Perspective

A Two-Step Process for Preparing a Revenue-Generating Company for Sale

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Preparation prior to a merger or acquisition is the key to mitigating risks and maximizing value for an eventual transaction.

The M&A Environment

2011 was a strong year for deal-making in the musculoskeletal space. Orthoworld reported that 43 transactions of all sizes were concluded by OEMs and suppliers in 2011. Over the next 24 months, an increase in merger and acquisition (M&A) activity is expected, driven by buyers pushing to bolster corporate revenue coupled with the buying power of strong balance sheets. Although mega-deals like JNJ DePuy and Synthes dominate the headlines because of their size, scale and impact, more than 90% of the M&A volume is in transactions with purchase prices less than $500MM. Approximately 60% of all M&A volume is in transactions in the "middle-market" – between $10 and $500MM.

Preparing A Company For Sale Takes Work

Acquiring a "middle-market" company, especially one that is privately-held, is typically a complex transaction filled with risk for the buyer. As a result, a seller should make every effort to mitigate those risks by preparing his or her company for an eventual SUCCESSFUL transaction. This preparation typically requires more work than most sellers realize. Thinking that you can do it yourself — and in an unbiased manner — is a mistake frequently made.

However, by identifying a company's value-drivers, telling a compelling story about each (that can hold up through due diligence), and by ensuring a seller's "house is in order" — sellers can enhance the value of their companies.

The 1st Process Step: Telling A Compelling Story – Which Requires The Identification Of Value Drivers

Value drivers are the attributes that differentiate — and distinguish — successful companies. They can better position a company as having a stronger business, more loyal customers and better products and technology than a sellers competitors. Value drivers can make a business more valuable to potential buyers.

Top Value Drivers

Listed below are seven key components that may serve as building blocks for telling a compelling story, along with characteristics that prospective buyers may find more — or less — desirable about each value driver:

1. **Customer Diversity**

Desirable — No one customer accounts for more than 5 to 10% of a seller's revenue; a high percentage of revenues are from repeat customers.

Less Desirable – Heath Care Professionals (HCPs) with equity positions, or HCP consultants or product designers who account for a disproportionately high percentage of a seller's revenues; too many customers with short tenures; declining trend in overall number of customers.

2. **Strong Management Team and High Employee Retention**

Desirable — Senior positions are staffed with proven professionals; performance incentives are in place; employee retention is at or below industry average; an adequate and well-trained labor pool is available.

Less Desirable — A management team that lacks depth and breadth; an owner who acts as a "one man show"; above average turnover rate.

3. **Intellectual Property**

Desirable — Patents, trademarks and licenses that are in order, well documented and properly secured; patents that cover the commercial products; clear ownership of IP by the seller; a freedom-to-operate opinion, especially in a crowded space, that has recently been secured.

Less Desirable — Poorly maintained privacy and confidentiality processes/documents; unclear ownership of patents; inventorship process not implemented in select countries; poorly managed licensing agreements; threatened or pending litigation; potential for claims post-close.

4. **A Go-Forward Plan and Consistent Financial Performance**

Desirable — Having a strategic or a solid business plan, or at least a set of well thought out projections with supporting assumptions; actual sales, profits and profit margins that have grown consistently over time — and are outperforming the market and key competitors; a reasonably strong balance sheet.

Less Desirable — "Top down" projections with growth assumptions that can't be defended or are overly optimistic in light of market trends; gross margins below industry average — and slipping; significant capital expenditures required to simply maintain the current level of business.

5. **Sustainable Competitive Advantage**

Desirable — Wide array of proprietary products and/or value-added services that have brand recognition and demonstrate a competitive advantage; products/technologies that improve patient outcomes cost effectively; carve- out of a desirable niche that can potentially define a space; a clear regulatory and reimbursement strategy for any non-commercial products in the development pipeline; unique operating processes.

Less Desirable — Product(s) and/or service(s) that are commodities, have little to no IP and are sold primarily on price; lack of availability of clinical and/or economic data for product(s); few operational or economics barriers for customers to switch to a competitive product or service.

6. **Developed Business Systems (Including Compliance)**

Desirable — Robust systems that track, analyze and report financial, quality and operating metrics; financial statements reviewed or audited by a reputable CPA firm; written procedures for engaging HCP consultants, including establishing deliverables and determining fair market compensation for each; process to track Foreign Corrupt Practices Act (FCPA) compliance; product marketing materials consistent with regulatory clearances; developed quality systems and processes for manufactured and vended products; vendors approved by one or more of the larger device companies (if manufacturing outsourced).

Less Desirable — Unorganized or deficient business records, documents, and processes that may impede future growth or hinder integration; unfiled or inaccurate financial statements, tax returns or Board minutes; undocumented IT systems; undocumented agreements; numerous, unqualified outside vendors – or total reliance on a single-supplier; HCP consultants providing services without written agreements or who are paid at above-average rates (undesirable); any off-label sales (undesirable).

7. **Marketing and Sales**

Desirable — Steady stream of successful new (and planned) product introductions and line extensions; a collateral material copy review process in place and taken seriously; well trained and focused sales force with performance incentives in place.

Less desirable — High sales rep turnover; long term (and difficult to break) agreements with agents or distributors; agents or distributors who sell “other” products that directly compete with those of buyer; lack of transparency with stocking distributor’s physician customers, especially outside the US (if US-based company — see FCPA comment in # 6).

The 2nd Process Step: Having Due Diligence Conducted On Your Company

The second step in preparing a company for sale is getting a seller’s “house in order.” A seller should have due diligence conducted on his or her own company well before taking the company to market. By having negative surprises identified and addressed, and having a risk mitigation plan written and implemented early on, a seller can be prepared to better define and defend his position during face-to-face management review meetings with buyers.

Listed below is a sampling of the due diligence items that frequently uncover risks:

- Examination of financial records and controls
- Review of internal and external agreements, including those with HCPs
- Review of IP that uncovers “flaws” of any type (Ex: patents — ownership, coverage, freedom-to-operate; trademarks/copyrights/domain names)
- Documenting procedures and policies
- Addressing issues regarding employees, sales reps, and litigation
- Ensuring compliance with applicable government and device industry regulations
- Quality systems audits

Suggestions For Those Planning To Sell

If you are looking to sell your company over the next six to eighteen months, you should consider initiating the planning process now — in an effort to exploit every opportunity possible to distinguish your company.

Allowing sufficient time to plan and prepare for a transaction can potentially:

- Reduce the scope — and speed the completion — of a buyer’s due diligence
- Increase the certainty of a close — without renegotiation of price and terms
- Optimize the price by minimizing risks and maximizing value, and
- Allow you to sell your business when you so desire

Deciding to sell may be the single biggest event in a company’s history. Being proactive in preparing for that sale will leave less to chance and translate into more desirable results for the seller. Remember — sellers don’t get a second chance to make a good first impression in front of prospective buyers. Maximize your opportunities by being prepared.

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