one deal. Sellers have often never been though the process of selling anything as personal as selling their company, "their baby and way of life." It is important to level the playing field with qualified buyers, and get experienced advisors for the seller's team.

Qualified sellers take the time to prepare. They put together a team. They plan a strategy and define what a qualified buyer might look like to them. They get understand how value is determined in the market. Did I tell you that all this is emotional for the seller? They prepare for the process of selling, and with patience, they sell their company. Don't forget that by planning for a sale, the seller can either shorten the time and cost of doing a deal, reduce the emotional stress, and/or increase the net yield (hopefully, do all three).

Henshaw/Vierra Management Counsel

Preparing for What's Next * Advising the Board of One

Henshaw/Vierra has been working with the owners and managers of payroll/workforce management companies since 1995. We focus on building better managed companies to give owners and managers a real choice to continue to do what they are doing, grow faster, or sell their company. We have owned and managed payroll service companies and software providers. We have built companies from the ground up. We have managed them. We have sold them. Consider how we might join your team. We are experienced at "Advising the Board of One".