



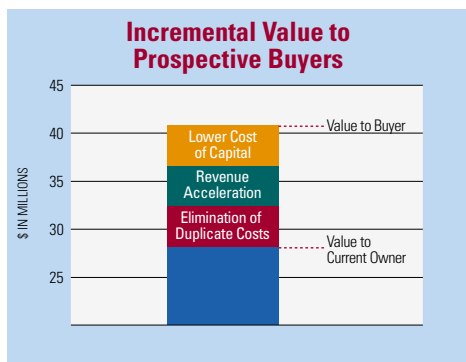
INSIGHT

The Controlled Auction

Creating competition among multiple bidders results in a higher value and better terms for the seller.

by William S. Hanneman

A “controlled auction” is a structured process in which prospective buyers compete to buy a business in a bidding war where the highest price wins. “Auction,” because there are multiple parties bidding for a business simultaneously. “Controlled,” because the process unfolds in a carefully planned sequence designed to build and maintain a strong negotiating position. In a controlled auction, the opportunity is presented to a select group of qualified buyers in a manner that simulates a market. Competing offers are sought through several stages to ratchet up the price until a winner is declared. Successfully conducted, the process creates value for the seller in both price and terms. A prerequisite set of conditions must be in place in order for an auction to work. Rarely do they all exist in practice, at least not without much advance work on the part of the seller and its advisory team.



As articulated in the Fall 2006 issue of *Insight*, beauty is in the eye of the beholder, especially as that applies to business value. That is, individual buyers will reach differing value conclusions for any particular business for legitimate reasons. Different owners may have a unique ability to accelerate sales, eliminate duplicate costs or assets, or achieve a lower cost of capital. And, some buyers may

KEY ELEMENTS TO A CONTROLLED AUCTION

- 1 There must be more than one logical, financially qualified buyer interested in owning the business.
- 2 Buyers must have all the information they require to commit to a transaction.
- 3 Buyers must have the financial capacity to quickly complete the transaction once an agreement has been reached.

just be more optimistic about what can be accomplished in the future than others.

Of course, buyers are reluctant to share with sellers the incremental value they expect to derive from the business. Indeed, the overriding objective of a prospective buyer is to pay as little as possible for a given opportunity. The only sure way to extract a portion of those value-creating opportunities for a seller is to create competition among several buyers. The goal of this effort is to put some portion of the value that a buyer may be able to create into the seller’s pocket.

PRECONDITIONS

The key elements of a successful controlled auction include the following:

- There must be more than one logical, financially qualified buyer interested in owning the business. This could result as a function of the important position the company holds in its market niche, a particular product or capability that would be valuable in another company’s hands, or simply strong performance in a growing market segment.

- Buyers must have all the information they require to commit to a transaction. This means that information must be assembled and provided in a relatively short time period to prospective buyers so that they are sufficiently well informed to reach firm conclusions regarding value and deal structure.

- Buyers must have the financial capacity to quickly complete the transaction once an agreement has been reached.

Conducting a controlled auction, with a dynamic operating business can be challenging. Perhaps the single most important reason to hire an investment banker is to develop a marketing plan and sale process that is de-

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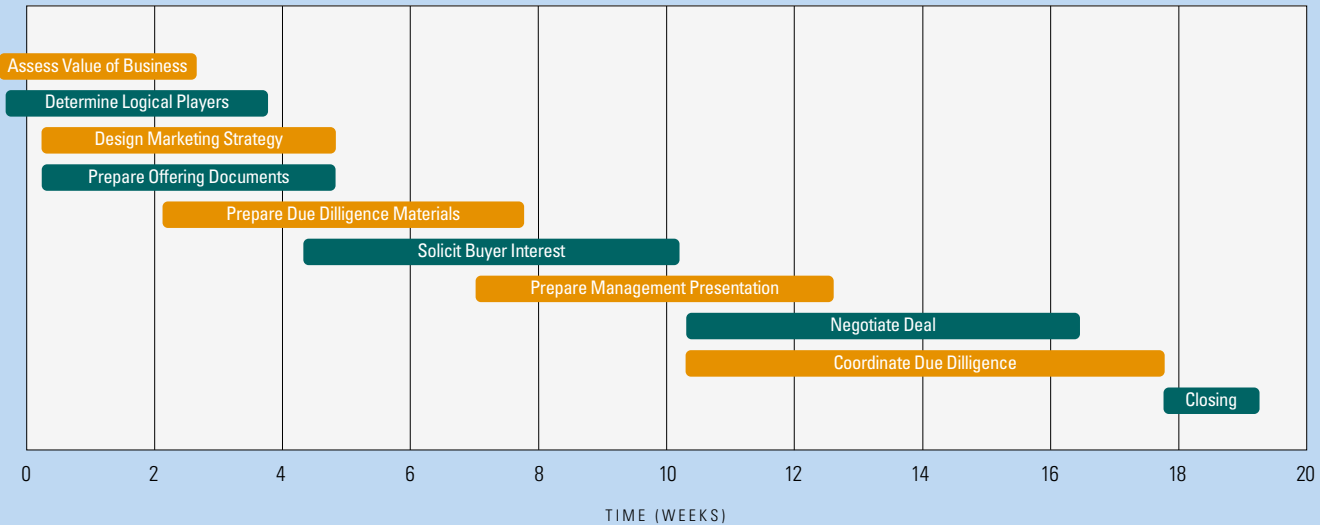
PROCESS

The first step is to identify all of the prospective buyers that, in some measure, can improve the economics of the business, either in a combination with another business or following the institution of improved business practices. The most logical buyers have some experience or an existing position in the seller’s industry, whether as an operating business or financial investor.

Targeted buyers must conclude that in order to be successful they must 1) put their best bid forward, 2) believe that once the process is over, the opportunity will be gone (lost forever to a competitor), and 3) the process will have integrity in that following the rules will be an advantage, not a disadvantage.

The investment banker, working with management, prepares a memorandum that showcases the best attributes of the business.

Controlled Auction Timeline



The information must be comprehensive and complete, not hiding any facts that could, if discovered later, slow or derail the process.

Information is provided to prospective buyers and valuation bids are solicited from all buyers simultaneously. Upon receipt, a short-list of buyers that express the highest values,

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demonstrate financial capability, and require the fewest closing contingencies are invited to visit the business and meet with management. At that time, select buyers are offered the opportunity to conduct more thorough due diligence to confirm the accuracy of the information that was provided. The hope is that this process will further stimulate the buyer's interest allowing them to increase their conclusions of value (and/or improve the probability of closing quickly). During this time, buyers are asked to provide objective evidence of financial capability.

Buyers selected to participate in this phase are provided with a draft purchase agreement rather than the traditional letter of intent. The purchase agreement does not specify a price but does detail the terms and conditions of a proposed transaction. Short-listed buyers are then provided with a short period of time to insert their final purchase price and mark

up the draft purchase agreement for the seller's consideration. This is typically the last opportunity to improve the purchase price and/or terms while still in the heat of competition.

Upon receipt of the marked up purchase agreements, a single buyer is selected with whom to finalize the purchase and sale agreement. Once executed, the purchase agreement will typically provide for a very short period of exclusivity during which closing conditions are met, required approvals are received, and financing is solidified (if necessary).

Accomplishing these tasks in a timely manner requires a huge dedication to advance preparation. The seller must be ready and able to close a transaction at the time that buyers are first contacted. Anything short of that will cause a delay and all delays deteriorate the seller's negotiating position and jeopardize results.

The above chart shows a typical timeline and the activities that take place in a controlled auction process. This schedule illustrates a 20-week process, which would be typical in a transaction where nothing goes awry.

PERILS

Not every business can be sold in a controlled auction and even those that begin that way can unravel. Here are a few of the many challenges to achieving the objectives of the controlled auction:

1. Critical to success is maintaining the integrity of the controlled auction process. Buyers must believe that there is no favoritism, that their offers will not be shopped, and that the intent is sincere.

2. Any differences between what is presented in the memorandum and what is learned in meetings with management or during due diligence is likely to derail the process. Accordingly, it is absolutely necessary that all information is disclosed, even the dirty laundry.

3. Timing and schedule are essential. If there is a belief that some buyers will be able to reach conclusions more rapidly than oth-

ers, they should be contacted later in the process. Regardless of how desirable a particular buyer may be, if the party lacks either the experience or discipline to efficiently navigate the process, adjusting to an individual buyer's situation can disrupt the auction.

4. Long lead-time events, such as third party consents, financing commitments, and due diligence efforts strain the ability to maintain the competitive fervor.

In reality, few middle market private companies are prepared to be sold in a controlled auction. But, many elements can be used in virtually every sale to increase competition for the opportunity and keep the process on track.

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The pressure of competition and the threat of the opportunity being lost to a competitor are the only factors that can compel a buyer to pay what the business is worth to them. Accordingly, the highest values are invariably achieved when businesses are sold in competitive processes. A well-run controlled auction can deliver a meaningful premium to a seller over the stand-alone value of a business sold in a negotiated transaction with a single party. ❖

A Search for Quality: Avoid the Due Diligence Quagmire

Business owners beware; do not underestimate the exhaustive financial due diligence process by a prospective buyer when selling your business.

by Mark Working

Perhaps it is the overhang of Sarbanes Oxley, the lessons of the late 1990's buy-out boom, or the legal exposure that can ensue with litigious investors, but one thing is certain, no buyer wants to risk learning of some material detail to the acquired business post-closing. As a consequence, we have found that both financial and strategic buyers have ramped up their due diligence efforts to look at business operations, performance, and systems at a very granular level. Prospective business sellers should expect to endure an exhaustive due diligence process. Preparation is a keystone to success in achieving the optimum value and the highest probability of closing a sale of the company.

Virtually every business owner we have known has underestimated the challenge of financial due diligence. Two common and sincere refrains are that "the CFO has all the information at his finger tips and can handle it" and "our accounting system is pristine." At the outset, the process is akin to an audit, but quickly expands beyond GAAP compliance into a free ranging investigation into cost accounting, product line and customer profitability, revenue concentration, breakeven analysis, earnings sensitivity, and business / financial risk assessment. The unsuspecting CFO will likely find the process to be far more intrusive than any financial audit.

QUALITY / CONSISTENCY

Due diligence starts with a financial review, with buyer inquiries directed toward determining the quality both of the data collected and the reporting of information. In this regard, "quality" is an assessment of the reliability and consistency of underlying data collection practices. A financial statement review is simply a launching point into the evaluation of data collection practices. It extends into the verification of how both financial and operating data is collected and finds its way to the company's management information system and financial statements. Effort focuses on reviewing systems, financial statements, and audit workpapers, together with staff interviews that delve into procedures for collecting, processing, reporting, and reconciling information.

The inquiry moves on to test the degree to which financial reports adhere with generally accepted accounting principles ("GAAP"). Here, the buyer is seeking to gain comfort with the consistency and integrity of the information presented in financial reports. A common misconception among business owners is that their financial statements are

fully GAAP compliant. Often private company financial statements are presented in "material compliance" based on judgments that minor variances from GAAP do not give rise to a material misstatement of results. That can leave room for debate regarding the methodologies for revenue and expense recognition and establishment of reserves for warranty, product liability, bad debt, and inventory obsolescence. Surprises can largely be avoided with the preparation of audited financial statements by a reputable accounting firm for at least several years preceding the sale.

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Although a review may suffice, a full audit is preferable, as it serves as independent confirmation of consistency in accounting practices. It is important that the CFO pays close attention to auditors' suggestions for reducing the reliance on "materiality."

EARNINGS QUALITY

In many cases, the most challenging aspect of due diligence is the buyer's effort to accurately quantify the intricacies of business operations and profit generation. That means an examination of data that explains business unit, customer and product profitability, and measures asset quality and utilization. This level of analysis requires an ability to integrate

financial and operating data and then "slice and dice" it in a multitude of ways.

Buyers are seeking to develop a detailed grasp of the economics of the business to determine the impact of accounting policies on smoothing performance and to understand exactly how and from whom its profits are earned, the factors that affect the ability to sustain those earnings, and the requirements for capital to maintain and grow each aspect of the business. A static analysis of the business will not suffice. Only a robust database of financial and operating data that can be arranged in a variety of formats enables the seller to fully address the buyer's questions.

PREPARATION IS THE EFFECTIVE COUNTERMEASURE

Anticipation is essential. Know that methods and results may be challenged at a deeper level than management normally requires or has seen. Although not a complete list of potential challenges, the table below highlights areas of potential conflict.

As the keeper of data and master of the systems, the CFO is the central player in the due diligence effort

Answering questions on the fly, while meeting day-to-day business demands, is difficult. On occasion, we encounter some reluctance on the part of a financial officer to cede control of a portion of the process. But, if the CFO has not recently been through a full diligence process and does not have sufficient internal resources, the process will bog down, usually to the detriment of the seller.

Anticipate, get some help, and avoid a perpetual due diligence quagmire that is likely to sow uncertainty among employees, and ultimately increase transaction costs and diminish sale proceeds. ❖

DUE DILIGENCE CHALLENGES	COUNTER MEASURES
Accounting practices will be challenged; no firm is exempt from improvements, but the list can be shortened.	Engage a reputable CPA firm and competent staff as part of the transaction team to review all procedures in advance. If challenges are anticipated, financial presentations can be adjusted in the beginning of the process to avoid "misunderstanding" about performance.
Alternative accounting treatments are commonly used as a rationale for restating business performance, fostering a renegotiation of price.	Disagreements regarding GAAP can spawn heated negotiation deep in the process. These differences often do not actually have any economic significance and therefore should not be the basis for an adjustment. Separate economics from accounting.
Financial statements rarely explain business economics in detail.	The ability to effectively articulate business economics with data has a major bearing on value and due diligence efficiency. As part of our preparation, we have often remapped the entire accounting general ledger of a company to create a customized presentation of income statement and balance sheet items to illustrate critical economic aspects of the business.

Size Matters

Why small good businesses are valued differently than their larger counterparts.

by Michael T. Newsome

News regarding the high cash price multiples garnered in today's markets does not elude the ears of small business owners. Nevertheless, for valid reasons, lucrative valuation metrics and all-cash prices are not necessarily applicable to many successful small businesses (< \$10MM enterprise value). Understanding the factors influencing this differential may help to moderate expectations and avoid disappointment at the end of a sales process. More importantly, it may set the stage for some actions that could improve the outcome.

Our focus in this article is on small service, distribution, or manufacturing firms that compete in narrow niche markets. Specifically, these are situations where competition is somehow limited and the market is relatively mature. Nestled in these niches are very good little businesses that consistently earn attractive returns on invested capital. These niche businesses often operate under the radar of larger competitors. In this environment, financial success frequently can be credited to a very lean organization, where the owner-operator is the dominant decision maker.

The reasons why good businesses like these are valued differently than their larger counterparts are several: lack of market depth for buyers, limited access to capital markets, lack of growth opportunities, and management succession risk.

The sheer size of the business and its market can mean that it does not fit into any corporate entity's strategic vision. In other words, the lack of opportunity for growth does not warrant the acquisition effort. There is no perceived synergy.

At the same time, private equity investors, either as a buyer or as a financial supporter of management, find this type of business to be a challenge for several reasons:

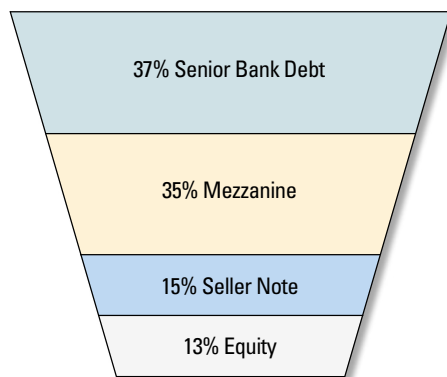
- The owner is usually crucial to the success of the operation; and when that person is bought out, a replacement is necessary. That transition introduces risk to the buyer.

- The stable, but static, business leaves little opportunity to effect change that will increase value, either through growth or improved operations.

- The same transition issues are likely to exist when it comes time to exit from the business.

Since growth is not available to enhance the investment return, the only way to achieve an acceptable investment outcome is through financial leverage of a conservative acquisition price, which is difficult to achieve in the

capital markets. The availability of borrowed money to support either a private equity or individual buyer is typically limited to the asset base that would serve as senior debt collateral and a thin market for small mezzanine financings. Business size matters to lenders because smaller firms are inherently more vulnerable to risks such as management turnover, competitive change, or economic cycles. Accordingly, financial leverage, if mezzanine lenders can be attracted, may not exceed 3x EBITDA. The end result is a valuation meaningfully below the premiums bandied about in the financial press. As an example, it would not be abnormal to see an acquisition price below 5x EBITDA having a capital structure as follows:



The owner of a small niche business can't change the market conditions in which the business operates, but can improve the outcome of a sale process by decreasing the risk to the buyer and all of the lenders, including the seller. Several actions can be taken to achieve these objectives:

- Groom replacement management. A succession plan that transitions day-to-day management to a competent team reduces risk from the perspective of buyers and lenders.

- Motivate managers to think like owners by permitting them to buy or earn (not

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be given) a piece of the equity. This spreads responsibility and represents a piece of the transaction financing that doesn't have to be raised by a financial buyer.

- Develop borrowing relationships with lenders. Creating a history of borrowing money fosters lender confidence that management can succeed under leveraged conditions.

If these things have been accomplished, when the time comes to sell the business, several conditions will be different. The risk of management succession will have been eliminated and lenders will have confidence that the team can successfully operate the business with leverage. Whoever the prospective buyers, greater certainty in management and readily available debt can lead to a more competitive atmosphere which can affect the purchase price and lessen the amount and risk of the seller financing. ♦

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to ZacharyScott.com.

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