

Selling the Closely-Held Manufacturing Company:

A Divestiture Guide for Owners



Magellan Advisors, Inc.

Business Transition Intermediaries

Overview

The business you've worked hard to develop may be your most valuable asset. Someday it may be sold due to retirement, relocation, death, disability or investment cash out. You'll want to maximize the return on your investment of time and personal funds. The sales price you ultimately receive is your final dividend.

Divestiture of a manufacturing business poses serious challenges given the technical issues and complexities associated with converting raw materials and distributing products in a competitive market. Furthermore, the value of many domestic manufacturing companies has been adversely affected by cheaper imports from other countries and a major world-wide recession.

Nonetheless, there is a strong demand for viable manufacturing companies, and private equity firms hold a prominent position in this market. Buyers are most comfortable with a seller who will negotiate in good faith in a timely manner and who will accept a deal under terms that are reasonable for the current market.

Despite the high interest that investors have for manufacturing companies, closing an equitable deal can still be challenging because given the nature of manufacturing operations, buyers can easily find glitches.

Buyers don't want your problems or surprises. They want a definable quantity, assurance of a going concern and financial justification for their investment. Any risks and unknowns will be discounted out of the sales price.

Most small manufacturers serve niche markets. It's to your advantage to be able to document your strengths in protecting your market share. The price you'll receive for your business is influenced in one way or another by what you do better than your competitors. Distressed companies need to explain their poor performance.

When it comes to divestiture, manufacturing companies are in a class by themselves. Characteristics of these businesses that affect entity value and marketability include:

- Global competition
- High capitalization
- High fixed costs
- Complex orchestration of resources
- Dependence on critical materials and operations
- High level of tangible assets
- Intellectual property
- High business risk
- Environmental and safety regulations

In the M&A (mergers and acquisitions) arena, there is a revenue break-point of roughly \$3,000,000 that separates the lower-market and middle-market businesses. The majority of individual investors execute transactions in the lower-market, while corporate investors dominate the middle-market where transactions are more complex. Given the fact that 99% of people selling a business have no experience in divestiture, they often have misconceptions about the process and jump into it unprepared. It's not uncommon for an inexperienced seller to abruptly pull his company from the market out of frustration.

Keep in mind too that the mechanics of a divestiture are time consuming and emotionally draining. When you're dealing with prospective buyers, accountants and attorneys, you're not running your business. Eventually, the business will suffer. If the

deal falls through, you start the process again with someone else. Selling a business is like crossing a dangerous intersection: *you need to get to the other side as quickly as possible!*

How long will it take to sell your business once it's placed on the market? Six to twelve months is a good estimate.

Other considerations for the business owner thinking of selling are discussed below.

Intermediary

Selling a business of any appreciable size is not a “do-it-yourself” endeavor, and this is especially true in the manufacturing sector. Buyers will take advantage of the naivety of inexperienced sellers.

You'll need to be represented by a qualified business broker/intermediary to level the playing field. Otherwise, you'll run a high risk of making major mistakes. A sell-side intermediary working on your behalf will establish a realistic valuation, locate prospective buyers, prepare key documents and assist with negotiations and due diligence.

Be aware that a prospective buyer may have a buy-side intermediary working to protect his interests and will likely be suspicious if you don't have professional representation. He will question your commitment to sell.

Most business brokers focus on “main street” businesses – i.e., the restaurants, gas stations and beauty parlors. However, when selling a manufacturing company, you need someone with specific expertise in understanding production operations, interpreting factory financial statements and who can find value in the numbers. This is not an assignment for a tax accountant or a realtor. The key question you should ask a prospective intermediary is: “What career did you have in the manufacturing sector before becoming a business intermediary?”

For mutual benefit, a prospective intermediary will assess the marketability of your firm before committing to a contract. The reality is some businesses cannot be sold as a going-concern, and you can't expect an intermediary to do the impossible. Furthermore, it's difficult for an intermediary to defend an asking price that's out of line with calculated value. This assessment process begins with a review of your federal income tax returns for the last five years.

The intermediary who represents you will be paid an accomplishment fee from your proceeds if and when the deal is closed, as well as certain up-front fees and a monthly retainer. As the accomplishment fee is contingent, the intermediary has a real incentive to close the deal for maximum price.

The accomplishment fee is calculated based on final transaction value. A typical fee arrangement works out to 10% for a \$1,000,000 transaction; 6% for a \$5,000,000 transaction; 3.5% for a \$10,000,000 transaction; and 2.25% for a \$20,000,000 transaction. Any up-front compensation paid to the intermediary should be deducted from the accomplishment fee.

Confidentiality

Confidentiality is an important aspect of any divestiture for obvious reasons. Leaks of a pending sale may cause your employees to jump ship, your customers to

find other sources and your suppliers to stop offering credit. This is why you don't see "For Sale" signs hanging on factories.

Maintaining confidentiality during divestiture does not mean hermetically sealing your company from the outside world. That would be both unnecessary and impractical. For one thing, no astute buyer will lay out millions of dollars to buy a company before having face-to-face contact with its key employees. At some point, you'll have to discreetly "open the curtains" on a need-to-know basis. Your intermediary will work with you to establish a confidentiality strategy that will allow the divestiture process to run its course, but in a discreet manner. This strategy will include how the intermediary communicates with you and your key staff. Confidentiality agreements will also be executed before the release of any information.

Timing

Timing of the sale is important because entity value is driven by current earnings. As such, the market value of a business will fluctuate over time. This is why business appraisals are always prepared as of a specific date. To receive maximum value, you must time your sale to coincide with a period of maximum earnings. However, you must also take into account the marketing lead time which is the time necessary to get your company into the market. You really need to start working with an intermediary well before your earnings peak.

Owner Solidarity

A closely-held business is not designed to be taken apart and sold in pieces. If your company has more than one owner, it's in everyone's best interest to sell out together. The owners should reach a consensus up front or the marketability of the company will be compromised.

Pre-market Preparation

You'd be wise to prepare your company for sale well ahead of actually placing it on the market, even though this may require several months and significant cost. Manufacturing businesses require more pre-market preparation than service businesses. The investment of time and money will, at the very least, shorten the time for a deal close and make your company more appealing.

The objective of pre-market preparation is to 1) clean-up the balance sheet, 2) eliminate issues that may arise during due diligence, 3) ensure that important documents are accessible, 4) ensure that critical resources are in place, and 5) perform general housekeeping.

The production area is of primary concern because prospective buyers will likely make an early walk-through before doing in-depth analysis, and first impressions do count. Is your factory a showcase or a dungeon? Does it have fresh paint and good lighting? Are aisles and work stations clearly marked? This may be a good opportunity to implement the 5S program you've been delaying for years: sort, straighten, shine, standardize and sustain.

In retrospect, the time to start thinking about pre-market preparation was the day you became owner.

Offering Memorandum

The *Offering Memorandum* or *Prospectus* is your formal marketing document presented to prospective buyers. It's the "packaging" that sells the company. A well-written offering memorandum will portray the business favorably but honestly and will lay the groundwork for subsequent due diligence. Without it, you'll be answering the same questions over and over with different buyers.

Prospective buyers will use the offering memorandum to decide whether to continue their review or walk away. Be prepared to assemble a large amount of data. For a manufacturing company, an offering memorandum is typically 30 to 40 pages in length. The sections usually consist of an executive summary, company description, product descriptions, ownership structure, historical financial performance, projected financial performance, personnel, market assessment, competitive assessment, sale terms and appendix.

The offering memorandum will be prepared by your intermediary. You may feel that you have the technical skills to assemble it, but you don't have the time.

Buyers

The buyer of your business can be a strategic investor, a private equity firm, an employee or a group of employees, a family member, a competitor, an individual investor or a consortium of individual investors. The negotiation process will be affected accordingly.

The strategic investor is looking for a business to complement an existing investment platform and is likely to offer the highest price. Private equity firms are looking for a true turnkey business. They are the most sensitive to earnings and cash flow and are the least tolerant of operational shortcomings. Competitors should be considered only as a last resort because they can benefit from sensitive information, and they are the most likely to violate confidentiality. It's a good idea to start thinking early about your options for locating a buyer.

Real Estate

Commercial real estate is a business in itself. Real estate owned by your company should be appraised separately and the operating costs segregated when calculating an earnings stream. For small firms and distressed businesses, real estate can dominate transaction value.

Deal Structure

You can divest your business by selling either the equity or the assets. Each method has advantages and disadvantages for both the buyer and seller. Selling equity is less complex and avoids reincorporation by the buyer. The primary downside is the buyer being exposed to the potential liabilities of past acts. If you sell

assets, you're responsible for all existing liabilities not assumed by the buyer, and your workforce ends up with a new employer.

Management Transition

If you're actively involved in running the business, you may be required as part of the deal to stay on as an employee or consultant for a specified period after the business is sold. The buyer may want you to provide training and to ensure a smooth transition. Such a relationship can be a serious imposition if your objective is to retire or start another business, and you may be uncomfortable reporting to a boss. You should decide early about your post-closing availability as this issue will likely be raised during negotiations.

Valuation

Establishing a value and asking price for your company is a complex and subjective process that must be performed by a qualified business appraiser. Valuation is based on numbers, not emotion. The objective is to adequately document the valuation so as to make it difficult for a buyer to challenge.

The value of a business can be determined by a variety of methods. However, a going-concern manufacturing business should be valued using an earnings-based method that applies an *earnings multiple* or *capitalization rate* to an earnings base. The earnings multiple is driven by specific business risk factors and the current risk-free cost of capital. Both the earnings multiple and earnings base will fluctuate over time. As such, valuation will also fluctuate over time. An earnings multiple cannot be used if the business is operating at a loss or at breakeven.

Earnings is subjective. It's important to differentiate books earnings, tax earnings and seller's discretionary earnings, none of which are relevant in determining entity value. An essential part of the valuation process is to normalize or "recast" books earnings where discretionary and extraordinary expenses are added back to arrive at true entity profitability.

Goodwill

This is where you earn the real money on the sale. *Goodwill* is the portion of the sales price over and above the net value of the balance sheet assets. In theory, goodwill is the value of the intangible or off-balance sheet assets such as company name, customer base, workforce, patents, trademarks and processes. Goodwill is comprised of two components: *going-concern goodwill* and *demonstrated goodwill*. A company that is being liquidated for the value of its tangible assets has no goodwill.

Growth Potential

A buyer is really purchasing an anticipated earnings stream and will see more value in your business if viable opportunities exist to increase earnings. Be prepared to answer the question: "How would you expand the company if you had the resources?"

Strategic Planning

When you decide to sell, you should refocus your operations to maximize earnings. This will allow you to realize the highest sales price. Avoid discretionary transactions that drain cash without providing an immediate gain to your bottom line. These include new white-collar positions, major equipment purchases, research and development projects and marketing campaigns. Be cognizant that new investment in infrastructure may be of no value to a new owner.

Audited Financial Statements

Preferably, the latest financial statements in the Offering Memorandum should be audited. Audited statements are more comforting to prospective buyers, allowing them to place a higher credibility on your disclosures. Although an audit may be costly, it will probably pay for itself in the long run. You should prepare for an audit by cleaning up inventory detail, equipment listings and accounts receivable as soon as possible.

Letter of Intent

A *Letter of Intent* will be submitted to you by serious prospective buyers after completing their early-stage review and discussions. The LOI is essentially a non-binding agreement to purchase the company pending completion of due diligence. It specifies the proposed terms and conditions and identifies the offered price. It also stipulates that you will take the company off the market pending completion of the deal. You will use the Letters of Intent to evaluate offers and to further negotiate terms and conditions prior to the formal due diligence review.

Due Diligence

Due diligence is the review and verification of business operations that a buyer performs to validate your representations. It consists primarily of document and records examination, but also encompasses inspection of tangible assets, observation of operations and contact with key employees, suppliers and customers.

Don't take due diligence lightly -- 25% of deals fail here. Ideally, you should perform your own due diligence to eliminate problems *before* the buyer brings them to your attention. Any issues discovered during due diligence must be resolved or negotiated. The offered price and terms and conditions may need to be adjusted accordingly. Furthermore, due diligence must be conducted in a manner that will maintain confidentiality. If the deal falls through, another buyer will be repeating the process.

Financing

The buyer may expect you to finance a portion of the deal with an installment note. You should establish your acceptable limits before placing the business on the

market, keeping in mind that the installments will be paid from future earnings controlled by the new owner. A note carries risk and should be collateralized even with the buyer's personal assets. Don't be afraid to pressure the buyer to obtain financing through a commercial lender.

If the buyer is a corporation, you may be offered stock as part of the payment. The stock of a privately owned company has no ready market, and you are essentially trading the ownership of one company for another.

Inventories and Equipment

The issues here are 1) do they really exist? 2) how much are they worth? and 3) will they contribute to future earnings? These are the questions a buyer will ask during due diligence. Small companies are often lax in conducting periodic physical inventories and may be carrying bogus assets on the balance sheet. Also keep in mind that a fully depreciated asset may have significant market value. At the very least, a buyer will insist on a supervised physical count and may ask you to match raw material stocks to bill of material requirements. Get a head start by doing housekeeping, confirming asset existence and disposing of obsolete items.

Lean Initiatives

The productivity of your business will be factored into the sales price. In today's global market, *Lean Manufacturing* is taken as the norm. A buyer will be willing to pay more if your company is already operating under the principles of lean and does not require additional investment to move away from classic batch processing and its related inefficiencies. Some of the key areas to address are redundant and complex setups, indirect workers, non-value added activities, rework, delays, long lead times and ineffective materials management.

Product Documentation

Will the new owner be able to continue manufacturing products after you and other key personnel leave? Everything you do in the factory must be documented and the documentation must be accurate. Intellectual property stored in your head or scribbled on oil-stained paper has no value to a buyer.

Product documentation is a major component of intangible assets and goodwill. It includes bills of material, routing sheets, process sheets, prints and similar data incorporating the latest engineering revisions. Such documentation will be scrutinized and possibly tested during due diligence. It's smart to get it all in order.

Operating Systems

Your internal systems for accounting, performance reporting, order entry, internal control and the like will also be reviewed during due diligence. Problems in these areas should be addressed as soon as possible to avoid credibility issues. If the buyer concludes that operating systems are inadequate, the replacement cost will likely be discounted from the sales price.

Tax Consequences

Your proceeds from the sale will be subject to federal and state income taxes. Depending on how the deal is structured, you may pay taxes on both capital gains and ordinary income over multiple tax years. Assets sold from a C corporation will be subject to double taxation. A tax advisor should be consulted before closing a deal because the tax consequences are irreversible.

Indemnification

Don't think you can walk away from potential problems by selling your company. As part of the Purchase & Sales Agreement, the indemnification section will hold you personally liable for liabilities and losses that are uncovered after the closing balance sheet. The exposure here comes from law suits, unpaid taxes, recalled products, failed equipment and missing inventory. The buyer will likely offset these damages against future payments due to you. You'll need to negotiate reasonable indemnification limits prior to closing.

Summary

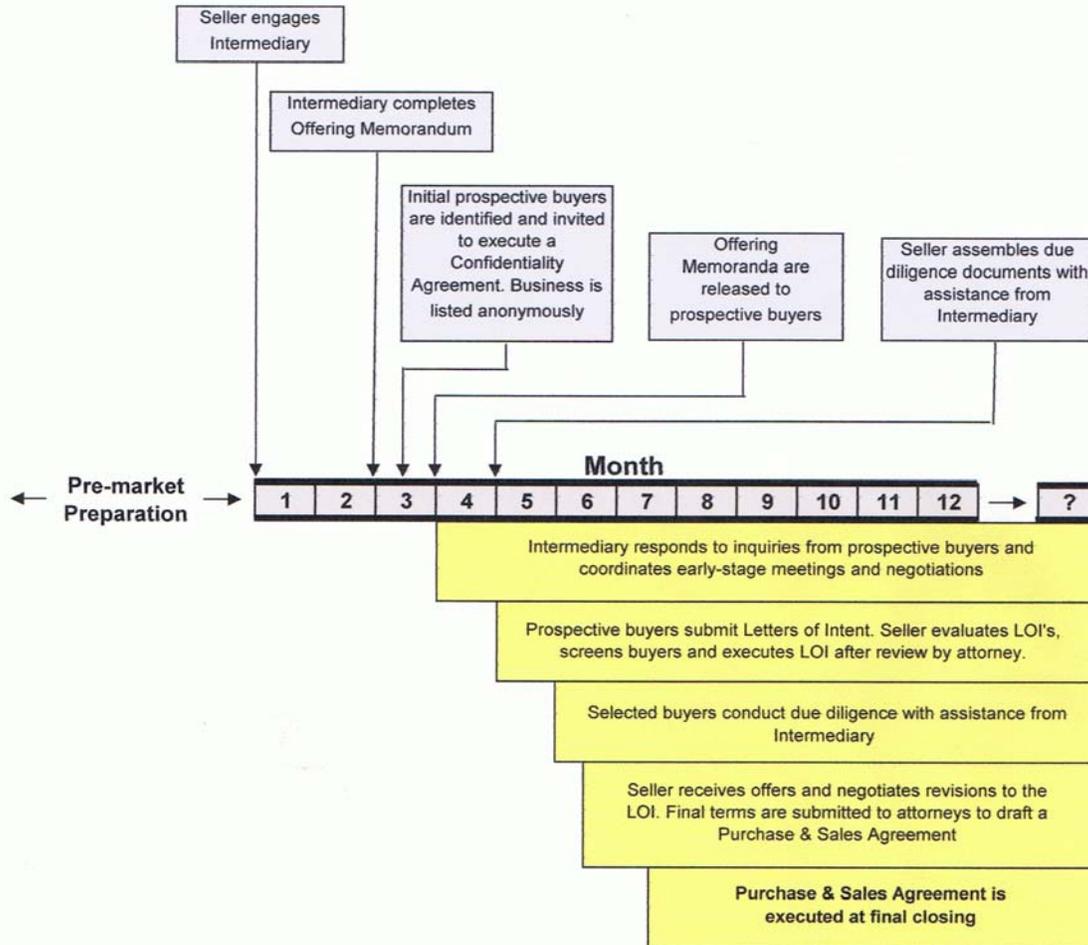
Divesting a manufacturing company is a major event in your life. Errors in judgment or execution can be very expensive, and there are no "do-overs." The selling process is time consuming and requires significant effort on your part. Advance planning is necessary to ensure a timely closing and a realistic sales price.

Like most sellers, you'll be venturing into new territory. This is no time to find yourself lost in a swamp. You'll need outside professional skills from various disciplines to guide and protect you. In the long run, cutting corners with outside support is self-defeating.

Avoid selling under forced conditions such as death or disability. There are other viable alternatives that should be discussed with an advisor.

Try to sell when you and your company are in a position of strength, but recognize the lead times to get into the market. Be flexible, honest and knowledgeable of current market conditions. Act intelligently and you *will* maximize your final dividend.

Middle-Market Transaction Timeline



Manufacturing Due Diligence Checklist

Entity

- Articles of Incorporation/Organization
- Bylaws
- Organization status
- Ownership
- Financing
- UCC filings
- Board minutes
- Delegation of authority
- Industry statutory law compliance
- Contracts
- Leases
- Disaster recovery planning
- Litigation and claims
- Government audits

Historical financial performance

- Five-year tax revenue and earnings
- Five-year product line revenue and earnings
- Extraordinary transactions

Products

- Technology
- Current products
- Planned products
- Services
- Industry trends

Assets

- Real estate
- Inventory
- Machinery and equipment
- Construction-in-progress
- Receivables
- Other assets
- Security

Accounting

- Independent accountants' reports
- Financial statement integrity and relevance
- Software
- Budget variances
- Account detail and analysis
- Cash flow
- Records retention

Information Technology

- Software licenses
- Network configuration
- Security
- Backup

Government Filings

- Annual reports
- Income taxes
- Sales and use taxes
- Employment taxes
- 1099's
- SEC filings

Human Resources

- Employment agreements
- Confidentiality agreements
- Union agreements
- Job descriptions
- Undocumented employees
- Uncompensated employees
- Independent contractors

Risk Management

- General business
- Business interruption
- Product liability
- Workers' compensation
- Errors and omissions

Production

- Bills of material
- Routing and process sheets
- Procurement
- Lean practices
- Workplace safety
- Environmental protection

Engineering

- Patents and trademarks
- Research and development
- Sustaining

Sales and Marketing

- Customer base
- Competitors
- Web site
- Marketing plan
- Credit practices
- Order entry
- Pricing
- Quotations and proposals
- Outside sales reps

Customer Service and Product Support

- Warranty policy
- Resources

Magellan Advisors, Inc. is an established business broker and M&A intermediary licensed by the Securities Department of the Illinois Secretary of State. We provide a wide-range of transition services to sellers and buyers including business valuations, due diligence, operations analysis, market packaging, strategic planning and turnaround management.

“We provide professional guidance so you can make intelligent decisions.”

Contact us to arrange a free consultation:

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