CHAPTER 1

Why People Sell Businesses

> "When faced with two equally appealing bales of hay, the donkey could not make up its mind which to eat and so died of starvation."
>
> Jean Buridan (1295–1358),
> French philosopher and theologian

I remember when a realtor told my wife and me, "Selling your home is the most important and stressful transaction you will ever undertake." While a truism for most people, selling a home is, for most businesspeople, child's play compared with selling the family business. Most entrepreneurs will go through four or five homes while selling their core business only once. They will have spent at least as much time on their businesses, which will have been the focus of their productive lives. Although the sale of a business is usually not as traumatic for a management team without an equity stake in the company, the whole process, and especially orchestrating the sale of a business where one works, is bound to result in many a sleepless night.

So why do otherwise sane, logical people put themselves through all the long hours, stress, and nail-biting inherent in a company sale? In my 26 years of investment banking, to say nothing of my partners' 150 years of the same, we have seen all the reasons: retirement, differences among co-owners, an untimely illness or death, a change in the company's strategic position that makes a sale timely or necessary, financial pressures forcing a sale, financial opportunities offering the prospect of a lucrative transaction, the closing-out of an investment fund, or an unsolicited offer, to name a few. The preponderance of our experience has been with family-held businesses, and this book is focused primarily on their situations. However, the lessons are just as applicable to corporate divestitures and sales of publicly traded companies.

HONESTY IS THE BEST POLICY

Before examining each reason for selling in turn, I urge every prospective seller to be brutally honest with himself, along with his investment banker and lawyer, about the real reason for the sale. This is critical for two reasons: First, it is virtually impossible to conduct an effective sale process if the seller will not make explicit why the transaction is being undertaken. This makes it difficult, if not 100 percent impossible, to market the business to achieve the seller's underlying objectives. Second, buyers are always probing to learn why the business is for sale. If the reason given does not fit the facts, they will become suspicious of everything they are told, true or not. They will see ghosts where there are none if they feel the reason for the sale is bogus, often reducing their offer or refusing to bid.

I recall one situation in which a client told us that his motivation for selling his company was to retire from full-time management, even though he was a vigorous man on "the sunny side of 60." However, as our marketing process unfolded, we learned that he was selling because he was terrified of technological developments that would undermine his company's market position. We learned this when he became frustrated at us for entertaining proposals in which he would retain a significant ownership in the enterprise after closing or accept part of the purchase price in the form of an earnout (more on these concepts in Chapter 4). Given his technological concerns, the most appropriate course would have been to focus on strategic, all-cash acquirers that could absorb his customer base and finance the new technology. To this day, I am not certain whether he was either not being honest with himself, not being honest with his investment banker, or some combination of the two. Whatever his reason for misleading us, the effect was a marketing process that was going 180 degrees in the wrong direction.

Ego and family politics are common reasons owners are not forthright about their reasons for selling. After all, they are accustomed to being the CEO, the patriarch, the boss. To many owners, selling the business means losing that power. When the business employs family members, the emotional stew becomes even spicier. Furthermore, many business owners are not used to confiding their personal plans, self-doubts, and vulnerabilities. To them, selling the business is often perceived as an act of weakness, or even mortality. I have often found that the Young Presidents' Organization or the owner's long-trusted attorney can act as a sounding board.

In the corporate arena, deciding to sell a business is usually a much less traumatic, less personal decision. Typically, senior management decides to raise cash by divesting a division or subsidiary that does not fit with the strategic plan. Sometimes, managers object because this means that the business units under their personal control will be reduced, but the stock market's expectations and the corporation's need for the cash make a powerful argument. The board approves the decision, hires an investment banker, and the divestiture is on its way. For top management, the decision is about as gut-wrenching as deciding whether they are going to have bacon and eggs or pancakes for breakfast. The direct consequences on the careers and livelihoods of the managers and employees of the unit being sold are another matter, but they are not the ones making the sale-versus-no-sale decision.[1]

Unlike the divesture of a public company's division or subsidiary, the decision to sell the entire company is generally quite emotional. Here, the board members and senior management have much of their professional lives and identities wrapped up in the company that they themselves have to decide to sell. Thus, the decision dynamics for the entire public company are often similar to those in a privately held business. The distinction is that the public company managers and board members, unlike many owner-managers of privately held companies, generally only own small portions of the company's stock. Thus, however much they try and claim not to act on them, they almost inevitably have interests in some ways distinct from the shareholders on whose behalf they serve. The most professional of these persons focus on the shareholders' needs and put their own on the back burner. The not-so-professional executives sometimes don't mince words about "what's in it for me?" It has been a big step forward that most members of public company boards have positions independent of those public companies, a situation that did not exist all that long ago.

The reactions of financial sponsors, organizations that raise pools of capital, invest it to purchase numerous companies, work with the companies' managements to improve their performance, and then harvest their invested funds through the companies' sales, public offerings, or recapitalizations, are similar to those of corporate executives. The financial sponsors are run by professional investors, and thus are not emotionally tied to any one company in their portfolio. Their limited partnerships are raised to start new or buy existing companies using financial leverage, so company sales are part of their world. Although the general partner's financial incentives are tied to successful sale transactions, each fund generally has a broad portfolio, thereby tempering the effect of any one deal.

So when investment bankers like me ask owners probing questions about their motives, our desire is to provide the best service to our clients. After all, a doctor can never effectively diagnose and treat a patient if the patient inaccurately or incompletely reports his symptoms.

MOST COMMON REASONS PEOPLE SELL

So why do people decide to sell businesses?

Retirement

For privately held companies, the owner's retirement is the most common reason for a sale.[2] As a distinguished trusts and estates attorney once told me, he has never prepared a will for a dying person who regretted not spending more time at the office. While retirement is a reasonable motive, many business owners do not realize that most buyers will want them to stick around during the postsale transition period.

There are two ways the owner can adjust to the transition period. The first is to plan the sale well before the owner wants to spend his time "hitting the little white ball." That way he can remain through the transition, which may be as short as six months or as long as three to five years. Generally speaking, the thinner the seller's management team, the longer he will have to stay if he does not want to accept a haircut to the purchase price linked to the uncertainty of a management transition.

The second way for the seller to adjust to the transition period is to, in effect, begin the process before the business is sold. This is accomplished by recruiting and installing a new president well before the owner commences the sale process. Ideally, the new president should start at least a year before the marketing process commences. Two years is even better because it provides time to hire a different person if the first does not work out (more on how to transition a new president in Chapter 5).

Differences among Co-Owners

Differences among co-owners are a common reason for a sale. These can be "friendly," such as diverging strategic perspectives or tolerance for risk, or "unfriendly," such as questions of business or personal ethics. When these differences do arise, they might be solvable through one co-owner buying out the other. However, if this is not feasible, then a third-party sale may be the best course of action. The key is for the co-owners to "bury the hatchet" during the sale process. Whatever their differences, they have a common interest in securing the best price and terms. Their common success will depend in significant measure on their professional cooperation and demeanor.

A sale forced by differences among co-owners can be especially challenging when one owner is going to remain with the business. We once dealt with a challenging situation in which a business had two 50 percent co-owners, a 65+-year-old man who had financed the business and a 45-year-old man who had built the business and would ostensibly remain in charge. My firm approached a publicly traded NYSE buyer that offered a terrific price, but the consideration would be in a very different form for each of the two shareholders. The 65+-year-old departing co-owner would receive cash. The remaining 45-year-old would receive a much smaller amount of cash, but also a potentially lucrative five-year incentive earnout that could end up netting twice the cash figure offered to his co-owner. Each man thought his deal was acceptable, but wanted to reject the deal because he thought that the other was getting too much. It took some careful hand-holding by their lawyer and me to focus each on his own payday and not worry about the other fellow. And this was a very lucrative transaction for both men! The situation can become exponentially more contentious when there is not enough consideration to satisfy the essential needs of all sellers.

Illness or Death

Many sales are unfortunately caused by an untimely illness or death. These are tragic for a host of reasons. First, the family and company executives are naturally distraught. However, this grief is compounded by the fact that the value of the business and the whole process of selling it may be severely compromised by the tragedy. Many a valuable business has been sold at a discount because nobody was in place to run it. This type of situation requires cool heads and a decisive course of action. It may involve bringing in an interim CEO to relieve the seller's pressure to rapidly sell. It may also involve approaching a limited number of strategic buyers able to move expeditiously, making it clear that the question does not have to do with the minimum price the family will accept. Rather, it is what competing strategic buyers might be willing to pay and what each buyer will do if its strategic competitor buys the business.

I know one successful investor who makes conservative "low-ball" offers on about a dozen pieces of real estate every year, none of which are for sale. He looks for solid properties where the owners are in their autumn years and future regional development is in the direction of the property. Every two or three years, he receives a telephone call from some distraught family member reporting that the owner has died and asking if his offer is still good. Never once has he had to increase his offer.

Change in Strategic Position

A change in a company's strategic position may make a sale timely or necessary. This may be due to technological changes, a shift in competitive dynamics, or the entrance of a new competitor into the industry. When this happens, the owners must go to market while they still have a valuable business to sell, not after the competitive world has passed them by.

We handled the sale of a chain of regional Ohio auto parts stores some years back. The owners saw what AutoZone and Wal-Mart were doing in other markets and decided to sell while they still had a profitable business with significant local market share. They received excellent value for these assets, unlike most of their local competitors who waited until AutoZone stores were operating just down the street from their then-struggling establishments.

Sometimes a company's strong performance, favorable competitive dynamics, and a "hot" financial market come together to make a company extremely valuable. In the words of Mae West, "Too much of a good thing is wonderful." This is typically the perfect time to sell a company and secure financial bounty. However, many family-owned businesses struggle under these circumstances, because to them the business is much more than a financial enterprise. It is the glue that holds the extended family unit together, giving its members a unified purpose, income streams, and standing in their community. The effect can be much the same with prominent public companies, especially in small towns. The sense of local pride, independence, and civic commitment is almost always lost if the business is sold, even if a one-time community gift is made to assuage the local community.

We worked on one situation in which a family-held scrap-metal processing concern was experiencing this happy situation. Their business was performing at record levels, the industry was consolidating for a host of technological and commercial reasons, and well-financed scrap industry consolidators were buying companies for record prices. The president of the company told us that the family business would never be worth more. Indeed, he said, it would probably be worth 50 percent less in five years as the scrap market consolidation continued to unfold. Yet the family agonized over the sale decision. They ultimately decided to move ahead and attained an excellent price. Just as the president had predicted, market conditions became much more challenging in the scrap-metal industry during the years following the sale. From a financial standpoint, it was the right decision. However, the cohesion of the extended family unit was never the same.

Financial Sponsor Liquidity Event

In the financial sponsor world, the managers are under continual time pressure to create *liquidity events*, a fancy way of saying "sales or public offerings." This is because these financial sponsors usually only receive their profit, expressed as a *carried interest,* on an investment in a company when it turns into cash or publicly traded stock. If that weren't enough incentive, each fund's internal rate of return (IRR), a key benchmark toward being able to raise the all-important *next* fund, will be correspondingly higher if the period of time over which it is generated is shorter. Furthermore, these limited partnerships typically have a ten-year life, meaning the sponsors have to return the investors' money within that time period. Although the fund life can usually be extended for special circumstances, this complicates the managers' lives and makes it just that much harder to raise future money.

I recall one situation in which a financial sponsor engaged us to sell a capital equipment company. We argued against an immediate sale because the company's results were projected to improve dramatically over the next two years, improvements for which buyers were not likely to pay at that time. This was because the company was still integrating a European acquisition, and its domestic business was still at the bottom of the industry's economic cycle. "We know all that," was the fund manager's reply. "But this is a small investment of our fund, and we are at nine years and counting. We just don't want to go on record as having to extend the fund's life." Although we were successful in selling the business for a good price, the business would have been worth 33 to 50 percent more if the financial sponsor could have waited to go to market. Under these circumstances, most individuals or public companies surely would have timed the sale differently.

Financial Pressure

Unfortunately, especially in these extraordinary times, financial pressures may force a sale. These can result from foreign competition (common today for manufacturers facing Asian competition), inability to secure financing through traditional means, investment in the wrong technology, or just plain mismanagement. All of these calamities strike hardest at companies burdened by debt. The (financial) sword cuts both ways. My partners and I have been through too many of these situations. Most would not have been nearly so devastating if the owners had acted faster once the trouble was apparent. The challenge in selling these distressed companies, whether in bankruptcy or not, is to get the buyers' focus off, "What is the minimum the bank, creditors, and shareholders would be willing to accept?" and toward, "What is going to happen if one of my competitors buys this company?" While an easy transition in theory, this is no mean feat in practice.

Unsolicited Offer

One of the happier situations that may spark a sale is the unsolicited offer. These come in two varieties: the blind *spray-and-pray* letter and the sincere expression of interest. Spray-and-pray letters are routinely sent by business brokers authorized by financial sponsors to look for transactions. They typically do not include the name of the interested purchaser, instead including vague language about the "well-financed acquirer" with a "sincere interest in the seller's business or industry segment." I get a chuckle when, on behalf of a client who has engaged us, we call in response to these letters. Almost invariably, the writers have precious little idea what our client actually does. Often, they claim to represent a number of buyers and will introduce the prospective seller to one of them if the seller will agree to pay a fee. Half the time, they say they refuse to deal with any company that is represented by an investment banker. So much for "sincere interest."

The other kind of inquiry could not be more sincere. It might be from a competitor or from somebody wanting to get into the prospective seller's industry or market segment. As such, it should be handled with the utmost care. Does it make sense to deal exclusively with the party making the approach? Have others shown interest in the past? Are there others who would likely show interest if they had any inkling that the company would be sold? Is the company likely to be worth significantly more in the future? Are the owners interested in selling at all? The sincere unsolicited offer, even if it is only an expression of interest in meeting with the potential seller, forces the owners to address these issues in real time.

PROACTIVELY MAKING THE SALE DECISION

As owners make the momentous and stressful decision of whether to sell their businesses, they are so much more likely to achieve the best result if they proactively *make* the sale decision, rather than passively wait for someone else to *make it for them*. Being passive about the sale decision and "hoping for the best" is like sitting monkeys in front of typewriters and "hoping" their random keystrokes produce great literature. Statisticians calculate that the chimps would randomly reproduce Shakespeare's *Hamlet* about once every $4.4 \times 10^{360,783}$ attempts, but one would not want to depend on a given monkey's efforts on a given day. The sale decision, more so than most business decisions, should be actively made and then managed. Unlike most activities in the life of a business enterprise, it will have terrific economic and social consequences and will only happen once.

Which brings me back to the first point of this chapter: The owners should be honest with themselves about why the business is being sold. This fact is at the core of the marketing and decision-making strategy to achieve their goals. I guarantee that the buyers will develop their own theories as to why the business is considering a sale and act on them. If they don't believe the reasons the seller tells them, they will suspect the worst.

NOTES

1. Senior management teams demonstrate an order-of-magnitude more personal concern when the decision is whether or not to sell the entire company. This is because their own careers and private lives can be dramatically affected by the outcome.
2. The imminent retirement of the CEO is also a reason why many publicly held companies end up being sold. Although this might make sense if the CEO is a unique dynamo or if the CEO's retirement coincides with strategic and timing considerations, boards are charged to manage leadership transitions independent of the CEO's personal desires. This is an area where the increased independence and professionalism of corporate boards is changing corporate culture for the better.