Merger & Acquisition Focus

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When to sell a division or subsidiary

Never too early …
Start preparing your business for sale now

Look out!
Spotting the signs of a troubled deal

Ask the Advisor

When to sell a division or subsidiary

One of the best ways to weather a weak economy is to streamline your company's operations, which can include divesting the business of divisions or subsidiaries. It can be a difficult decision, however, particularly if you've intended to drive your company's long-term growth with the unit. But selling a piece of your company can be a smart — even business-saving — move that may keep you well-capitalized enough to ride out a rough patch.

Timing and preparation are essential when selling a unit. Before putting it on the block, be sure you understand the unit thoroughly, including its strengths and weaknesses.

Selling a subsidiary

Whether the unit you're considering selling is a division of your company or a subsidiary can make a significant difference in your selling strategy. For example, standalone subsidiaries are typically easier to sell than divisions. The unit is already a separate legal entity and can generally be sold as a separate business. There are still plenty of issues to address before you sell a subsidiary, however.

Determine how much your parent provides to your subsidiary and decide whether you want to offer continuing services to the buyer during integration.

For starters, you need to determine who owns the subsidiary's assets (including intangibles) — the subsidiary or the parent company? This can be particularly challenging when it comes to intellectual property. If your parent company owns, for example, proprietary software the subsidiary uses to manage inventory, you must decide whether to transfer ownership to the subsidiary or retain ownership and negotiate its use with the subsidiary's buyer. Also review corporate agreements to learn which governance processes are required to transfer shares or divest business assets.

There are also many service- and support-related issues, because subsidiaries usually depend on their parents for everything from legal advice to HR management. So determine how much your parent provides to your subsidiary and then decide whether you want to offer continuing services to the buyer during the integration period. (See "Ask the Advisor" on page 7.)

Finally, be sure to provide the buyer with a list of services that your parent company provides and what they cost. The buyer will need to incorporate this information into its analysis of the acquisition's potential profitability.

Divesting a division

Selling a division can be a somewhat more difficult endeavor than sloughing off a subsidiary. You must essentially "carve out" the division — deciding, among other things, which employees, property, product lines, customer contracts and sales territories are officially up for sale.

Work with a financial advisor to create a pro forma financial statement that separates, as much as possible, the selling division's assets, debts and revenues from those of your parent company. And get ready to answer some tough questions. For example:

- ❖ What will you do with employees who work for both the parent and the division?
- ❖ Will you transfer or cancel the 401(k), health care and other employee benefits programs for those employees who go with the sold company?
- ❖ Will you include in the sale such properties as production facilities, offices and technology equipment with the spun-off division?

Be sure you know which features and assets are important to the value of that division and include them in the transaction.

Finding a buyer

Selling a unit can be time-consuming. One way to improve your chances of successfully selling a division or subsidiary is to draw up a list of prospective buyers. By targeting other companies operating in your product niche or in a complementary sector (for example, a manufacturer that may be interested in acquiring the distributor it already uses), you can get a jumpstart on the process. Your M&A advisor may have potential buyers in mind as well.

With a short list of possible buyers, you can tailor your selling strategy and offering proposal to suit each serious contender. For example, if you're carving out a division for sale, you may have the flexibility — depending on the potential buyer's needs and interests — to expand or reduce the size of the workforce and number of products or facilities being offered.

Making the right choice

You may be reluctant to sell one of your divisions or subsidiaries — particularly if it's a strong performer with future potential. But this is exactly the right type of unit and the best time to divest. Buyers are far more interested in acquiring a successful unit with growth prospects, and will pay a higher price for it. If, on the other hand, you try to sell a troubled unit, your intention will likely be obvious to any serious buyer.

Selling can take a substantial amount of resources and time — anywhere from six months to more than a year. If you're serious about this partial sale option, start preparing now. ■

Never too early …

START PREPARING YOUR BUSINESS FOR SALE NOW

If you're like most business owners, you're consumed with the day-to-day responsibilities of running your company. So you probably haven't thought much about your business's eventual sale and what potential buyers are likely to look for in an acquisition.

Making your company an attractive target that will realize a fair price, however, takes years of preparation. Don't wait until you're ready to retire or move to other ventures to tackle such tasks as improving your company's name recognition and correcting financial and operational weaknesses.

Perform a self-diagnosis

One of the first steps to take in anticipation of a future sale is to conduct a thorough business analysis. You might want to assemble an internal taskforce to conduct

this assessment, but outside M&A experts will be better able to objectively review your operations and financials with the marketplace in mind.

In either case, break down your company's business units, analyze their performance and determine their strengths and weaknesses. (See "Analyzing operations: A quick guide" at right.) This breakdown includes listing and categorizing company assets, including intangible assets such as brands, trademarks and intellectual property. Be sure you account for such items as property you're leasing and equipment contracts. If you discover anything that could be a distraction in an M&A deal negotiation — for example, a warehouse lease that requires renewal or an expiring software license — take care of it *before* you're ready to put your company on the block.

Streamline, streamline, streamline

If you've never thought about selling your company, the odds are that your financial statements need some tidying up. You want potential buyers to be able to easily find critical information, and to view your statements in a format that can be compared with those of other companies.

If, for example, you don't follow Generally Accepted Accounting Principles (GAAP), consider adopting them. And a professional valuator can help "normalize" your financial statements, or adjust them for their likely performance under another owner. This gives prospective buyers a more accurate idea of your business's value.

Review your company's contracts with suppliers and customers and isolate the most complex and potentially troublesome ones — for example, routinely late-paying customers or unreliable suppliers. If you decide the stresses of the contracts outweigh the benefits they create, end those relationships now. Also revisit the buying terms you have with suppliers. Depending on your spending patterns, you may be able to arrange more cost-effective scheduled or bulk purchase agreements.

Further, make any *ad hoc* policies official. If supervisory functions (such as the chain of command between employees and managers), customer relations, or strategic partnerships are informal or have evolved organically, consider formalizing them. Prospective buyers might regard such informal relationships as an integration — and acquisition — challenge.

Make the first moves

Making your company presentable will certainly improve its marketability, but, more than anything, you need to put yourself in a potential buyer's shoes. If you were thinking of buying a company, what would *you* look for? Low debt? Strong management? A market-leading brand?

Analyzing operations: A quick guide

One of the critical tasks when preparing a business for eventual sale is assessing your operations. There's no simple blueprint, but depending on the size of your business and the scope of the job, you might:

Create or update an organizational chart. Document the chain of command so that you — and a prospective buyer — know which employees report to which managers, and which people run departments or are in charge of projects or products. This process will help you spot management inefficiencies.

Examine workloads. Are some employees overextended and departments or units understaffed? Are others overstaffed and less productive?

Know your customers. Talk to managers and employees to learn about your company's best and most valuable customer relationships and, conversely, those that are difficult and might be terminated.

Set short-term goals. Use your initial round of company analysis to establish goals for set periods — say six months, one year and five years. When you're ready to sell, you'll have concrete improvements to show prospective buyers.

If you have a prospective buyer in mind (for example, a strategic partner or competitor), become acquainted with their business objectives and long-term goals, and determine how your company might fit into their plans. If a potential buyer hopes to expand into a market in which you operate, you might increase your presence and market share to make your company a more obvious — and, thus, valuable — target.

Time is on your side

If this seems like a lot to consider, remember that time is on your side. If you're not planning to retire or move on to another venture right away, you can prepare and position your business at your own pace. The important thing is to be ready when you finally decide to make your move. ■

Look out!

SPOTTING THE SIGNS OF A TROUBLED DEAL

There's plenty that can go wrong with M&A transactions before they close, because they're long and delicate processes. Both buyers and sellers, therefore, need to know the hazards inherent in any merger transaction and be able to anticipate deal breakers and other problems that may get in the way of long-term success.

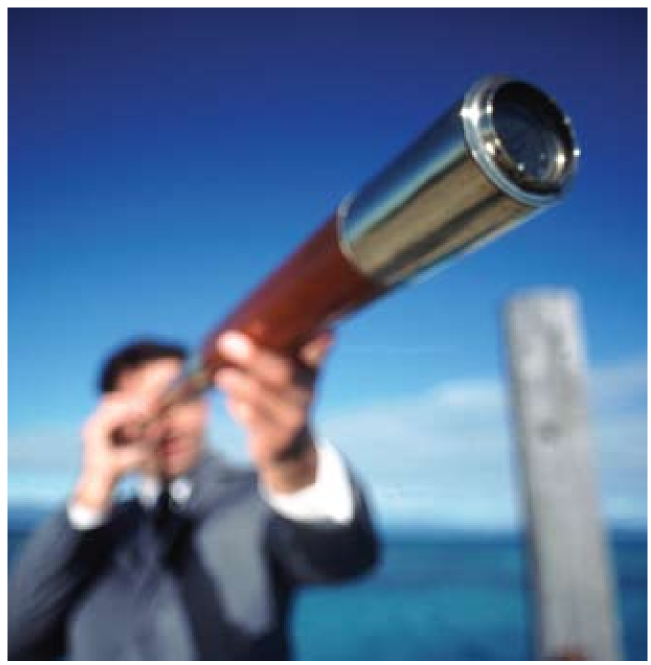
Focus on minimizing roadblocks that will prevent you from reaching your final destination, including cultural differences, disruptive employees and communication misfires with staff, customers, suppliers, and other stakeholders.

Employee battles over customer accounts or management positions undermine synergistic goals and may threaten a deal's viability.

On the inside looking out

Sometimes M&A deals fall victim to outside influences, such as industry turmoil or a tight credit market that prevents buyers from obtaining financing. More often, however, transactions die because of company-specific factors, such as cultural incompatibilities. So try to choose a merger partner with similar values and management structures. Owners and executives also must watch their words at the negotiation table. Many deals fall apart simply because the parties misunderstand one another or can't get along.

It's natural for your employees to try to grab what control they can when merging their departments with those of another company or to lock down customers



for themselves. These natural tendencies, however, don't necessarily benefit the merger or its objectives. Most M&A deals are made to achieve such synergies as cross-selling to customers; battles over customer accounts or management positions undermine those goals and may threaten a deal's viability. To facilitate an integrated culture, you may want to create more companywide mutual incentive productivity programs.

Communication is key

Communication — or lack of it — is another common deal-breaker. You may be wary of sharing information about your deal before it closes, but withholding too much will only fuel the employee (and public) rumor mill. And damaging rumors, such as those about widespread layoffs, have been known to sink otherwise promising mergers.

Announce the deal as soon as feasible and share as much information as you can about changing office locations, compensation, benefits, assignments and supervisory roles. Your HR staff can act as point people for employee questions and concerns and, if necessary, assist laid-off workers in finding new jobs.

Along the same lines, don't neglect to communicate the big picture to employees. Explain your merger goals, clearly outlining what you hope to achieve (for example, 10% annual growth, increased productivity and greater market share), how employees can help the company meet those goals, and how they'll benefit in the long run. Be sure to offer measurable benchmarks, such as an increase of 500 new customers in the next year, so that employees can easily track the newly merged company's progress.

There's nothing worse for employee morale than to sit around for months waiting for inevitable bad news.

If your company fails to involve employees in these larger objectives, they'll be more likely to focus on smaller, internal matters such as office space, vacation plans and benefits packages. This can slow productivity before you even close the deal, and is likely to make the integration phase that much harder.

When a merging company puts off making hard decisions, the result is rarely good. If, for example, your merger will result in redundant jobs and require you to terminate part of your workforce, don't put it off. There's nothing worse for employee morale than to sit around for months waiting for inevitable bad news.

Don't neglect outside stakeholders

Employees aren't the only stakeholders who need to hear from you. Be sure to communicate your plans and any likely changes with external stakeholders, such as shareholders, lenders, suppliers and customers.

Speed is paramount: Customers, for example, need to know if prices or contract terms will change, and you must inform suppliers if you'll be terminating a contract. But don't rush the process so much that you neglect details or forget to address every issue. External stakeholders won't appreciate frequent terms revisions or addenda to earlier communications.

Spotlight on decision-making

These are only a few of the issues you need to look out for. Most M&A deals encounter unanticipated obstacles, but as long as you keep the lines of communication open, your chance of closing a deal that benefits both parties is good. ■

Bring your board on board

Whether you're buying or selling a company, your board of directors can help you determine the viability of a deal as well as minimize risk for shareholders. But directors can fulfill their important role only if they're given the right information to evaluate the transaction. Good communication is essential.

If you're a buyer, present your board with a post-merger business plan that illustrates likely positive, neutral and negative scenarios and that describes the expected effect of synergies on key metrics. Also share an integration plan that details tasks and participants at different stages of the deal and a summary of due diligence findings that highlights any calls for action — such as revising the price.

Both your board and the seller's need to see a fairness opinion prepared by an independent advisor. This will help assure your board that synergies and cost savings are realistic and the seller's board that shareholders are receiving fair value for their investment.

Ask the Advisor

Q. Should I sign a TSA when I sell my business?

A: A transition services agreement (TSA) is a legal contract in which a business buyer agrees to pay the seller a fee to maintain specific services for the business after the deal closes. TSAs typically are used to keep acquired companies running smoothly while buyers integrate them into their existing business operations. The TSA is separate from the sale agreement.

TSAs generally appeal to both buyers and sellers. They free the buyer from immediate responsibility for all of an acquisition's day-to-day operations, making the integration process easier. And they can help speed up the deal process, meaning sellers get paid faster. A TSA generally is a short-term agreement, mostly because sellers rarely have an incentive or desire to provide these services on an ongoing basis.

Breaking it down

A standard TSA will contain several key sections, including:

A list of services. This is a breakdown of the services the seller will provide for a set period of time. Services can range from managing employee health care insurance plans to maintaining IT equipment.

Performance standards. Buyers generally require a set of standards to ensure the seller will provide services at a consistent, high-quality level. A TSA, for example, could specify that a selling company maintain company vehicles or manufacturing equipment at premerger performance levels.

Time limits. Typically, services are provided for three to six months. But it's possible for TSAs to extend as long as 18 months. TSAs also may contain language determining when and for how long the buyer can request a service extension.

Rates. Service rates can be tricky to negotiate. Typically, sellers are paid a flat fee when the contract is completed. But sellers might also receive a variable fee based on factors such as unit performance.

Valuable tools

Although TSAs can be a valuable tool for any type of M&A, they're essential in carve-out deals — transactions in which a seller divests a formerly dependent business unit. Many carved-out units don't have their own IT support or benefits programs, for example, so buyers typically need sellers to maintain such functions until the company is fully integrated into the new owner's company.

If you decide to take advantage of a TSA, be sure to work with legal and M&A advisors to make the agreement as specific as possible. Don't get locked into a TSA that doesn't directly state which services are in question and precisely how long they'll be provided. Treat a TSA as you would any contract, ensuring that, before you sign, it actually benefits you. ■

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