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WHITE PAPER

The Value Enhancement Journey

Your Journey from Business Builder to Wealthy Investor

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The Value Enhancement Journey

■ The Challenge

Privately owned businesses in the mid-cap segment, with fewer than 250 employees and less than $50 million in revenue, are recognized as the primary engine of economic growth throughout the Western economies. Virtually all successful privately owned business corporations reach a stage when it's time for new ownership – usually by way of outright sale or sale of a controlling interest to a strategic buyer or, perhaps in concert with the management team, to a private equity fund or other financial buyer.

The events that trigger the decision to seriously consider a sale vary, but often include the age of the founder and his or her desire both to spend more time on new pursuits, and to diversify family wealth away from the highly concentrated risk of a single business. In many cases, the sale is triggered by the recognition that increasingly competitive business conditions will require a substantial increase in equity capital to support the investments needed to maintain, and continue to grow, the company's market position. It is not unusual for the required capital investment to be more than is prudent or even feasible for the owning family to fund.

Regardless of the reasons for considering a sale, it is the ultimate conclusion of a career spent building a very successful business. Our experience with founders and builders of entrepreneurial businesses clearly indicates that advance preparation for the sale can have a profound impact on the quantitative and qualitative outcomes in this, the most important financial transaction you are likely ever to complete.

To assist owners of highly successful companies in achieving all of their objectives in this concluding stage of business ownership, we have laid out a roadmap for the **Value Enhancement Journey**. The roadmap outlines some key steps we have found, through many travels along this path, that most significantly impact the ultimate outcome – the price that the buyer pays for your company.

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The overarching goals are to maximize the value you receive on the sale, minimize any risk of post-sale liability, and eliminate any unnecessary interference with your life and the normal operations of the company throughout the journey – in the planning period and during the actual sale process. You may have additional important objectives that reflect the many years of hard work you have invested in building such a successful business, and these can be well accommodated in the planning process.

■ Your Value Enhancement Plan

The roadmap for maximizing value and minimizing post-sale liability is your **Value Enhancement Plan**. This plan precedes the actual sale process. It is comprised of a short and carefully selected list of positive business and structural changes that can be implemented in a reasonable timeframe without impairing ongoing business progress, and without unduly delaying the sale. It is developed through a careful analysis of the value drivers in your business, existing value impediments, and the profile of prospective strategic and financial buyers.

■ Timing of ultimate sale

The time needed to implement a **Value Enhancement Plan** varies substantially depending on the situation, usually in the range of six months to three years. Typically the structural changes can be implemented more quickly, while business changes take longer to implement fully and to positively impact reported financial results. This time can often overlap with the time until other timing factors (described below) reach a suitable or optimal point for commencement of the sale process.

In addition to the time needed to implement your **Value Enhancement Plan** there are three governing factors to be considered in the timing of a sale process:

1. **Industry and Competitive Conditions** – emerging competitive changes, technological change and risk, foreseeable major capital spending requirements to maintain market share and the risk of regulatory change will often influence the optimal timing of a sale.

2. **State of Capital Markets**. During the course of a capital markets cycle there are usually wide swings in the multiples being paid for attractive acquisition targets, and in the availability of acquisition finance. Demand for your company among both strategic and financial buyers will be highest in the top portion of the capital markets cycle. Currently, for example, the combination of low interest rates and relatively high availability of debt to finance acquisitions has contributed to high multiples on companies that can readily support a substantial portion of debt in the acquisition finance mix.

3. **Personal Factors** in your life and your family situation may well suggest a particular year for moving on from full responsibility for the business to a new and different life, and these should be reflected in selecting a target “exit” date.

It is rare to find perfect timing alignment, i.e. full completion of your **Value Enhancement Plan** and concurrent peaks in industry and competitive conditions, capital markets and personal factors. All of these should be considered, and necessary trade-offs evaluated, in deciding when to “go to market” through a sale process. The sale process itself typically requires six months from start to closing.

While in our experience, most successful private companies can attract higher value by taking the time to carefully develop and implement a **Value Enhancement Plan**, there are exceptions. Some businesses are immediately ready to move into the sale process and attract full potential value when the other three timing factors above indicate such a move. If you are confident that your business is well positioned to attract full value today, you may want to skip ahead to The Sale Process - Going to Market on page 7.

■ When in doubt – start early

While you cannot expect to have perfect foresight on timing factors, especially capital markets conditions, there is no disadvantage to beginning your **Value Enhancement Plan** early. The benefits of the completed plan will continue to positively affect results while, if necessary, you defer the decision to “go to market” pending better market timing.

Key Analytical Steps

The first step in developing a highly effective **Value Enhancement Plan** is an objective analysis of several characteristics of your business, including:

I. Its major value drivers;

II. Existing performance, structural and similar impediments that currently undermine its value to buyers; and

III. The potential buyers – competitors and other strategic buyers as well as financial buyers and the particular characteristics of your business that are major sources of synergistic value to each of them.

■ Value Drivers

The major value drivers vary to a degree among businesses, but most buyers attribute higher value to businesses with the following characteristics:

- Sustainable earnings and cash flow with a proven record of growth
- Recurring revenue relationships with customers, particularly if these are inherently “sticky” (hard to unseat)
- Significant and defensible market share
- Products and services differentiated from competitors’
- Strong management team
- Scalable business model and identifiable growth opportunities
- Ownership and governance to enable outright sale
- Sale process that is buyer-friendly, enabling efficient, timely analysis, due diligence, and commitment

Your analysis should be aimed at identifying the most important value drivers in your business, apparent gaps between current and potential levels, and the business changes that have significant scope for enhancing value over the short to medium timeframe.

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■ Typical High Impact Changes

There is, of course, no generic prescription for the "right" value enhancements. However, we have found that the following business and structural changes are valuable in many cases:

- Reduce any excess customer concentration by broadening customer base
- Sell off or close persistent loss-making business units or products/services that are not essential to the core business
- Increase the recurring portion (contractual or otherwise) of the revenue base
- Fill key management gaps (including the gap that will occur when you withdraw from the business upon its sale) with proven high performers who "fit" the organization and its strategy.
- Replace outdated IT platform and enhance processes to reduce costs
- Ensure your essential intellectual property is protected in all potential markets
- Resolve distracting litigation and compliance issues
- Simplify complex ownership arrangements and tighten agreements among shareholders to enhance deliverability of outright ownership
- Structure share ownership within the controlling family to reduce or defer taxes on the planned sale
- Improve working capital efficiency
- Stabilize the capital structure by negotiating optimal long term financing
- Harvest redundant assets
- Be selective in making new capital expenditures and other investments

Developing the Value Enhancement Plan

Your **Value Enhancement Plan** needs to be realistic in scope in order to be effective. It has to be implementable without seriously distracting you and your management team such that ongoing business operations suffer. The last thing we want in this interval is any deterioration in ongoing business. This is a period that requires close attention to customers, employees, key suppliers and other relationships that contribute to your sustained business performance.

■ Decision Criteria

Each business or structural change that has been identified as a potential value enhancement should be assessed on the following bases:

- Expected impact on value
- Resource requirements and cost of implementation
- Implementation risk
- Required lead time through value impact

It is important to choose a plan that can realistically be implemented, given the available resources, and your organization's capacity to implement change. Organizational commitment to implementation will benefit from including some relatively rapid components in the plan, as the early "wins" will help maintain motivation and momentum.

Ideally, most or all of your chosen changes should be ones that will have a positive effect on future business performance, whether or not you sell. Beyond the obvious benefit, this enhances your bargaining position in negotiations, as explained below under "Build Your BATNA".

■ Assign Responsibility

Be sure to assign responsibility for each business and structural change in the chosen **Value Enhancement Plan**, and for overall monitoring and coordination. Responsibility for the structural changes can often be assigned to appropriate outsiders – lawyers, financial advisors, etc. while business changes need appropriate champions from the leadership team. Where responsibility is assigned to an operating executive, this is an opportunity to challenge and assess the executive in an unfamiliar role, adding to the basis for subsequently deciding on your replacement and other changes in the top leadership team.

Be sure to assign responsibility for each business and structural change in the chosen Value Enhancement Plan

Build your BATNA

In order to sustain strength in negotiations with potential buyers, you will need a viable and credible BATNA (Best Alternative to Negotiated Agreement).

The normal BATNA, relative to negotiations with any one prospective buyer in a competitive process, is the alternative of selling to a competing buyer. This BATNA, however, loses some of its effectiveness in the advanced stages of the sale process when the selected buyer has an exclusive period for final due diligence and negotiations.

One strong BATNA that applies throughout the sale process, and regardless of the breadth of competitive buyer interest, is a viable, financially attractive strategy to retain and operate the business long-term. This requires adequate leadership depth, a compelling and organizationally supported strategy, and adequate financial resources. The business changes, and some of the structural changes implemented as part of your **Value Enhancement Plan** will generally be positive for the sustainable cash flow of the business, and thus a positive factor in your BATNA.

As mentioned earlier, we often find that one of the external factors motivating an owner's decision to sell is the belief that developing competitive trends will require substantial new investment in the business to sustain market share. In that case your BATNA will require either a viable new source of capital as a key component or a less aggressive strategy than the strategy imbedded in the sale process, which assumes additional capital investment from the buyer.

In addition to its role in strengthening your negotiating position, a well developed BATNA, involving a "retain and operate" strategy, possibly including raising additional capital, can help to provide cover and thus preserve confidentiality within the organization on the planned sale while substantial business changes are progressing.

Implementing and Monitoring the Value Enhancement Plan

It is essential to keep the organization as a whole focused on maintaining core business momentum, while a smaller group implements the **Value Enhancement Plan**.

Some of the business and structural changes (particularly the latter) will likely require outside expertise, working closely with selected members of the leadership team for effective implementation. For overall coordination, many business owners find that it is best to use an experienced outside advisor rather than overburden operating executives with responsibilities outside their zone of expertise.

■ Business Priorities During Plan Implementation

As implementation of the **Value Enhancement Plan** proceeds:

- Maintain focus on your people, customers and ongoing business performance – any deterioration in business will undermine the value enhancement objective and lengthen the timeframe.
- Extend and deepen the analysis of competitors and other prospective buyers
- Develop strong documentation in all key areas to facilitate data room preparation, buyer due diligence and generate buyer confidence during the eventual sale process
- Monitor implementation progress as well as external timing factors regularly, and keep the plan flexible to adapt as needed

The Role of Governance in the Value Enhancement Plan

A strong, independent board of directors or advisory board can be particularly valuable during this period of change, serving as an objective sounding board for the owner/CEO, objectively overseeing implementation of the **Value Enhancement Plan**, adding confidence in the fairness of the process for minority shareholders, providing mentorship for key managers, and subsequently enhancing buyer confidence in the business.

Ensure that you have experienced legal counsel, and if your financial statements are not already audited, consider upgrading your accountant's mandate to add greater assurance in reported historical financial results when the sale process commences.

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The Sale Process

■ Going to Market

When your monitoring of the external timing factors and implementation of the **Value Enhancement Plan** indicate that the timing for a sale is near, it is time to make detailed plans for the sale process.

Maximum sale value is normally obtained through a controlled auction process that protects your confidential information, including the fact that you are considering a sale, while developing strong interest in your company among multiple prospective buyers who are both financially capable and strategically well motivated to make the acquisition.

Managing the sale process and the progressive disclosures and negotiations requires the skill of experienced advisors.

Managing the sale process and the progressive disclosures and negotiations requires the skill of experienced advisors. You may have chosen advisors much earlier, to assist in developing and implementing the **Value Enhancement Plan**. If not, now is the time to do so. You are entrusting your single most important financial transaction to your financial advisors, and your intimate knowledge of the business, the industry and many of the prospective buyers is an essential ingredient in a successful sale process. Be sure to select a firm that has strong, verifiable experience in the sale of privately owned businesses, and whose senior people have good positive "chemistry" with you and any other family members or other shareholders involved in the decisions. Diligence in the selection of your financial advisor will be well rewarded in the important process ahead.

The final leg of your journey from business builder to wealthy investor has begun. This typically requires about six months from start to final closing – longer if, for example, regulatory approvals are needed on competition, environmental matters or the transfer of government licenses. The major phases and steps in this time period are outlined on the next page.

The Sale Process - Step by Step

Pre-marketing phase	• Thorough analysis of the business and all matters relevant to a sale • Analysis and classification of prospective buyers • Preparation of a Confidential Information Memorandum (“CIM”) and a “Blind Teaser” • Organizing and populating the electronic data room that will later be accessible to qualified prospective buyers • Internal review of the data room materials, identifying potential due diligence issues and appropriate solutions and responses. • Legal review of draft Confidentiality Agreements and other sale process documents • Owner decision to “Go To Market”
Marketing Phase	• Continue to expand and refine list of potential buyers • Confidential initial contact with each prospective buyer • Obtain confidentiality agreements • Release the CIM to prospective buyers and outline sale process/timetable • Manage buyer queries • Obtain “Expressions of Interest” from buyers • Evaluate Expressions of Interest based on indicated price and other factors, decide upon short list of prospective buyers for next stage • Provide selected buyers with management presentation and limited and monitored access to additional information in electronic data room • Manage additional queries from buyers • Obtain Letters of Intent from prospective buyers • Evaluate Letters of Intent, select primary and secondary prospects • Negotiate Letter of Intent with primary selected buyer, providing an exclusive period for due diligence and negotiation of sale agreements • Owner decision to enter into the Letter of Intent • Suspend negotiations with other prospective buyers
Final Due Diligence and Negotiations	• Provide selected buyer with full access to remaining data room contents • Manage buyer queries • Establish communications plans, protocols and key messages for use when the sale is completed. • Negotiate full details in definitive agreements for the sale transaction • Owner’s final decision to proceed with sale – execute negotiated agreements • Clear transaction conditions, including any regulatory and similar approvals • Complete the sale and receive the proceeds • Manage communications with employees, customers, suppliers, other stakeholders

Planning Your Use of Proceeds

While your business progresses through the sale process, begin considering plans for reinvestment of the expected proceeds, possibly including trusts for future generations of family members, major gifts to your alma mater or favourite hospitals and charities, etc. You can expect to be inundated with requests once the sale is announced, so have a plan for dealing with these in your own chosen timeframe.

■ Reinvesting the Proceeds

Upon completing the sale transaction you will have completed a radical shift to the left on the risk:return curve. You will have crystallized and converted your wealth from one large and illiquid investment in a single, undiversified risk (albeit one under your direct control) and with a relatively high rate of return, into liquid assets. Having achieved great success in your business career you will undoubtedly want high performance in the management of your investments. More specifically, you will want to reinvest with a very careful eye on both managing risk and maximizing return consistent with your chosen risk envelope, and likely with substantial diversity in all dimensions, including geography and asset class as well as security selection.

■ Selecting Investment Managers and Deciding Investment Policy

Your newly liquid wealth will both raise the importance of highly effective investment management and open the doors to additional asset classes and to a whole new realm of "best of breed" investment managers who restrict their client base to ultra-high net worth families, pension funds and endowments. With a much larger portfolio, it is more likely that you will want to retain more than one investment manager to access specialists in particular asset classes, styles or geographies. It is important that you select and retain a global custodian, independent of the investment managers, to hold your assets under your ultimate control, apply your overall risk management guidelines in settling trades decided by your investment managers, and consolidate investment reports across the various managers.

We strongly recommend that you retain independent expert advice before selecting and retaining investment managers and developing investment policies for management of your own funds and the funds in any family trusts or endowments that you decide to establish. This process is extremely important to your family's financial future and peace-of-mind. You should take time to complete the analysis and reach the important necessary decisions and should allow additional time to implement at a deliberate pace in order to reduce the risks associated with market timing. In the interim ensure that your proceeds are held in very safe custody with top tier financial institutions.

It is often worthwhile to retain your independent expert and start the process of selecting investment managers and developing investment policies one or two months before the expected closing date of the sale transaction. We will be pleased to refer you to the firms we know both in and outside Canada who conduct comprehensive independent research and monitoring of top money managers around the world.

Your newly liquid wealth will both raise the importance of highly effective investment management and open the doors to additional asset classes and to a whole new realm of "best of breed" investment managers

About Cambridge

Cambridge Corporate Development Inc is a specialist M&A and strategy boutique serving the corporate finance needs of Canadian and multi-national clients through a team of highly experienced senior professionals. The firm specializes in helping entrepreneurs turn their successful business efforts into wealth, and is known for successfully creating value for clients in complex situations.

Cambridge provides advisory and transaction services on:

- Assessing strategic alternatives and positioning for value maximization
- Selling companies
- Acquisitions and mergers
- Intra-family ownership, control and leadership transition
- Corporate finance strategy

Our client base includes the owners of private companies, management teams and boards, shareholder groups, investment funds and family offices.

■ Contact Us for a Confidential Discussion

Having successfully completed complex and challenging transactions in many situations, industries, and global markets, Cambridge has the deal-proven experience to solve problems creatively and complete value-enhancing transactions.

For additional information or a confidential discussion, please contact Paul Lavelle at 416-642-5222
or plavelle@cambridgegroup.ca.

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