Published by TechExit.io, the M&A Ready Event

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PLAYBOOK

GETTING THE MOST VALUE FROM A POTENTIAL EXIT

8 KEY COMPONENTS FOR SUCCESS

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introduction

In tech, things move fast. And deals are no different.

Some companies are created with an exit in mind from the beginning. Others may find themselves suddenly thrust into negotiations when they receive an unexpected offer.

In addition, events like the global pandemic have caused some companies to experience strong growth and others to experience significant hurdles. Either way, companies can always be more prepared, and truth be told, selling a company takes more time than many imagine.

Most companies are built to grow but not to sell, which is why this playbook was created. And while there is no one-size-fits-all strategy, the following provides tech executives with a framework to start planning their exit now.

GETTING THE MOST VALUE FROM A POTENTIAL EXIT

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2. Importance of an advisor
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1. types of buyers

The C-Suite should anticipate what type of buyer may be interested in their company early on. While this may change as the company matures, identifying this early will help leadership determine how to best position themselves leading up to an exit.

Financial buyers

Financial buyers (typically private equity firms) are looking to acquire business' future profit streams. Most financial buyers require a minimum growth rate and level of profitability before purchasing a company. As these firms most often have financial, rather than strategic, incentives for acquiring promising tech companies, they're often willing to let the operation run on its own while providing valuable operational and financial advice. In short, they're professional business builders and will commonly generate and incent more profitability while opening up new growth opportunities.

If the C-Suite plans to sell their company to this type of buyer, they should focus on improving profitability, demonstrating growing market interest in their product or service, and strengthening their management team. If they plan to move on to new ventures after the exit, they should be able to demonstrate critical distance from the company. In other words, sellers need to prove that the company can function on its own, independent of its founding team.

1. types of buyers

Strategic buyers

Strategic buyers focus acquisition activity on companies whose capabilities can fit within or enhance their own company and product offerings. In tech, strategic buyers will look at a company's technology, customer base, and geographic markets. They may consider buying a company to recruit its key employees, such as their top engineers — in these "acquihires", the amount offered may be expressed on a "per head" basis. In order to achieve synergies, the buyer may also eliminate parts of the acquired business.

Companies who want to attract strategic buyers should focus on enhancing their technology and market share. By researching and partnering with companies who would benefit from their tech, companies can start building a working relationship with prospective buyers, achieve strategic alignment, and improve their valuations as they track towards formal M&A discussions.

Strategic acquisitions are becoming more commonplace in tech markets and often result in higher multiples. As more traditional companies develop their technological capabilities and shift away from the legacy aspects of their business, we expect to see more strategic acquisitions of tech companies.

2. importance of an advisor

An advisor can help you get the team in order and identify blind spots.

An advisor helps sellers navigate a tightly controlled process and adds a layer of sophistication to the deal that sellers likely cannot achieve on their own. Sellers will want to choose advisors who have strong relationships with the buying groups that they're after (i.e. advisors who have insight into their initiatives, strategies, roadmaps, and typical approaches to deals).

That said, it's no secret that exits put an immense amount of strain on the senior management of any business. In scenarios where tech companies have been approached by an interested buyer, an advisor can ensure that process is timely and that momentum is preserved when a deal needs to be closed on a tight timeline — let's be honest, most tech teams don't have the resources nor the expertise to take this on.

Advisors offer a number of benefits throughout, including:

- Preparing **financials** and **marketing materials** at each stage of the process
- Establishing the **key transaction timeline**, including the date that internal materials need to be ready, the **go-to-market (GTM) date**, when to expect expressions of interest, and when the books are ready for review
- Managing the process, taking the pressure off the C-Suite so that they can continue to run the business
- Identifying **pitfalls** down the road and preparing for unexpected parts of the process
- Assuming the role of "bad cop" in negotiating with interested companies so that no business relationships are soured

3. process and approach

While no two deals are the same, there are consistent touchpoints along the journey that a company must be prepared for.

Transaction timeline

In an ideal scenario, companies would have 24 months to prepare for an exit, but this often won't be the case. On average, the M&A process takes 6–8 months to complete, regardless of how simple the deal is. The executive team should consider creating a forward-looking calendar of events to know what will need to be managed, such as major buyer milestones, travel schedules, and due diligence requirements.

Information memorandum and letter of intent

Building marketing materials to showcase the business is critical, and the confidential information memorandum is the first official step in going to market. This document should be comprehensive and motivate potential buyers. It will also serve as a precursor to any Letters of Intent (LOI) received from interested buyers. As a result, accuracy and transparency are key.

3. process and approach

Management presentation

This is an opportunity for the C-Suite to tell the story of their business. Typically this is broken into a few presentations. The first showcases the strength of the management team and presents the company in the best possible light, highlighting everything from the roadmap to product strategy to customer relationships. The next presentation is usually more buyer-led, allowing questions from buyers after they have performed some due diligence.

Companies often underestimate the importance of the management presentation. This is the chance for the management team to demonstrate the passion that drives their service or product. Even in tech, getting too technical can bore potential buyers. Advisors can help teams hone messaging and rehearse delivery.

Key milestones

It's critical that the company sets reasonable expectations for the buyer. These milestones should be achievable and reasonable — buyers can be skeptical if companies fail to meet their own targets; conversely, if companies vastly overshoot their forecasts, buyers will be equally unimpressed. Demonstrating a strong handle on business growth is imperative.

In tech, this is complicated by ongoing product releases. Regardless of how mature a company is, there will always be new iterations of software and products. Before an exit, the C-Suite needs to set realistic expectations with buyers for version updates and the functionality of the product for each new release.

3. process and approach

third-party assessments

A third party provides a critical lens when determining valuation. Consider hiring an advisor to conduct one or more of the following:

- **Financial due diligence reports** ensure that prospective purchasers have an understanding of a company's earnings, including historical top line and expenditure trends. The C-Suite should be ready to explain these trends to a buyer.
- **Vendor due diligence reports (VDD)** can help expedite the process by providing the buyer with the necessary information to make an informed decision. VDDs provide the seller with an independent third-party assessment of the historical financial picture of the company. This will help with future buyer-driven financial due diligence by speeding up the process and allowing sellers to identify and mitigate any risks that may complicate the exit process.
- **A formal valuation** establishes valuation expectations, including a "walk away" price. This should be an honest reflection of a company's worth — exit processes with unreasonable valuation expectations are doomed to fail.

4. picking an approach

Whether companies are approached by buyers or are actively trying to sell, they may shop around for the best fit and offer using one of the following approaches:

A broad approach (or "broad auction") is the least confidential, but may lead to the highest valuations. The intermediary will typically reach out to high numbers of strategic and financial buyers. With the right confidentiality agreements and "blind outreach" tactics, confidentiality is still possible here, though it is much harder to manage. This approach is typically more risky, as competitors who find out about the sale may steal customers or strategies.

A narrow approach reduces the stress of publicizing internal processes and resources and increases the likelihood of a sale by tailoring the company story to each buyer. An experienced intermediary can help businesses build a purchase package that is both specific and attractive to potential buyers. Here, it is much easier to maintain strict confidentiality. In some cases, companies are forced into a narrow approach, particularly when their industry is highly niche. A good advisor can help uncover less obvious buyers that may end up being the right fit.

5. deal structure considerations

The capital structure and payout policy will determine how much sellers walk away with immediately after a deal.

Share sales vs. asset sales

The fundamental difference between a share sale and an asset sale is, perhaps, obvious: a share sale includes everything in the sale structure, from the company to the IP to any liabilities. With asset sales, only certain assets are being acquired — this may or may not include the IP. The seller will typically want a share sale to capitalize on capital gains exemptions and other tax benefits. In other scenarios, if the seller has a number of outstanding lawsuits or other liabilities, the buyer may push for an asset sale to avoid inheriting liabilities.

Asset sales allow management to discard certain assets (i.e. a line of business, certain customer contracts, or teams) and keep others (a brand or company name, a secondary product, or burgeoning aspect of a business to pursue otherwise). If the objective is to monetize, sell the company, and start something completely different, selling the shares is often the preferable exit route.

Equity and enterprise value

When offers come to the table in an M&A process, they're typically on a debt-free, cash-free basis. This means that when the buyer acquires the company, they expect no debt on the books; in exchange, the seller will take all excess cash out of the business. While sellers may think in terms of the "total" value of the company (equity value), it's important that they calculate earnings based on enterprise value (enterprise value = equity value + net debt - cash). In other words, sellers will often realize the business through the lens of equity value, but offers from buyers will come in as enterprise value, which can sometimes be overlooked.

It's also common to lose sight of working capital. One needs to consider the amount of capital they'll have to leave in the company upon closing to keep the business running. The working capital negotiation is a fundamental part of the M&A process — and should not be overlooked. Understanding what working capital is required for their business month-to-month will allow management to be prepared for this negotiation.

5. deal structure considerations

Forms of Consideration

Most sellers will prefer 100% cash at close. For a growing tech company, however, it's likely that sellers will receive some cash upfront, or a mix of cash, shares, and an earn-out.

In certain deal structures, sellers of a business collect earn-outs (or "conditional payments") once the company achieves certain financial goals. This way, buyers can hold sellers accountable to growth and ensure they reach their revenue targets. Earn-outs allow buyers to de-risk their investment while maintaining an attractive valuation for the seller.

It's important that sellers are extremely discerning when it comes to accepting shares as part of a deal. While shares of a public company with analyst-reported upside may be seen to sweeten the deal, many other shares carry inherent risk. Understand historic valuations, liquidity, and risk prior to accepting shares as consideration.

6. legal considerations

Escrow and holdback

Holdbacks are mechanisms used by buyers to withhold a portion of the deal consideration until certain conditions have been met. This protects buyers from losses in a post-closing indemnification claim or representations and warranty claim. Selling companies often request that this amount is held in escrow.

Holdbacks can result in a portion of deal proceeds being put at risk and delayed (or worse) — sometimes for up to 1–2 years.

Representations and warranties

Reps and warranties typically cover most of the seller's business operations, such as financial statements, liabilities, assets, and intellectual property rights. In a definitive acquisition, these help the buyer confirm their due diligence findings; if representations and warranties are found to be untrue at any point, the buyer may be able to free themselves from the terms of the agreement or claw back some of the purchase price. Reps and warranties are negotiated items in most transactions.

An increasingly important focus for tech companies is patent infringements. Small companies may never have had a patent infringement, but if they're in a highly patent-laden area and are in negotiations with a large buyer, patent infringement litigation becomes an important consideration. The C-Suite needs to work closely with legal counsel to get out in front of this, ensuring due diligence and coverage in reps and warranties for protection.

CEOs may want to use their corporate counsel to sell their business — but it's important that they bring on someone with extensive M&A experience who thoroughly understands how these negotiated terms will affect deal value.

All legal and certain business costs considerations have been provided by LaBarge Weinstein.

7. financial and tax considerations

Tech companies may suddenly find themselves in a transaction. If financial planning is done well in advance, this transaction can take place as quickly as needed.

Normalizing adjustments

Every company has incurred one-off expenses and abnormal charges in its history. These must be normalized to reflect the financial story, as they then increase or decrease the revenue and earnings before interest, taxes, depreciation and amortization (EBITDA) — often a critical driver of valuation. Common normalizations in the tech sector include R&D costs, startup costs related to expanding into new verticals or introducing new products, overpaying for highly sought-after talent, and other types of unusual contracts.

Advisors will provide normalizing adjustments they consider fair before going to market, as many growing companies incur one-time expenses that impact both the top and bottom line, and buyers will want to understand the true economics of the business.

Corporate tax structure

Planning the tax structure in advance of a sale will help to minimize the impact of taxes on founders, shareholders, and option-holders. Tech companies should consider:

- **Capital gains exemptions:** This is one of the most valuable tax incentives provided to shareholders of private corporations and can help them save hundreds of thousands of dollars of lifetime capital gains related to a sale. Certain other legal structures like family trusts can multiply capital gains exemptions.
- **ESOP:** Instead of issuing employee stock options with pre-scheduled vesting periods, companies should consider offering a tax-efficient buy-back clause. This allows the company to buy back from employees who leave early and allows employees to take advantage of any capital gain exemptions, as they'll be more likely to own the stock for two years before a liquidity event.

8. managing change post-exit

After the deal, there's still work to be done...

Post-deal integration plan

Without proper plans in place, many acquisitions stumble and can ultimately fail. A post-deal integration plan helps both companies ensure that the acquisition meets growth forecasts, properly anticipates new hires, and prevents costs from overrunning. Advisors specializing in these matters often help with this process, guiding companies from the mid-deal point until after the deal is finalized. This helps to avoid common pain points that occur after a deal, including missed targets and the loss of key employees. Ideally, someone from the deal team will also be part of the integration team to help alleviate any friction.

Managing role changes

Depending on the buyer, business life will change substantially for the sell-side senior team. If the company is bought by private equity, chances are they could find themselves in the same exact roles. If they're acquired by a strategic buyer, their roles will likely change considerably — often the CEO will become the CEO of a product instead of the leader of a company. This can be a big shift, particularly for teams who aren't used to reporting up; post-deal, there should be incentives in place to keep them motivated.

CONCLUSION

The deal isn't done. It's just a new beginning.

Be it an acquisition, merger, or IPO, an exit is really just the start of a new era for a company.

For executives and founders, the company will begin to evolve as it takes its new shape. And, for the advisors associated with the transaction, it doesn't stop there either. They are there to support throughout the entire process — from long before to long after, sharing invaluable advice and experience along the way.

Most companies are built to grow, but with proper exit planning, they can also be built to sell.

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Despite the downturn that Canada's tech market is facing, M&A will continue to play a key role for tech companies in 2023. The market conditions, uncertainty and volatility create enormous opportunities to share ideas, to partner, to merge and acquire. As a Founder, how can you learn more about exiting your company. How can you learn about making smart, strategic acquisitions?