KeyBanc Capital Markets

So You're Considering a Sale of Your Business – Now What?

In this Q&A, experts from The CapStreet Group and KeyBanc Capital Markets® share their observations on what an industrial distribution company owner can expect when preparing to sell a stake in the company.

As you consider the big decision to sell your business, you would be well served to prepare the business to attract potential buyers' attention and maximize the price it can command. Paul De Lisi, a partner with The CapStreet Group, a private equity firm active in the industrial distribution sector, and T.J. Monico and John Newman, investment bankers and co-heads of the Industrial Distribution & Logistics practice at KeyBanc Capital Markets, provide an insider's view of how to prepare and what to expect.

What are some of the key considerations for preparing to sell one's business?

De Lisi (CapStreet): The most attractive industrial distribution business has a leadership team with operational strength. They offer a big-picture view of where the industry is headed and how their company can succeed in that future. So, a team that is considering selling its business should develop a strategic plan (projections and vision) that articulates a compelling story of how the company is going to grow over the next three to five years.

Monico (KBCM): A vision for the future is vital—but so is being able to explain the past. Owners who are deciding whether or not to sell their business should review their historical financial results and be able to explain the changes in top-line results, margins, working capital, and other similar metrics.

Essential Data to Gather Before a Sale

- ☑ Sales and margin by customer, supplier, salesperson
- ☑ Branch-level results
- ☑ Explanation of volume, pricing, working capital trends, etc.
- ☑ End markets served and associated trends
- ☑ Monthly financials
- ☑ Near-term (1 year) and long-term (2-3+ year) projections
- ☑ Strategic plan

Also, the owner should be clear about his or her personal goals. If he or she wants to retire in the near future, that plan should be stated upfront. The role of the owner has a big impact on post-sale planning, and the acquirer will want to factor succession planning into the investment decision.

What specific kinds of information does a seller need to gather for potential buyers?

De Lisi (CapStreet): T.J. (Monico) is right—we want to know what drove performance in the past and how that performance "bridges" to projected results. If the company does not have audited financials, having an audit performed can help prepare the team for a sale process. That being said, having an audit is by no means a "must have" for us—we have acquired numerous companies that have not had audits previously. With or without an audit, buyers almost always ask to perform a quality-of-earnings analysis. It may behoove the seller to perform his/her own QoE analysis to understand all the potential issues in advance of entering into discussions with potential buyers.

Newman (KBCM): One of the primary valuation metrics buyers utilize is a multiple of earnings (typically EBITDA). As a result, sellers should make sure that their earnings accurately reflect the business as it will look under new ownership. For example, expenditures that will go away under new ownership (e.g., charitable contributions, excessive salaries or T&E, salaries to non-employees, one-time IT or legal costs), should be identified and "added back" to the historical financial results.

What kinds of critical data do owners typically find most challenging to provide?

De Lisi (CapStreet): Many companies that we look at are unable to provide detail behind their historical results. For example, we like to look at sales and margins broken down over time by numerous metrics, including by customer, salesperson, supplier/product line, branch, end markets, etc. This level of detail helps us understand the business more completely—both where it has been, and where we think it could go if we were to make an investment. As with audits, this type of information is a "nice to have," but we have made numerous acquisitions without having access to this level of detail at the time of our investment.

Monico (KBCM): On occasion, we have found that management teams have a hard time providing sufficient backup for their projections, particularly if those projections extend beyond the standard one-year budget. As previously discussed, buyers want to know that the business has a long-term strategic vision, and this vision is judged in part by the rigor of the process by which the projections are developed. Buyers like to see a rationale for the vision, and "math" on how that rationale translates to the projections—for example, substantiating growth to a specific customer or customers by utilizing third-party data on projected growth in the end markets that those customers serve. Also, if adding sales personnel or new branches is part of the story, then be prepared to back up the projected new sales by highlighting historical performance when new sales personnel or locations were added in years past.

Other requests are bound to come up that are specific to a business or a set of prospective buyers. To anticipate those, it's best to have an advisor "in the trenches" with experience selling distribution companies specifically, to help the owner anticipate diligence requests and prepare the necessary information to accurately and advantageously present the value proposition.

What are common mistakes that owners make when preparing for the sale of a company?

Newman (KBCM): Owners are often surprised by the time and effort required to provide the data and documentation necessary to satisfy the diligence needs of prospective buyers. A common mistake is to understaff the preparation and ongoing effort—often in the name of keeping the process confidential. However, this under-resourcing can be extremely counterproductive. Often, not having the correct or enough personnel involved in the process results in

> "The more completely an owner can document past performance, projected results, and underlying assumptions, the easier it will be for potential buyers to not only see, but also believe in, the full potential of the business." T.J. Monico, KeyBanc Capital Markets

incorrect data or delayed response times, which can in turn lead to a delayed timetable or a lack of confidence in the business team. It's no surprise that these issues will likely negatively impact valuation, turn off a desired buyer or even scuttle the deal entirely.

De Lisi (CapStreet): Owners sometimes try to sell the company when results are nearing a peak. Realistically, it is hard to time a sale perfectly. An owner is more likely to get a better valuation when the outlook for the business is positive and the business has a runway for future growth. Room for growth is particularly important if the owner is going to either remain in an operational role or participate in future upside by owning a portion of the equity going forward, as is often the case when selling to private equity.

What is a common misconception about private equity?

De Lisi (CapStreet): Two common misconceptions come to mind. First, that all private equity firms are the same. In fact, the numerous "styles" of private equity substantially affect how a management team works with the new owners. For example, some firms are actively involved with their portfolio companies and engage in weekly discussions with their management teams, whereas others are more comfortable with quarterly strategic discussions.

In addition, many firms like to place former industry executives on the boards of their portfolio companies, whereas others maintain more informal board structures. Understanding the differences between various potential investors should inform a seller's decision on which partner to select. Valuation is clearly important, but the selection of buyer should not be based solely on price.

The second common misconception is that private equity is short-term focused, aiming to cut costs to grow the bottom line. In fact, most firms are more focused on investing for growth to increase the value of the company—whether by expanding the management team or sales force, implementing a more robust IT platform, investing more significantly in working capital or making strategic acquisitions. We look to add value by investing in infrastructure (e.g., IT, new locations, personnel) upfront, and then grow the business organically and through acquisitions over the life of our involvement.

> "We want to see a concise, decisive strategic vision for the company."
>
> Paul De Lisi, CapStreet

Monico (KBCM): Some sellers believe that private equity investors will maximize leverage to minimize the equity that they have to invest—and that this will prevent additional investment in the business going forward. Frankly, we disagree with this outlook. While debt is certainly utilized to finance the transaction, often to a greater degree than a private owner is used to, the leverage is not at a level that prevents investing for growth. As Paul said previously, private equity firms are focused on growth, and the last thing they want to do is implement a capital structure that prevents them from achieving the goals of the business.

How important is the management team when you are evaluating an investment opportunity?

De Lisi (CapStreet): Having a strong management team in place that will remain with the company long term is clearly a positive for us, but it is not a requirement. We have invested in numerous situations in which the owner intended to retire within the next one to three years. We work very closely with our companies on succession planning, and we are comfortable transitioning an owner out of the business if that is his or her goal. The key for us is that the transition plan with the CEO is clearly discussed before closing the transaction. Our ultimate goal is to have a management team in place that will continue to drive the business long after we have exited the investment.

Newman (KBCM): Whether the buyer is a private equity investor or a large strategic buyer, the management team is usually a very important ingredient in the investment decision. Not to repeat an overused adage, but distribution is a people business, so management continuity is extremely important. And the quality of that next layer of leadership—regional/branch managers, sales directors, etc.—can also be important in driving buyer interest.

Are we in a good market cycle for selling an industrial distribution business?

Monico (KBCM): Today's market remains extremely "seller friendly." With today's oversupply of capital and robust valuation multiples (particularly for distributors), there has never been a better time than now to explore options. And that is really all it is—exploring options. I agree with Paul that many owners become too fixated on timing the market while maximizing company performance. Today's market affords business owners the opportunity to monetize a portion or all of the value they have created by making a strong argument about the future potential of the company. Time and time again, we have seen both private equity firms and corporate acquirers pay big prices for companies that have strong future potential.

De Lisi (CapStreet): It is clearly a good market for selling a business, but another key consideration is to understand how value will be created for the owner if he or she retains a portion of the equity. Owners who partner with us typically hang on to a portion of the equity to retain some of the upside. Often, our owners have made more money on rollover equity when we exited the business than when they originally sold the business. So, as I mentioned earlier, it is much more important to put your company in a position to succeed with the right partner than to be concerned about whether or not it is a good market for selling.

To learn more, contact:

Paul DeLisi
The CapStreet Group
713-332-2722
pdelisi@capstreet.com

Visit capstreet.com

T.J. Monico
Industrial Distribution Investment Banking
KeyBanc Capital Markets
216-689-3079
tj.monico@key.com

John Newman
Industrial Distribution Investment Banking
KeyBanc Capital Markets
216-689-5496
john.m.newman@key.com

Visit key.com/industrial

KeyBanc Capital Markets