DEAL GATE

Transaction Readiness
A Practitioner's View

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Is our Business "Transaction ready"?

The vast majority of business owners and managers would answer "yes". In reality, transaction readiness is common among publicly traded companies, but very rare with private firms or business units. If a business is performing well, this does not necessarily mean that it is automatically "transaction ready". Transaction Readiness is not just about business performance and owner readiness. It particularly is about the attractiveness of the business to potential buyers and the smooth and speedy realization of the transaction.

A business is "transaction ready" if it could be sold (a) within six months, (b) at or above market valuation, and (c) without interfering with current course of business.

The success of a divestment, carve-out of a business unit, merger, IPO, or capital increase strongly depends on early and thorough preparation.

This essay focuses on the purpose, scope, and benefits of a Transaction Readiness Assessment.

Why Transaction Readiness

Owners or Boards of Directors often claim that they would not actively look for a buyer for their business, but if an interested party would knock on their door, they would verify the offer. Unfortunately, the owners and managers do not exploit the full value potential of the firm with this passive approach. Waiting for an "invitation to dance" is not the ideal way to find the perfect partner. Instead, owners and managers should decide if their business will be sold or bought.

How to easily destroy value

The Chairman of an industrial group received an unsolicited offer from a competitor for one of its business segments. As this segment was not strategic anymore for the group, they intended to divest it anyway sometime in the future. Due to other priorities, the management had previously decided not to actively look for a buyer in the medium-term, but to examine upcoming inquiries of interested parties. The valuation seemed interesting and the outlined timeline maximum of nine months until closing were favorable for the Chairman, as the group could use the funds for upcoming investments in other segments. As there was already a buyer at the table with a detailed offer, the group felt no need to hire an M&A advisor, nor to produce a selling company presentation. The two parties soon started their talks and exchange of information. After fifteen months of intense negotiations, and with a final purchase price far below the initially offered valuation, the owners had the choice to either accept the final terms or to withdraw from the transaction. One could say, this example is a rare exception. **However, while a well prepared deal should be signed within less than six months after going into the market, over half of deals still take more than twelve months. Moreover, more than three quarters of deals are closed at a price below the initially offered valuation. The major reason for this is that the businesses were not ready for the transaction.**

Before passengers enter a commercial airplane, the ground staff maintains the jet, and the pilot walks around the aircraft in

order to make sure that the plane is in good shape. If the pilot would only check the airplane from his seat, he would be limited to his range of vision and his instruments. Just like the pilot, sellers should not only view the business from their own perspective, but instead also take a broader (=the buyer's) perspective.

Be prepared!

Reasonable owners and managers avoid potential M&A pitfalls before they start the deal process or even before they engage an M&A advisor. They allow themselves enough time for the deal preparation. The owner and the management of a business are not the ideal persons to perform a Transaction Readiness Assessment. They would be too focused on their internal view and perhaps on performance improvement. **"Transaction readiness" is not just a question of whether a company or business is performing well or not. It goes much further than a "business health check".** The business needs to be viewed from an external perspective, and potential buyer concerns need to be discovered and rectified in advance. This analysis needs to be performed by experts who have worked on both sides of transactions, the sell-side and the buy-side. Such experts are able to put themselves in the situation of the buyer. The business needs to be prepared and positioned in such a way as to maximize attractiveness for possible acquirers, to reduce duration of the transaction, and to optimize purchase price. Likely issues from acquirers need to be addressed, value creation measures identified, and actions taken prior to commencing a transaction.

If the object to be divested is a carve-out of a business and not a complete legal entity, the Transaction Readiness Assessment is even more important and complex. It helps to identify the level of integration with the overall organization, and define the necessary steps and roadmap towards a stand-alone organization of the carved-out business.

After signing the sell-side mandate, even M&A advisors often go too quickly to market without reflecting on transaction readiness first.

If owners intend to sell a business within the next five years, it is highly recommended to start the Transaction Readiness assurance now.

Scope of a Transaction Readiness Assessment

The goal of a Transaction Readiness Assessment is to ensure that a business's strategy, positioning, operations, performance, systems, and documentation are robust enough to realize maximum value and minimize the risk of a broken deal. Transaction Readiness is not a Due Diligence[1] review. One of its key purposes is to identify issues and questions which may arise during Due Diligence. It will gain the management enough time to remediate the issues before the transaction even starts, or to proactively disclose the issues during Due Diligence.

Strategy and Business Plan

When asking second and third level management about buzz-words like "strategy", "unique selling proposition", "competitive position", or "customer segments" of their business, the answers

[1] *Simply put, Due Diligence is a prerequisite to any major financial transactions such as mergers, acquisitions, equity investments and debt investments. It is performed to bring out the assets and liabilities of a company, and also to assess its commercial potential and risks. Due Diligence is a highly complex process that requires a great deal of knowledge.*

are often manifold or vague. Too often such subjects are implied knowledge but not put down on paper, challenged and updated from time to time.

The Transaction Readiness Assessment analyzes if the strategy formulation is documented, clear, focused, feasible, realistic, and value optimized. This does not just encompass vision/mission/strategy of the business; an industry overview (market, competitors, industry structure, industry development, and outlook), own strategic positioning, and SWOT[2] analysis need to be established and updated over time. Furthermore, the coherence of the business model, value chain, strategic business units, product groups, operations, and resources with the strategy need to be challenged.

The chosen path and required resources for reaching the strategic goals, as well as clearly defined milestones, need to be reflected in a business plan document.

Often management teams are focused on day-to-day activities and lack the resources for this type of planning. The Transaction Readiness Assessment is not another strategy formulation or business restructuring exercise. **The purpose of challenging the items above is to make sure that there is a formulated and implemented strategy, which could be reproduced in the confidential information memorandum, and which is feasible for the potential acquirers.**

Financial Reporting

An enterprise's financials are rarely "transaction ready". Financial reporting and annual statements of accounts often follow other goals: simplicity, prudence, or even tax optimization. Coherent and transparent financial information is a must for a transaction. The financial figures need to provide a true-and-fair picture of how profitable the company really is. Buyers need to feel confident that the systems used to capture financial data are reliable and accurate. **If it takes too long for the financial team to answer questions, investors might have doubts about such systems, the financial team, or even the CFO.**

The audited financial statements of the past 3-5 years need to be transformed into true-and-fair statements. During such an exercise, extraordinary items will be separated, and non-business related items excluded. If for example the owner drew wages which have been above market, the surplus can be credited to the true-and-fair view. If the owner worked without salary, the opposite needs to be done.

During Financial Due Diligence, the buyer's advisors will have a thorough look at the company's recognition policy: Did this policy change over time? Has all revenue always been recognized according to the policy in place? If revenue was accounted for on a cash basis, it may be necessary to convert those figures into the accrual basis of accounting. Those facts need to be proactively disclosed in the Due Diligence. **It would be embarrassing and not confidence building, if the buyer's team finds it out themselves – and they will!** Their advisors need accurate financial statements in order to determine the value of the business to be transferred.

Buyers usually are not satisfied with the data from the annual financial statements. They want to know departmental margins, product margins, transfer pricing, customer group profitability, and more. If the business is structured in several segments, it would be helpful to present the performance figures according to those segments, which is not always on-hand. Depending on the reporting system, part of such information is already available and

[2] *Strengths, Weaknesses, Opportunities and Threats*

could be pulled from the system. If such information is not available, it needs to be prepared, which is exhausting and time consuming. During the transaction process there is no time for this work at all.

If the historical financial information has not been audited in the past, it is highly recommended to catch up on this early.

Carve-out transactions require additional work from the financial team in order to prepare stand-alone financial statements for the business to be carved out. To separate the revenue of the carved-out business from the remaining business is mostly an easy task. But when it comes to separating operational costs and balance sheet items for the carved-out business, there is often a lot of wiggle room. Shall such financial items (e.g. rent, marketing, fixed assets) be split according to the revenue share or according to the share of employees of the carved-out business? Whatever the management team decides concerning the allocation, the chosen solution needs to be documented in detail, as it will be thoroughly challenged by the buyer's advisors.

Financial Planning

Most firms establish a budget for the coming year. For the purpose of a transaction, the planning horizon needs to be expanded up to 3-5 years. The length of this period depends on the duration of the investment cycles of the business (a power plant has a longer investment cycle than a retail shop), and the fluctuation of the business over the years (the International Olympic Committee would need to show at least four years of planning due to its business cycle).

Budgets are usually limited to the P&L statement or only parts of it. For the purpose of a transaction, balance sheet and cash flow statements would be good to have. Establishing an integrated financial model is a time consuming and technical challenge for the team. **The model needs to support the strategic plan of the business, and deliver the detailed planning of the P&L items, balance sheet and cash flow statements, including investments.** Such information helps the buyer understand the future Free Cash Flows of the business, which is an important input for the discounted-cash-flow-method valuation. The assumptions in the financial plan need to be documented and achievable. This should be reviewed and updated on a regular basis.

Financial plans for carved-out businesses need to be established bottom-up in detail. Extrapolating the historic allocations based on percentages of revenue or headcounts does not reflect the stand-alone character of the carved-out business. If the carved-out and the remaining businesses shared corporate services (HR, IT, legal, accounting), such capabilities should also be included in the bottom-up plans.

Balance Sheet

In purchase offers, the enterprise value is usually expressed on a “net debt” or “cash and debt free” basis. This means, that in order to calculate the purchase price for the equity of a firm on closing, interest bearing debt will be deducted from enterprise value, and cash will be added.

The management of a firm can influence this formula in multiple ways, not only through the company's profit. The balance sheet statement offers huge one-off opportunities to increase cash or reduce debt until closing day:

- Reduce the cash cycle duration of the business: send customer invoices earlier and with shorter time allowed to payment, more actively manage overdue accounts receivables, reduce the inventory through intelligent ordering systems, and stop paying suppliers before payment is due.

- Check all the non-current asset positions on the balance sheet. A loan granted to a third party is value destroying for the sellers. Assets not directly used to perform the business such as participations, securities, and real estate should be converted into cash or transferred to the owner.

In one of our recent mandates we were able to increase the equity value of a business by almost 10% within three months through enhanced net working capital management. Most of the above listed measures can't be resolved within months. Depending on the measure, it could take up to a few years. Implementing and enforcing such a simple cash management policy will instantly start generating cash for the firm, which equals value increase for the owner. If this is not done long before the sales process starts, the buyer will do it himself and capture his first low hanging fruit at the former owner's expense.

Management Team

Buyers prefer to have a functioning management team in place, which assures the continued implementation of the selected strategy. Operational active owners usually want to leave the ship upon closing the transaction or soon after. **If the business strongly relies on the owner, this could have a negative impact on the valuation.** The owner needs to think about making the business less reliant on him before the sales process starts. Selecting, forming, and educating the future owner-free management team can take several years. It is the responsibility of the owner or board to start this process early enough.

If a carve-out transaction is intended, corporate management needs to decide which managers will stay with the remaining organization, and which managers will go with the carved-out business.

Ideally, top-performers will be retained with appropriate measures before starting the divestment process, without introducing golden parachutes.

Intellectual Property

One of our clients spent years and millions of dollars for the development of the latest version of its key software product. After the successful introduction of this new version, the owner found it was the right time to sell the business. During Due Diligence, the potential buyer analyzed the code base of the software and found that our client's developers used a lot of third party open source software for their product. In most cases this is not a problem as long as the open source software was not adapted. The management was not aware of this fact and the buyer claimed a steep reduction of the purchase price for future remediation efforts. Furthermore one of the employees claimed that he developed software, which was used internally, during his spare time and that he owned the intellectual property rights.

Another client needed to register some international domains a long time ago and the Head of IT was so kind to do this for his employer under his private account. Years later, the Head IT left the company in dispute without transferring the domains to the employer. When preparing for Due Diligence, this fact was discovered. Imagine the difficulty of these discussions with the former employee about transferring the domains! During a transaction, the management has no time for this.

Whether a divestment is intended or not, **a company needs to know who really owns the intellectual property** (patents, trademarks, software, internet domains, and more) used for the business. Often, the entrepreneur owns such intellectual property rights, and they could easily be assigned to the company.

Corporate Housekeeping

Do you know for certain that you are the legal owner of your firm? It may sound like a silly question, but having difficulty doing so occurs more often than one would think: One of our recent clients received the family firm from his father who bought it a long time ago. After over a decade of successfully growing the business, our client decided to sell it. During legal Due Diligence he could document the handover of the ownership from his father, but unfortunately, he was not able to provide watertight proof that the registered shares had been properly transferred from the former owner to his father. For the buyer there was a potential risk of the former owner's heirs claiming ownership of the firm.

Better start searching for the physical shares early. If only one cannot be found, defined measures need to be initiated depending on the jurisdiction of the company.

While most audit reports and general assembly protocols are at hand, board of director meeting protocols, executive management meeting protocols, and other corporate documents are more difficult to locate. Whether a transaction is envisaged or not, such documents need to be collected and saved electronically just in case. As these are confidential documents, only a few people can do the scanning work. Just as with other tasks, during the divestment process there will be no time for this.

Legal issues

Do you know all your company's agreements with customers, suppliers, lessors, financiers, employees, and other parties? How quickly and easily can you access such agreements? Starting to collect all agreements when the transaction process starts raises undesired questions in the organization about the purpose and short-noticed deadline of this task. In any case there will be many agreements missing after such a short-notice exercise. Therefore we generally recommend managing all agreements on a central server. Start a project to collect all the agreements now without having too much time pressure. If the agreements are scanned in advance, a large-scale scanning effort will not be needed for the Due Diligence.

If a company uses standard agreements (e.g. for clients, suppliers, employees), buyers want to know which agreements deviate from such standards. Agreements which correspond with the standard agreement do not need to be uploaded to the data site. A list of such agreements is sufficient.

Some of the contractors could legally be considered as employees. The agreements with externals need to be airtight in this respect.

Some information is still too confidential to be shared with an interested party during Due Diligence (e.g. terms, conditions, prices, margins, contractual parties). Before uploading such information to the virtual data site, the confidential text needs to be blacklined. This is another time consuming and important task, which needs to be done by an experienced and trustworthy employee or manager and for which there is no time between Letter of Intent and Due Diligence.

Agreements with a change of ownership clause and agreements that may not be assigned to the purchaser without the prior consent of the contractual party require special attention in the transaction readiness work. Until the signing of the purchase agreement, sellers better keep the fact of a potential divestment confidential. Consent of contractual parties is usually a condition precedent to closing.

The seller has to contact the contractual parties and get their consent between signing and closing of the transaction. In one of our recent transactions, the seller had to collect fifteen customer consents. However, one of them did not sign and unreasonably delayed the closing of the transaction. An immediate action for transaction readiness is to avoid change of ownership clauses, to identify active agreements with such clauses, and to find a way to retrospectively waive such clauses.

Pending or threatened lawsuits are an additional uncertainty for the buyer, because he is not able to judge the impact of the legal causes on the company. The buyer will ask for an indemnity in the purchase agreement for an amount that exceeds the accruals built in for the lawsuits. Easy said, but if the settlement of pending and threatened lawsuits could be accelerated and agreed upon before the transaction starts, it would reduce discussions with buyers and risks of a broken deal.

Corporate Governance

Most of the corporations defined and hopefully implemented rules and processes about how objectives are set and pursued, and how the firm is directed and controlled.

The content and quality of such rules and processes does not directly affect the potential divestment of the company. What matters for the transaction is that the internal and external stakeholders complied with the rules and processes, including applicable law and regulations.

Transaction Structure and Strategy

There are several different types of transaction structures: merger, share deal, asset deal, or IPO[3]. Each of them has different requirements for the transaction preparations. The earlier the most likely transaction structure is known, the better for the readiness team, because they know what to focus on. Imagine a deal which was prepared as a share deal and during the negotiations is changed into an asset deal. This change of transaction structure would have a massive negative impact on transaction speed as Due Diligence data was focused on another transaction structure. The disintegration would have to be prepared ad-hoc, which increases the potential for chaos.

Owners need to decide early enough about the strategy for the intended transaction. Waiting for buyers to knock at the door is a passive approach, even though the business is transaction ready. Contacting potential buyer(s) is an active approach, which could include a broad auction, a limited auction, exclusive talks with only one party, or an IPO. The pros and cons of each approach will be left for another best-practices essay.

Potential Buyers

Long before a divestment process starts, owners and managers need to identify potential strategic and financial buyers, analyze them, and monitor them over time. When establishing a longlist of potential purchasers, one needs to look beyond the value chain (supplier, competitor, client), and also include e.g. the technology dimension. One should not prematurely focus on a few potential partners, as it is not always the most obvious candidate that buys the firm in the end.

Potential sellers need to be able to clearly articulate the benefits of purchasing their company. Such internal views are sometimes quite ambiguous. It is

[3] *Initial Public Offering*

in the interest of the seller to present the buyers with potential quantitative and qualitative synergies. Sellers should help the buyer's deal team create their investment case and deliver arguments for their superiors on "Why this business is worth acquiring". This internal and somehow limited view needs to be challenged and complemented by external industry and transaction specialists, as they know what could be of interest for buyers and why.

Establishing relationships with the CEO or Divisional Head of the potential buyers long in advance of a potential sale is highly advantageous for the envisaged transaction. These relationships can start to be established at trade fairs or industry organization assemblies. During such talks candidates could be further analyzed and acquisition rationales collected. One's business could be moved into the focus of the potential purchaser. Especially if your business is much smaller than the potential acquirers, they might not be fully aware of what exactly your company is doing, and how good your firm is. Establishing a relationship based on trust and respect will be advantageous if it comes to starting the divestment process or solving upcoming problems during the process.

Due Diligence

The longer a Due Diligence process lasts, the higher the probability that the buyer will have concerns. Sellers are well advised to collect necessary Due Diligence data before the potential purchasers are contacted.

Experienced buyers have professional acquisition processes that have been implemented and tested. Either they have their own team or they hire external advisors, which will dig deep into every detail of the target. **The list of questions can soon start to overwhelm the management team, while it should be taking care of the actual business.** Slowing down the business during a sales process can have adverse effects on the transaction or the valuation, and should be avoided. **The Due Diligence professionals' key goal is to find the weak spots of the target. And they know where to find them! They will exaggerate every item which would potentially help reduce the purchase price.**

Valuation

Before starting a divestment process, owners and managers need to determine a sale price that is acceptable to them and also realistic. After the strategy, business plan, and financial plan have been formulated, a corporate finance specialist can perform a valuation analysis based on those assumptions for internal use.

The valuation serves as a guideline for the decision process during the divestment project, and enables the owners to be in the position to turn down unacceptable offers.

Disintegration / Day 1 Preparation

Carve-out transactions are the most complex deals. In most cases, the buyer does not take over a stand-alone operational entity. The parent and the carved-out business often share the same data servers, data base, or phone system. The ultimate goal on Day 1 after closing is to avoid interruption of the parent's and the carved-out businesses.

Post-closing, the IT infrastructure and data need to be uncoupled from the former parent's system. This can be a time-consuming task which lasts several weeks to months.

The buyer might need corporate services such as HR (e.g. payroll services, historic data pull), finance, (accounting, invoicing, collecting) and IT performed by the parent organization for a transitional period. The

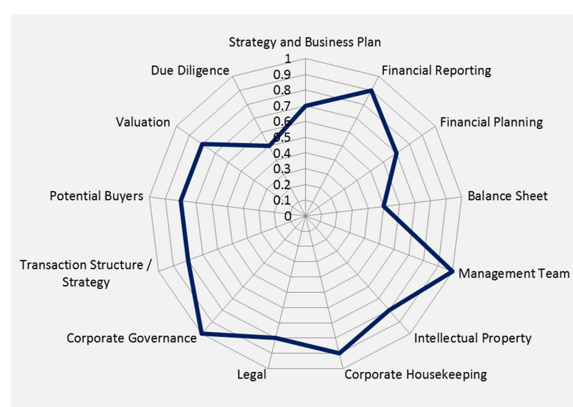
level, cost and duration of such support during the transitional period is ideally specified in the Transition Services Agreement (TSA). In the majority of carve-outs we have seen, the seller did not think far enough ahead about the necessary separation steps. Drafting the key items of the TSA during the negotiation phase delays the process. Experienced transaction professionals with operational understanding could identify the level of the integration of the carved-out business way ahead of the transaction. This allows for proactively taking corrective measures and preparing the TSA draft.

Benefits of a Transaction Readiness Assessment

It is easier to wait for an unsolicited offer than to prepare for it in advance. Owners and managers often underestimate the work it takes to prepare the information needed to sell a business, or to identify and rectify potential deal breakers in advance. **During a transaction, time is not the seller's friend.** The longer it takes, the higher the risk of an information leak, management overwork and frustration, as well as the possibility of losing sight of daily business.

A Transaction Readiness Assessment will help to:

- identify and address issues that may adversely affect purchase price, speed and certainty of the transaction among many other significant terms of sale;
- provide the board and its advisers with practical steps that can be taken in the short- and mid-term to assist a future transaction process;
- implement key changes before going to market and reduce the transaction's risk and cost, while creating value; and
- organize and present the business in such a way that transferring ownership is smooth.



Example of a Transaction Readiness overview

With a careful and profound assessment there will be no surprises, when an owner decides to start the divestment process, or when unsolicited buyers knock at the owner's door. Conducting a thorough Transaction Readiness Assessment and implementing its findings, puts the owner in control, and ensures a smooth transition, while keeping a close eye on maintaining business performance.

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About the Author

Beat Dolder has almost 20 years of experience in corporate finance and turnaround management. He is the Managing Partner of DOLDER Corporate Finance (www.doldercf.ch). Previously, he served as Partner with Ernst & Young, where he focused on mergers & acquisitions, corporate finance, transaction readiness, and restructuring. Beat also served as the Head of Corporate Development for a global player in the security access industry

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About DEALGATE

DEALGATE (www.dealgate.com) is the global deal matching platform. We provide a closed and secure environment where our members exchange divestment and acquisition profiles, as well as enterprise financing.

Our members can post their opportunities anonymously, allowing for absolute discretion. Other DEALGATE members might have access to potential targets or buyers beyond your research or network. This dramatically increases your chances of finding the perfect match.

In mid-market cross-border deals, how much would a full research for potential sellers or buyers cost you in time and money? A fortune! Let’s face the fact that we cannot possibly know the acquisition or divestment strategy of every corporation around this globe. Be realistic, even if you had an M&A network partner in every country, your network would be limited to their personal connections and knowledge.

In the globalized M&A business, alliances are playing an increasingly important role. Applied properly, all parties involved will benefit from expanding their network globally and gaining transparency within a secure environment.

Over 5,000 M&A professionals from around the globe are part of our community, sharing an ever-increasing number of interesting opportunities.

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