

# MFA Perspective

*Preparing For An Exit*



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# PREPARING FOR AN EXIT

As the US emerges from the recession that has plagued the economy during the past 18 months, private equity firms that have been entrenched in their investments are beginning to evaluate exit options in the hopes of earning what is now a long overdue return on their investments. However, there is still a lot of uncertainty on the horizon and as a result, transactions are being subjected to deeper scrutiny as buyers seek out companies with a compelling growth story that can withstand today's prolonged due diligence process.

In this market, there is no guarantee that any exit will be as timely or profitable as fund investors would hope or require, but market ready businesses can still be sold quickly and at a solid multiple. The key to success? Strategically preparing for an exit. Not only will exit readiness enable the efficient execution of a sale, but it will also maximize its value.

## HOW IMPORTANT IS EXIT READINESS?

As credit markets have tightened, it has become even more critical that companies looking to sell anticipate risks and issues that might arise and potentially disrupt, or lower the value of a deal. Buyers will undoubtedly uncover any hidden problems during the buy-side due diligence process; therefore, it's important that the seller is aware of any "hidden gems" and has that knowledge available when negotiating sale price.

In addition, there is an ever-present "need for speed" during any transaction, particularly given the drain on management's time and energy associated with preparing for and executing a sale. In order to quickly and effectively execute a transaction, it's critical that the seller is fully prepared to exit when the business is taken to market. If not, the seller risks exposing the company to the buyer, prolonging the deal and ultimately lowering the sale price.

## SELL-SIDE DUE DILIGENCE: READINGY FOR AN EXIT

Sell-side due diligence is a valuable component of any exit strategy, particularly in today's uncertain economic environment. Sophisticated bidders have advisors on hand to find any problems within the business and therefore, it's important that the seller has taken an in-depth look at the company in advance to prevent any unwanted surprises. Sell-side due diligence allows the seller to proactively address any risk areas of the deal and can even expedite the transaction process. Well executed sell-side due diligence includes a

thorough assessment of the financial health of the company, as well as an evaluation of all operational, technological and human resource issues. A thorough sell-side due diligence partner assists with five critical phases of the deal:

1. **Pre-sale planning.** The seller and its due diligence partner must identify any potential issues in order to avoid broken deals or decreased valuations. Pre-sale planning includes performing due diligence and preparing an analysis of the business positioning, providing support and insight for the information memorandum and assessing the baseline valuations range, among other activities.
2. **Data room and management presentations.** It's critical to develop financial data and schedules on a basis of accounting consistent with the information memorandum.
3. **Negotiation and execution.** Sell-side due diligence enables the seller to anticipate the purchaser's challenges to valuation, support negotiations from a fact-based position of strength and avoid any delays to the transaction process.
4. **Operational separation.** The seller and its due diligence partner must proactively identify any stand-alone issues including commercial and customer risks, and analyze the cost of those issues.
5. **Post-closing issues.** Once the deal is closed, the information garnered via thorough sell-side due diligence can help with purchase price adjustments and other post-closing issues that might arise.

Sell-side due diligence allows sellers to counter transactional risks by taking a proactive approach to mitigate potential deal breaking issues. Before moving forward with a potential deal, sellers should:

- Evaluate the financial health of the company by assessing the quality of earnings and identifying any non-recurring charges or credits to maximize the company's value;
- Develop realistic budgets and forecasts;
- Assess trends in revenues and EBITDA to identify key business drivers;
- Appraise the quality of assets to be sold and liabilities that would be assumed;
- Evaluate trends in required working capital and develop a target working capital level in advance of the purchase agreement;

- Appraise the impacts of fixed versus variable costs, capital expenditure requirements and the importance of certain administrative activities;
- Identify internal management and operational weaknesses, as well as any potential transitional issues;
- Identify tax risks including federal, state and sales tax obligations;
- Determine the optimal tax structure of the seller before the deal and for the deal, and evaluate the impact on potential buyers;
- Consider related party activities and the related transfer pricing or intercompany activities;
- Define key terms and expectations in purchase agreements;
- Mind the GAAP (Generally Accepted Accounting Principles)

## TAX PITFALLS AND OPPORTUNITIES

Whether the exit involves an IPO, a strategic/financial acquisition, or another exit option, tax matters can and do drive valuation, specifically when valuable tax assets such as net operating losses and tax credits exist. Two primary areas that require attention are the deal structure and the optimization of the underlying tax assets residing within the target.

From the seller's perspective, it is essential to:

- Negotiate whether the sale will be an asset sale or a sale of stock. From a tax standpoint, a stock sale will generally benefit the seller and therefore, if it is an asset sale, it's important to get a premium on the asset sale to put the seller in the same after-tax cash position.
- Consider state tax exposures prior to sale and to mitigate any concerns that might arise. For example, the seller should look at how to structure the sale from a state income tax perspective, evaluating ways to allocate income to low-tax states.
- Look at items such as tax accounting methods that might trigger income on an asset or stock sale, and evaluate how to mitigate the impact on the sale.
- Look for the possibility of tax-free reorganizations, particularly if dealing with a public strategic buyer.

An agreement between the parties related to taxes on a pre- and post- transaction basis should be drafted. Issues related to taxes such as documentation related to basis, net operating losses and

## TAX STRATEGIES FOR A COMPANY GETTING READY TO SELL

Any company considering a sale in the near term would be wise to get its tax matters in order well before there's a buyer in the picture. If there are valuable tax attributes to consider, sellers can and should have that knowledge on their side at the negotiating table.

Too often companies considering a sale in the near future focus all of their energies on product development and sales, and do not pay attention to the possible hidden gems of tax value that reside in their business until it's too late. Once a transaction has been initiated, it is often overwhelming for a company to respond to the questions posed in the timely manner required during the due diligence process. As a result, amounts are set aside out of the purchase price to deal with the contingencies until they can be resolved, or even worse, the overall purchase price is reduced to reflect this deferred maintenance and uncertainty of value associated with tax assets.

Here is what you can and should do from a tax perspective to optimize organizational value between now and the time you sell:

- Understand the process of how an acquiring company will value the tax assets such as net operating losses and tax credits;
- Ensure your entity structure is tax optimized for current and scaling operations;
- Understand the process an acquirer would follow to review tax issues at the time of sale; and
- Be sure to have your tax filings, agreements, valuations and audits in order so they cannot decrease entity value due to the uncertainty of costs related to fixing any inherited issues.

By taking these steps now, when a suitor makes an offer to buy the company, management will be able to confidently secure a higher return for the company due, in part, to the knowledge that they had optimized the tax assets that were acquired.

credits come up several years after transactions are completed and it is important to identify the responsibilities of both the seller and buyer. This includes taxes triggered through change-of-control payments.

The choice of entity and whether the sale is structured as the sale of stock, a straight asset sale or a deemed asset sale can have many variables that should be considered prior to sale.

### **LOOKING AHEAD...**

As markets and exit multiples continue to stabilize and investor demand for liquidity continues, private equity firms are seizing the opportunity for potential exit strategies - looking to maximize the return on their investments. However, planning how to exit an investment is just as important as completing the transaction. Companies should be sure they've considered all options and invest proactively in presale diligence to expedite the sale process, maintain control and credibility, and enhance exit value.

### **FOR MORE INFORMATION, PLEASE CONTACT**

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