

BDO CANADA TRANSACTION ADVISORY SERVICES INC.

SELLING YOUR PRIVATE BUSINESS

A plan for success



▶ THE DECISION TO SELL IS A DIFFICULT ONE FOR ANY BUSINESS OWNER.

While it's natural to develop a deep affinity for enterprises that you have nurtured and grown, owners and their advisors should also consider an exit strategy as part of any business planning exercise.

A well-executed sale process can maximize the value of a business and benefit all "stakeholders" — shareholders, employees and customers alike. A sale to the right party can enhance prospects for accelerated growth of the company and create new opportunities for employees.

Nevertheless, transactions can be difficult to execute, and assessing the value of a business can be a complex process. In addition to historical and projected financial performance, outside factors, including the general economy, investor sentiment and the strength of the debt markets, must be considered since they can play a meaningful role in determining how much a purchaser is willing to pay.

While key transaction terms can be agreed upon in a matter of weeks, a typical sale process can take six months to a year, even after pre-planning is completed. Furthermore, a buyer may need certain key members of the management team to continue working with the business for a year or more after the sale.

The following high level questions should be addressed by every potential seller:

- What is the motivation for a sale? Is it to obtain simply the highest possible price and best terms, to achieve the best possible strategic fit with a new owner, or to partially sell in order to obtain growth capital?
- How much involvement is desired after the sale? Should all ties be severed or, alternatively, does the seller want to participate in the future potential of the new business combination?
- What are the legal and tax-related issues of a particular transaction structure, and how might they affect the purchase price?

This publication is designed to assist business owners in contemplating the issues addressed above and raise other considerations to be addressed in connection with a potential sale. The professionals at BDO are available to help you navigate the transaction process and ensure that the decision to sell is sound and ultimately profitable.

Overview

A sale process, conducted with the assistance of a transaction advisor, such as BDO, is a proven effective means to achieving the highest sale value and best possible transaction terms. At the same time, it (a) protects confidentiality, and (b) allows the management team to remain focused on ensuring the solid financial performance of the business.

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A standard sale process is comprised of many steps, including initial business preparation, buyer analysis and approach, negotiation and completion. This document provides an overview of the process while also addressing selected "hot button" considerations that arise in almost every transaction.

Preparing for a sale

Ideally, exit strategy planning should start at least a year in advance. This time is necessary to make appropriate human resource decisions, complete tax planning, make changes in ownership structures, and anticipate any other matters that should be resolved to ensure an orderly sale. Insufficient preparation, such as the lack of a clear management transition plan, may result in a smaller buyer universe and lead interested parties to discount your company's value.

Although selling a business can be difficult under any circumstances, an unplanned sale — such as one triggered by cash flow problems, revenue shortfalls, ownership succession issues or other unforeseen events — will usually yield suboptimal results. Selling too quickly weakens bargaining power, whereas a well-planned sale can serve to both reduce owner emotion and optimize results. It is best to prepare in advance and choose the appropriate timing.

Positioning the business

Once a decision is made to sell, consideration should be made to make the business as attractive as possible to buyers. Factors to consider include:

- Capturing the seller-friendly attributes of the business
- Identifying the growth opportunities that a new owner can leverage
- Understanding characteristics of prospective purchasers that can best maximize your company's value, therefore justifying a higher price
- Deciding on alternative forms of acceptable consideration, including cash, stock, debt, contingent payouts, etc., to maximize total consideration

Indicative controlled auction sale process



Advisors who specialize in structuring transactions and positioning companies for sale can be helpful at this point in the process. They can offer objectivity, experience and an external perspective to present the business at its highest value.

BDO professionals can advise on the best form of transaction, and work in conjunction with an owner to identify what structure may be most salient for his/her business.

Advisors will also offer insight into the stock versus asset sale decision. Buyers typically prefer to acquire assets, as they do not assume the seller's unknown liabilities. However, most sellers prefer to sell stock, both because this transfers future liability for unknown liabilities to the buyer, and because a sale of assets may result in additional transaction-related taxes for the seller.

BDO can help analyze this decision and work closely with tax experts to ensure the most efficient structure is utilized.

Your company today

A detailed financial analysis should be performed before any business is put up for sale. In addition, historical financial statements and business projections should be restated to eliminate the effects of non-recurring expenses, such as lawsuits and extraordinary items, as well as specific expenses that would not be incurred by a new owner.

Privately-held businesses are often managed to minimize taxes rather than maximize profitability. Expenses that are typically capitalized may be expensed. These same businesses may also have certain built-in expenses, including owner perks, charitable contributions, generous benefit packages and car leases. It is critical that all excess expenses be accounted, segregated and disclosed to a prospective acquirer. The process of presenting "pro-forma" financial statements is the key to maximizing the value of the business. For a business in an industry with a valuation multiple of six times earnings, "add backs" of \$500,000 can result in a \$3 million increase to the selling price.

If the company's financial statements have not been independently audited in the past three years, a seller may want to have audited financial statements prepared so that prospective purchasers can have confidence in the reported results. Audited financial statements can greatly facilitate the due diligence process should bank financing be necessary to complete the

purchase. The audit process can also raise issues that should be addressed prior to entering a sale process.

Steps should be taken to ensure that the business is in compliance with all legal and regulatory requirements, including environmental regulations, occupational safety compliance measures, and federal, provincial, and other taxes. Trademark registrations should also be brought up to date. Careful consideration should also be given to key employees whose individual contributions are critical to the future of the business, such as a star salesperson, scientist or head of marketing.

Retention of critical personnel is usually very important to preserving the value of a business. Ensuring continued employment can be accomplished through employment contracts, stock options or bonuses tied to the successful completion of the transaction.

If there is ongoing litigation potentially not covered by insurance, consider settling prior to beginning the sale process. A prospective buyer may worry about the outcome, and a plaintiff may see the new owner as having "deeper pockets".

It is inevitable and expected that your pre-sale review will reveal problems. Candidly disclose problems at the appropriate time in a negotiation with your buyer, and explain how they can be corrected. Failure to identify or disclose these problems may result in an unsuccessful sale or significant reduction in price.

Your company's prospects

Most buyers, especially those who will pay top dollar for your company, are interested less in current results than in prospects for growth. Explaining the real potential of your company — what it can become if a new owner takes advantage of the opportunities you have identified in the marketplace — will be beneficial to your sale.

► ITEMS TO CONSIDER DURING THE PREPARATION PHASE:

- Obtaining an independent financial audit
- Checking regulatory compliance
- Creating stay-behind bonuses for key employees
- Resolving litigation issues ahead of time

► UNDERSTANDING HOW A BUSINESS IS VALUED

The only true measure of a company's financial value is the price offered by a willing and informed buyer. Before negotiating a sale, an owner should obtain an estimate of value, even if it is just a starting point for final negotiations. The standard methods by which companies are valued, summarized below, each have their own strengths and limitations. They are typically used together to determine the most objective valuation range.

► Comparable public company multiples

A private company is valued according to the metrics available for similar publicly-held businesses. While this provides the most up-to-date valuation information on a particular market segment, sellers should understand that public companies often receive higher values as a by-product of their large size and transparent financial reporting procedures.

► Comparable transaction multiples

A company is compared to other acquired companies in the same industry. The challenge is that finding true "comparables" is difficult, and the timing of a transaction can influence the value. Even if price information is available, key terms are often confidential.

► Discounted Cash Flow (DCF)

This method mathematically examines the free cash flow projected to be generated by the company over a given period (typically five years), and the value of the company at the end of the period. These values are then discounted back to the present, using a weighted average cost of capital (cost of equity and after-tax cost of debt), in order to derive a valuation range.

► Payback period/internal rate of return

This is the length of time it will take to generate net profits equal to the purchase price and provide a risk-adjusted market-based return on investment. Standard methods of valuation have recently been challenged as a result of off-balance sheet accounting issues, including pension obligations, intangible assets, litigation and environmental claims. Sellers should be mindful of valuing their people, knowledge, relationships and brands much in the same way as tangible assets like property, plant and equipment are valued.

Understand your buyer, including key strategies and how your company can help achieve his/her objectives by creating value in the new combined organization.

You may also succeed from updating your business plan so it presents a detailed road map to the company's future. The price received for your company will be determined by how attractive you make that future look, and how credibly your forecasts are supported. BDO can help you articulate the opportunities you have identified, and support projections with market data, statistics, demographic information and other validation.

Consider your company's key value drivers:

- Why would someone buy it?
- What is proprietary or unique about it?
- What growth strategy will propel its success and differentiate it from your competitors?

Finding the right buyer

A common error made by owners trying to sell their businesses is to assume that the best place to find a buyer is among the people and companies they already know, e.g. the existing management team, respected competitors, suppliers or customers. However, in the long run, most sellers discover that there are often better alternatives.

Management teams are intimately familiar with business issues and, therefore, may well undervalue the company. Likewise, they may not have the financial wherewithal and can make dealing with other prospective purchasers difficult due to their imbedded conflict. Direct competitors with knowledge of a pending sale may misuse the information in the marketplace, making suppliers and customers feel threatened.

When considering a sale of 100 percent of the business, the best price and terms are likely to be offered by a strategic buyer already invested in the same industry as the seller. Strategic buyers — including public companies, individual investors and investor groups — purchase companies based on the prospects they see for future growth, rather than primarily on asset value or past results. A corporate acquirer may be attracted by a new market, distribution channel, valuable trademark or other attribute that can leverage the performance of the parent company. Individual investors are attracted by similar advantages, which they believe they can help maximize through hands-on management.

On the other hand, a financial buyer may be the right choice if an owner would like to retain a minority stake in his/her business in the future. Although valuation may be marginally lower than from a strategic acquirer, the owner may consider the ability to create liquidity, diversify wealth and participate in the future upside of the business just as valuable. A financial buyer is typically inclined to focus its valuation on two elements: (a) the company's historical financial performance and (b) strategies to improve future financial performance, either through top-line revenue growth or cost reduction. Financial buyers may or may not take an active management role in the business but will almost certainly sit on the board of directors.

► BDO CAN PROVIDE CREATIVE AND OBJECTIVE ADVICE TO MATCH YOUR SPECIFIC FINANCIAL NEEDS, INCLUDING:

- Identifying and assessing your capital market alternatives
- Developing strategies to meet your corporate and personal objectives
- Executing a transaction that will maximize your shareholder value
- Mergers, acquisitions and joint ventures
- Raising private equity capital for growth companies
- Strategic capital markets consulting
- Providing fairness opinions
- Valuation analyses

The sale process

During the sale process, it is typical to prepare several key documents.

Confidential Information Memorandum: This marketing document, usually prepared by the company with the assistance of a financial advisor, is used to describe the company, its operations and growth prospects. It contains an analysis of operations, detailed financial results for several years, a discussion of those results, the history of the company, an analysis of its markets and operations, and well-supported projections for the future. Buyers will carefully review the executive summary and financial information in the memorandum before deciding whether to proceed.

Non Disclosure Agreement: This undertaking between the seller and prospective purchaser defines the terms under which confidential information will be shared. It is negotiated and executed prior to the sharing of the Confidential Information Memorandum.

Bid Solicitation Letter: Usually transmitted along with the Confidential Information Memorandum, this requests a written non-binding expression of interest in the acquisition outlining a proposed purchase price and other requested information. Prospective purchasers are further qualified based the content of their nonbinding expressions of interest and other research.

Management Presentation: The buyers that are most interesting to the seller are invited to attend a face-to-face management presentation where attending parties will present and discuss their respective businesses. The seller presents his/her business in this form, prepared in collaboration with the financial advisor. This presentation describes the business in more detail than the Confidential Information Memorandum, and provides a controlled forum for the mutual exchange of additional information.

Purchase and Sale Agreement: Following the presentation, buyers are typically asked to review and comment on a draft Purchase and Sale Agreement as prepared by seller's counsel, and update their latest perspective on valuation.

Data Room Index: Purchasers may also be granted access to detailed legal and financial information on the business as outlined in a Data Room Index, which is used to help manage the dissemination of information. Data rooms are typically housed in secure websites that are password protected, thereby allowing due diligence to occur remotely. At this stage in the sale process,

detailed negotiations between prospective purchasers and the seller usually take place.

Letter of Intent: In certain instances, this letter between the prospective purchaser and the seller (advised by the financial advisor when appropriate) may be executed prior to the negotiation of a definitive Purchase and Sale Agreement. It outlines some of the key terms of a potential transaction, including the price, form of proceeds, form of transaction, employment terms for key employees and the timeframe in which to execute a definitive agreement. Most of the terms are non-binding and protect the buyer while doing little for the seller. In fact, many contain a "no-shop" clause, which prohibits the seller and his/her advisors from dealing with other potential purchasers during its term.

The final negotiation

In a sale transaction, everything is negotiable, including the purchase price, how it is paid, and what is actually sold. From a liability and tax perspective, sellers typically want their buyer to acquire shares, not just selected assets, while buyers prefer to purchase assets and assume specified liabilities.

If an owner's personal abilities or customer relationships are vital for the company's success, the buyer may require the seller's continued involvement during the transition period. The amount of time, responsibility and compensation for this work must be addressed early and negotiated in detail.

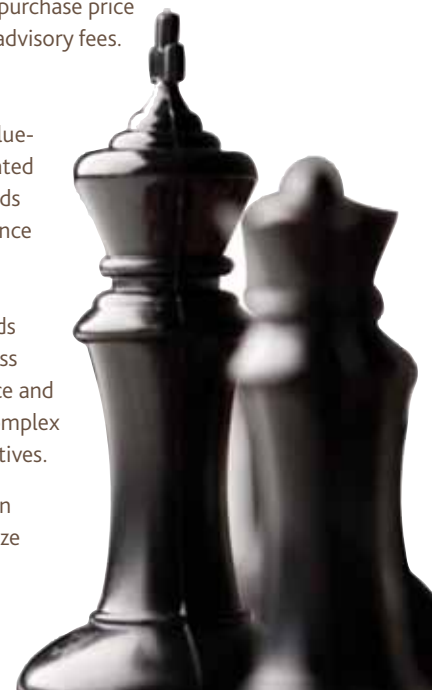
Finally, a seller may be more optimistic about the company's future than a cautious buyer, resulting in a seemingly unbridgeable gap in valuation. Often, the solution is an earn-out or contingent payout. At closing, the buyer pays a base amount and also agrees to make future additional payments if the company reaches certain net profit, cash flow targets, or other agreed-upon benchmarks. Structuring and documenting earn-out agreements need the attention of experienced financial advisors, accountants and lawyers.

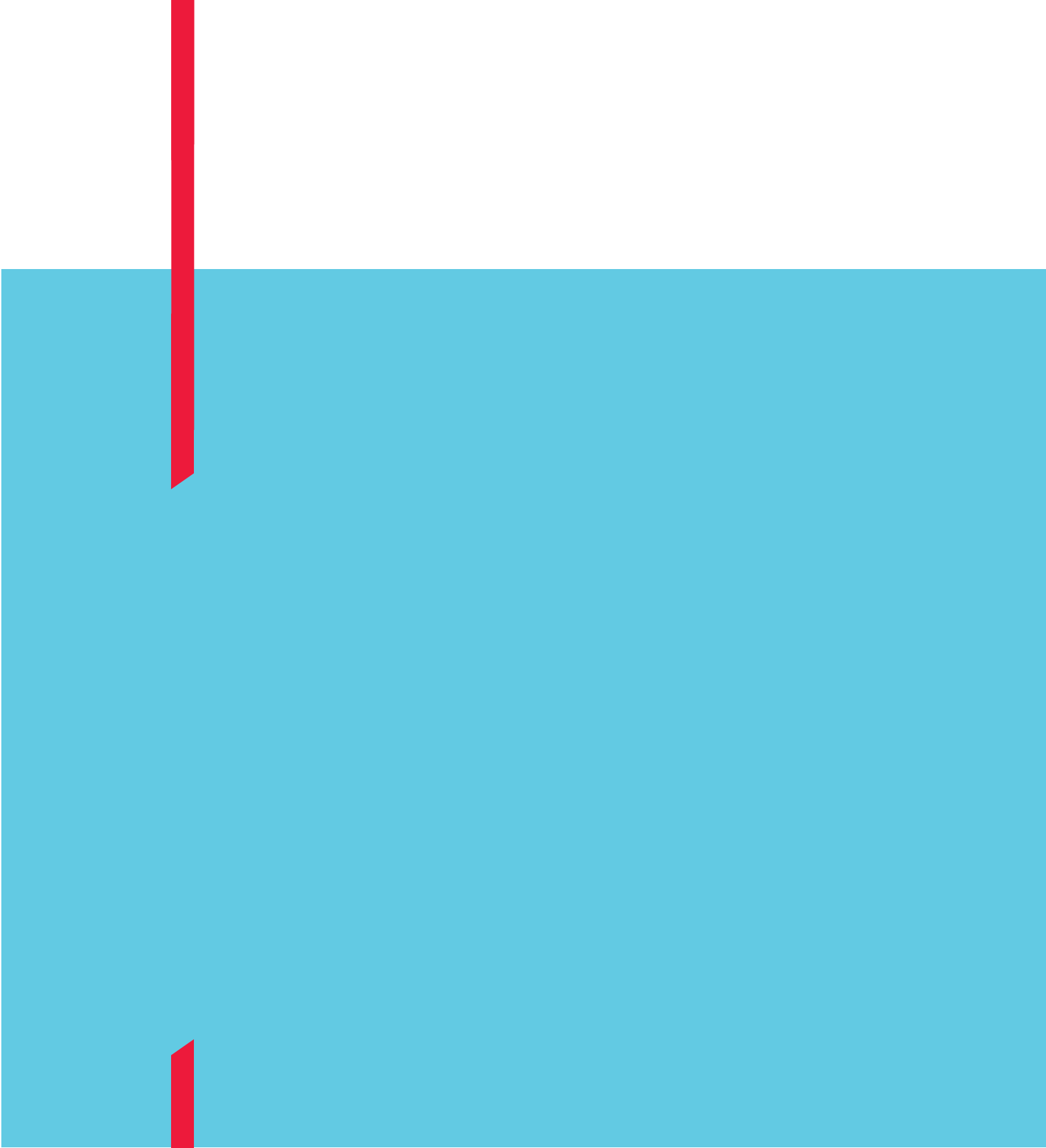
An experienced advisor can help business owners anticipate a wide array of issues that arise in a sale process. The increased likelihood of completion, combined with improved purchase price and sale terms, more than offsets the advisory fees.

How BDO can help

BDO is uniquely positioned to offer value-creating solutions. Through our integrated service approach, we serve clients' needs from both strategic and corporate finance perspectives. Whether your company is considering growth opportunities, transitioning to new ownership or needs to increase financing, we can help assess your options. Our significant experience and relationships help us recognize your complex business issues, as well as your alternatives.

We recognize that every client situation is different. Consequently, we emphasize the importance of gaining a thorough understanding of each business and its owner's individual objectives.





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