MODERN DISTRIBUTION MANAGEMENT The Newsletter for the Wholesale Distribution Channel

What Sellers Should Expect, pt. 2

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How to make the best deal work, part 2

Part 1 of this article is here.

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Curb appeal
Many buyers are afraid of buying a distributor who has recently undergone a change in senior management, implemented a new software system, or relocated its main operation. These traumas may destabilize a distribution business, causing it to lose key employees and customers. Some buyers would rather wait until the business is back to normal.

Think of the process of selling residential real estate. A property with recent repairs can arouse a buyer's suspicion.
A house with many minor flaws can cause concerns about the underlying structure. A cluttered interior may prevent the buyer from seeing the potential of the property.
A home with genuine curb appeal looks good as the buyer pulls into the driveway, has no telltale signs of patching up, is immaculate and free of clutter. All of the systems are in good working order and there are no obvious flaws, however minor (leaky faucets).

The same logic applies to distribution businesses. Companies with great curb appeal have dependable information systems with well-trained users, prompt and accurate financial reporting, and excellent housekeeping. They don't have mountains of stale inventory and they don't have ancient receivables on the credit reports. The people are professional, presentable, and friendly.

Even if your company is not for sale, the likelihood of an attractive unsolicited offer coming over the transom is a lot better on a well-run ship. A side benefit of having a company with curb appeal is that it is much easier, and a lot more fun, to run one of those than a fixer-upper.

The seller's story
Everyone loves a good story. That is how we learn how mankind passes knowledge from one generation to the next. It's a good idea to have a well-rehearsed story about your business. For example, the people at your company should be readily able to explain important information such as what the company does, why its customers buy from the company, and what the company's values are. Taking this a step further, the company's leaders should be able to explain where the company is going, why it's going there, and how it will get there. This information is important to the people who work there and to the people who do business with the company. It is also of vital importance to prospective buyers.

Buyers like to know that the people at the company have a strong sense of purpose and a clearly defined direction. Buyers need to be able to visualize how the company would be successful under their ownership. Buyers love to have a story to relate about the proposed acquisition to their people, their directors, and their lenders.

If you have some exciting initiatives under way, weave them into your story about the company. Create a vision of the future of enterprise with new customer segments, new products and services, and new geographic markets. The story may tie in to your reasons for selling, including the need for capital and more skilled people. It's great to have a detailed strategic plan, but it's more important to have a good story that conveys your vision and enthusiasm for the company's

future.

Changing the purchase price
Don’t be surprised or offended if the buyer comes back after due diligence and tries to change the purchase price as stated in the letter of intent. Even if the buyer states that he never (well, almost never) tries to "nibble," many do. They may find that recent sales are trending below expectations, that economic conditions are deteriorating, or that the buyer has become worried about globalization or whatever.

Buyers often try to revise the purchase price (downward, of course). You will have to decide the sincerity/validity of the request, evaluate the reasoning behind this, and decide what your response will be. This is often part of the game; so don’t get mad unless you think that cutting off the discussions is in your best interest.

Delaying tactics
Buyers sometimes need to delay closings for legitimate reasons, and occasionally they stall them deliberately. The buyer may want to wait to see more results from the business, the outcome of a contract renewal or a labor negotiation. Advisors (notoriously attorneys) and lenders working on the transaction often cause delays.

Delays are common and are usually in good faith. You will have to get the facts and make a judgment as to how long of a delay you are willing to accept. There are also many risks to the buyer in delaying the closing (you may find another buyer or change your mind about selling). Don’t expect everything to go smoothly or exactly according to schedule.

Good cops/bad cops and other tricks
Poker, especially Texas Hold ‘Em, has been riding the wave of popularity since broadcasters starting putting high-stakes games on TV. Poker fans and other students of human nature enjoy watching the way different characters (and I do mean characters) play what is really a fairly simple game.

Like poker, there are many ways to play your hand when negotiating a business transaction. Use of negotiating tricks – including dirty tricks – depends on the person. Some people either rely on playing games or disdain them as a matter of personal preference. Buying and selling businesses is a high-stakes enterprise. Unlike a poker game, the process is very complicated and usually takes a long time.

The seller needs to be prepared for anything when negotiating. People still play the old good-cop, bad-cop game. Some players make outrageous demands and then make tiny concessions. Buyers try to hook the seller with an attractive proposal and work backwards later. Be prepared for nibblers, screamers, and people with conveniently poor memories.

Junk mail & voice messages from strangers
Hungry financial intermediaries send countless business development letters and make endless phone calls to owner managers. Owners of distribution businesses are high on the list of juicy prospects. Many owner managers have a knee-jerk reaction to most or all of these solicitations. I suspect that many envelopes are tossed into the wastebasket unopened, and most of the voice messages go unanswered. The vast majority of these inquiries are bogus and don’t deserve any attention.

Unfortunately, the barrage of junk mail and calls has conditioned owner-managers to ignore all inquiries from strangers. Legitimate investment bankers and other sincere inquiries have trouble getting through. The clever ones can get through all but the most impermeable barriers unless the prospect makes it so difficult that even the most persistent efforts aren’t successful.

Owner-managers who cannot be bothered to separate the wheat from the chaff may miss out on the contact that would be the deal they have been dreaming of. I am a follower of the theory that nearly everything is for sale if the price is right.

Owner managers need to be prepared for these inquiries. I propose a process:

- Toss the obvious garbage
- Do a little homework on the inquiries that may be legitimate. Research the firm and the individual to see if they are legitimate.
- Forward the inquiries that pass scrutiny to an outsider, such as a member of your advisory board. Ask the outside advisor to phone the person and screen the inquiry by evaluating the firm, the caller, and the legitimacy of the inquiry. The identity of the buyer should be provided as well as background information.
- The outside advisor will gather whatever information he can for consideration by the owner-manager and possibly

the advisory board. The company will decide if, and how, to respond to the information requested from the prospective buyer.

- Many owner-managers would like to know what outsiders feel their company is worth. It will be necessary to provide some information about the business. Summary financial data can be very basic and need reveal nothing about the company's customer, employees, or suppliers. Most buyers are willing to start pricing discussions based on a brief summary of recent income statements and a current balance sheet.
- The owner-manager who is unwilling to share any information may ask the prospective buyer to describe his valuation methology. The company can apply the valuation mechanics to its data and estimate the value.

Investment bankers will do an appraisal on a fee basis. Some firms will consider applying the fee towards a large contingent fee for helping the client find a buyer. Many investment bankers are eager to do a valuation, since this is often the first step toward sale of the business.

An appraisal for the purpose of the sale is usually much less costly than a valuation for estate-planning purposes. Valuations for tax purposes include an extraordinary amount of documentation justifying the valuation and discounting methods, technical tax information, and the appraiser's qualifications. Estimates of potential selling price are less time consuming.

Some acquirers of distribution businesses may not be as smart about the industry as they think they are. They can be like colonists occupying a new land where the natives already know how to run the place.

Both large and small distributor acquisitions are likely to fail, for these reasons:

- Buyers often bite off more than they can chew, both in terms of finances and management time, skill, and commitment.
- Buyers are tempted to jump to another pond rather than go to an adjacent lily pad. A distributor in Queens may be better off acquiring a company in Brooklyn than in Albany.
- Buyers may become victims of trying to venture out too far without proper intelligence about where they are headed.
- Buyers may lack the discipline to stick to their strategy (good choice of targets); to negotiate well (good choice of weapons); to perform proper due diligence (good intelligence), and occupy well (good integration).
- Some buyers lack the sensitivity to understand the selling method used by distributors and do not recognize the value added by salespeople.

The process by which mistakes occur varies, but the effect can be the same. Buyers spend operating money on the purchase price and can't afford to invest in the business following acquisition.

Even two companies in the same line of trade in the same city may speak the same language but be unable to communicate. Depending on the circumstances, one distributor buying another is certainly more likely to be successful than other buyers. He may fail, however, if he tries to impose his own playbook before he fully understands the company he acquired.

He who is most likely to succeed is

- Another distributor
- From a nearby market
- With complementary products

- And a similar culture
- Who has customers with similar needs and relationship dynamics
- And uses a similar method of establishing and securing his customer relationships.

Acquisitive distributors, with everything else going for them, sometimes succumb to an error of geography. They fail to recognize the importance of acquiring a lily pad close enough to drive to and from in a single day.

Some managers will try very hard to avoid making an overnight business trip. If the management team is not willing to make those sacrifices, or to relocate altogether, there won't be much face-to-face contact between the buyer and seller. This may be a blessing in disguise, or a big problem.

Some buyers eventually become insecure with the hands-off management approach and start to meddle or, worse, attempt

to run the remote location by telephone and e-mail. This can be much worse than regular, personal visits. Visits by top management to the remote location are much more effective and less disruptive than branch manager visits to headquarters.

The buyers with the greatest likelihood of failure are those with unrealistic expectations. Some investors entered the distribution arena in the late ‘90s looking for technology style returns, such as a private-equity firm shooting for 30% compounded annual returns and an exit within five to seven years. This type of investor expects to take his profits, withdraw his capital, and move on. This type of buyer will, of course, be disappointed (or worse).

Most buyers are woefully unprepared, information-wise:

- They will skip or make short shrift of business due diligence. This may be for cost reasons or in response to time pressures. Much due diligence that could (or should) be performed by outside experts will be done by inexperienced company employees or not at all.
- "Market due diligence," different from business due diligence, pertains to study of the industry, geographic market differences, and customer demographics. It should be performed prior to identifying acquisition targets. This step is often overlooked.
- Buyers fail to do their homework in the strategy phase. They go in blind – almost aimlessly, as though in a maze – and grab the first company that looks good to them. They don’t know how much to pay and lack discipline in making that determination.
- Buyers lose sight of their strategy (if they had one on the first place) during the acquisition process. The process would work more smoothly if they planned their work and worked their plan, but it usually doesn’t happen that way.

Contingent purchase price and other claims

Buyers often offer a contingent purchase price when pressed by the seller for a higher price than the buyer is willing or able to pay. This condition poses some challenges.

- Can the parties agree on objective, measurable criteria to avoid future disputes over the amount due?
- Can the buyer provide adequate assurance to the seller that he will be able to make the payment out of sources other than the acquired company if necessary?
- Can the seller feel comfortable that the buyer will not try to avoid paying the contingent amount by making offsetting claims?

Regarding offsetting claims: A word of caution is needed. It is not uncommon for buyers to assert claims that the seller was overpaid due to inventory discrepancies, unrecorded liabilities, professional fees, tax claims, employment related issues, etc. Buyers have also been known to make claims, justified or otherwise, that sellers failed to comply with non-competition or non-solicitation agreements. Disputes also may arise between the buyer and seller in relation to real-estate leases between the parties.

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