How private companies can plan for an exit in a downturn

The best thing sellers can do is continue to invest in their business now—so they can quickly monetize that investment in an IPO or M&A transaction when markets rebound.

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Introduction

When private companies and their investors evaluate exit options, the typical paths have been either a sale to another buyer in a merger-and-acquisition (M&A) transaction or an initial public offering (IPO). More recently, companies also employed a third option, which involved going public through a merger with a special-purpose acquisition company (SPAC).[1] However, macroeconomic uncertainty, the risk profiles of companies seeking a merger with SPACs, waning interest from public investors, and heightened regulatory scrutiny have slowed SPAC market activity significantly. Many smaller, emerging growth companies have been forced to delay and reconsider their exit plans while waiting for market conditions to become more favorable and valuations to return to levels that make an exit more compelling.

In this paper, we aim to show owners and top management of sellers what they can do now to prepare for the exit option they are considering—most likely a traditional IPO or M&A transaction, given the more challenging path for SPAC mergers. The current lull in valuations and market activity offers sellers a timely opportunity to pursue transformational change to accelerate IPOs or M&A activities when the economic sentiment turns positive again. In fact, dual tracking, or preparing for an exit through an IPO and M&A transaction simultaneously, can be a useful tactic for the seller to attract even more interest from potential acquirers. The prospect of missing an M&A opportunity to an IPO can introduce an additional component of competition and drive up bids for your company.

[1] In 2020-2021, SPACs became a particularly compelling exit vehicle for early-stage companies that were not yet suitable candidates for a traditional IPO or M&A transaction.

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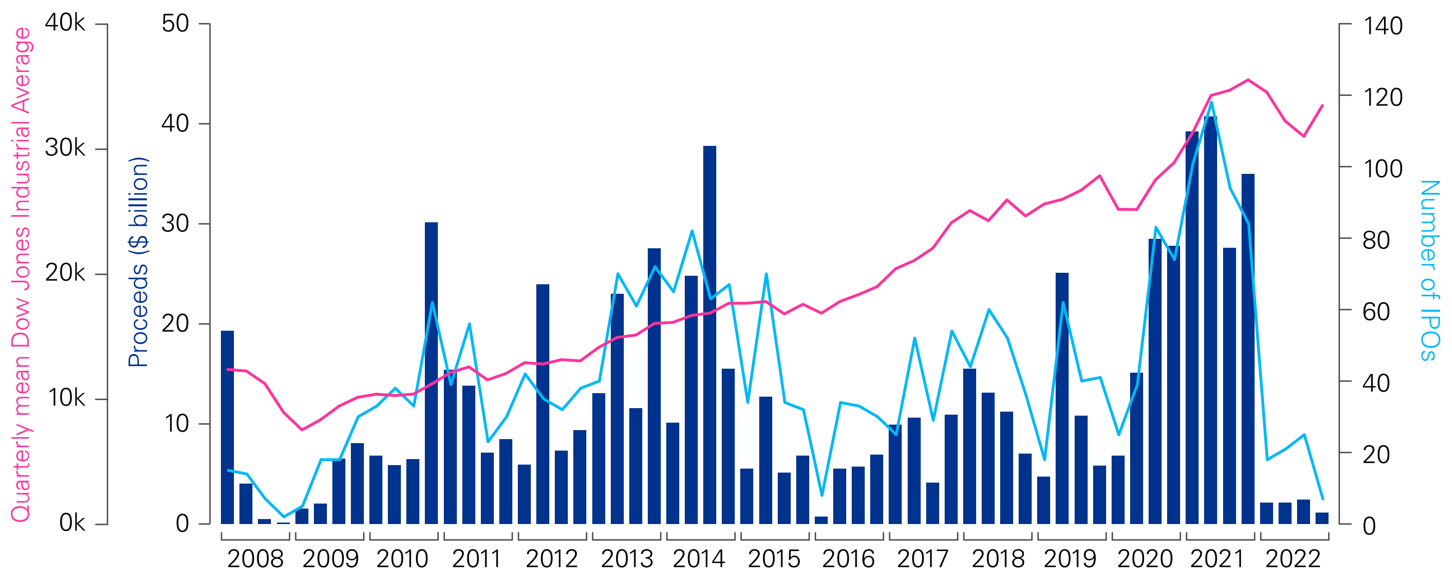
Why it makes sense to start preparing now

Both IPO and M&A markets can bounce back quickly once macroeconomic conditions start to improve, driven by an acceleration in valuations and rising stock markets. This means sellers that do not have their houses in order can miss out on the ideal window for a deal. It is important to keep in mind that an IPO transaction usually requires at least nine months of preparation, while pre-deal activities for an M&A transaction can take up to six months.

Exhibit 1: IPO quarterly trend



Note: Q1'08-Q4'14 IPO and proceeds are based on S&P Capital IQ data; Q1'15-Q4'22 IPO and proceeds are based on Renaissance Capital data

Source: S&P Capital IQ and Renaissance Capital

IPO launches by companies can be unpredictable from quarter to quarter (Exhibit 1). While several factors can impact the timing and decision to launch an IPO, the primary ones are macroeconomic trends and investor sentiment, as well as potential valuation. Coming out of a downturn, IPOs often follow three to four months after market indices start to trend up. That means companies that are agile and prepared to take advantage of a "market window" within a short timeframe are able to attract attention from investors and achieve optimum market valuations for their IPOs.

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What to prepare

For each exit strategy, a privately held company must consider various requirements for a successful outcome.

1 Traditional IPO

Being a publicly traded company will come with additional scrutiny as competitors and customers will now have increased transparency into your financial information. While an IPO is complex and time-consuming, there are numerous benefits, such as increased visibility, credibility, and permanent capital. An IPO must be planned very carefully for a favorable public debut. To take advantage of a market window where measures of valuation, investor interest, and competitive position come together, timing is key.

The IPO process requires significant preparation. It also requires **an attractive equity story** that will appeal to investors as a compelling investment opportunity that suits their risk profile. The equity story can differentiate the company from competitors and will highlight to investors its business model, growth strategy, and strengths for future success. A key element is forecasts, as IPOs are generally priced based on forward-looking financial information and specifically on profitability-related metrics. Having a robust business forecasting ability will be the cornerstone of an accurate valuation process and communication with investors.

As a public company, the entity will be required to produce **high-quality financial information on a timely basis** for regulatory purposes and disseminate it to investors. This information will include periodic filings with the Securities and Exchange Commission (SEC), Public Company Accounting Oversight Board audits, Sarbanes-Oxley Act compliance, and corporate governance criteria. Special consideration should be given to any subsidiaries using different management information systems or reporting bases as it can take time to prepare data for inclusion in consolidated financial statements.

A publicly traded company needs **a robust corporate structure**. This structure will need to be supported by systems and processes that can effectively and efficiently help execute the company's strategy, drive financial results, and provide agility to adapt to business or market trends. More standardized and streamlined processes will reduce the potential for errors, save time, and provide a basis to identify insights, trends, and key metrics, allowing for better and timely decision making by management.

Another key factor to consider is setting **an appropriate investor relations (IR) strategy**. IR activities include earnings calls, conference calls, roadshows, and investor presentations. Communicating key messages and business metrics to investors will help provide a better understanding of the company and its performance against its peers.

A company should consider reviewing **its current capital structure for any potential short-term savings** that can be achieved with money raised in an IPO—for example, paying off long-term debt with high interest rates.

Over the last several years, a trend has developed where companies pursue a "dual-track" strategy whereby they prepare for both an IPO and a private sale simultaneously. As a sales tactic, the company is able to put a finite timeline to its IPO plans and at the same time elicit interest from private buyers. This approach has proven to be successful in publicizing the fact that the company is for sale and can help draw a larger number of interested private buyers while setting the deadline of an imminent IPO. This can result in a competitive bidding process among private buyers. The benefit of this process is that the valuation from the underwriters provides a base against which to measure private bids and determine if they are compelling enough to accept in favor of abandoning the IPO. Ultimately, this enables selling shareholders to achieve the best available exit valuation for either path.

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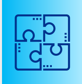
2 M&A transaction

For an exit through an M&A transaction, the story (i.e., value proposition) of your business must be supported by the right information in the right way to withstand the intense due diligence process that comes with it.

Management visibility and information transparency are crucial to a successful due diligence process. From a buyer's point of view, the most common red flags include:



Inability to articulate your key performance indicators and how they translate into your business success and potential synergies

Presence of material weaknesses identified during external audits, pointing to unsound accounting policies, weak internal controls, outdated/outgrown information technology (IT) systems, data vulnerability to cyberattacks, appearance of a control environment incapable of supporting growth aspiration without significant investment, and likelihood of Generally Accepted Accounting Principles (GAAP) adjustments

Lack of consideration for exposure to tax risks

Absence of comprehensive knowledge and assessment of potential legal ramifications on intellectual property, customers, vendors, and internal stakeholders, particularly in the context of a change in control or ownership

Lack of evidence of future value creation and clear strategy for growth beyond the immediate exit

These factors, together or singly, can scuttle a deal and are all issues that can be mitigated if recognized early and addressed appropriately before entering a sale process.

Thorough presale preparation will undoubtedly create significant demand on the company's resources, requiring **robust project management** with oversight by a steering committee. Early involvement of a supportive board, consistency in communication strategy (including on the role of major shareholders), data room preparation and readiness, and management's ability to effectively manage and to remain accessible to buyers and advisers during the process will aid in successful execution of M&A transactions. To minimize remedial action on due diligence findings, analyze your data as early as possible. To enhance management performance during the period to exit, consider equity-structured awards that vest at exit that strengthen the executives' incentives to remain committed to the business.

Post-sale involvement of company directors and senior management will increase a buyer's interest in your business. Ensuring continuity, even in the short to medium term, of key managerial resources and operational know-how can be an important influence on the buyer's decision.

A concise yet comprehensive management presentation that aligns with the historical performance and future growth of the company during the bidding phase will help narrow down the list of bidders. Focusing on relevant buyers early in the exit process will allow **greater flexibility in price negotiations.**

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In light of the recent decline in the volume of M&A transactions, disruptions in the lending environment and higher interest rates, management's ability to navigate this disruption and continue to drive the growth and strategy of the business will be vital to position the company for a successful future transaction. Be prepared for a robust process and **to drive an optimal result**, be ready to:

Undertake significant cost-cutting activities to preserve working capital and manage cash flow, while ensuring a focus on brand quality and talent retention.

Protect potential competitive and sensitive information.

Communicate management's vision and sense of the importance of exit timing to internal stakeholders.

Conduct a thoughtful and managed transaction process involving multiple options and bidders.

Ensure **a more credible due diligence process** by preparing forecast models early to allow for inputs for stress testing and results simulation. This will help gauge limits of business performance and make prompt adjustments to due diligence findings. Supported by a historical track record and benchmarking analysis, forecasts must incorporate flexibility to account for anticipated and unanticipated changes from identified and yet-to-be-identified areas for improvement.

A right sizing of capital structure might be required to support your company's future growth. It is important to align your business plan, strategy, tax structure, financial projections, and financial arrangements with your business capital structure. Consider amending the mix and magnitude of existing debt facilities to appropriately support forecasted growth.

Noncore or orphan assets take away from business attractiveness. Perform a "bottom line" analysis to identify low-profit/loss-generating subsidiaries that could erode your transaction price. Consider divestitures or closure options especially of noncore businesses to maximize the transaction price.

To make your company even more attractive to buyers, consider **targeting small acquisitions.** As buyers evaluate your company, enhancing and strengthening core elements of business performance that result in additional and accelerated revenue growth, better costs synergies, and improved market positioning will help bolster their investment thesis. If making small opportunistic acquisitions is feasible for your company, evaluate challenges and benefits of such integrations during the period to exit to ensure that the overall net outcome will be accretive to enterprise value.

In addition, evaluate and invest in **an environmental, social, and governance (ESG) framework** that matches the current expectations of buyers who are increasingly becoming sensitive to balancing their portfolios with acquisitions that meet robust operating ESG benchmarks. This will put your company ahead of others as an attractive target.

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Conclusion

By carefully considering these steps and taking the time to prepare for either an IPO or an M&A deal when the next market window opens, companies can not only help bolster the certainty of efficient execution but also strengthen their position as attractive investments for potential buyers.

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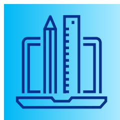
How KPMG can help

KPMG can help companies at various stages of development throughout the business lifecycle, mindful that an exit strategy is a significant milestone for any company. We understand that each exit strategy is unique, and we customize our service approach to address your specific needs and challenges.

For a traditional IPO, our experienced capital markets specialists offer a three-phased approach with an optional fourth phase to help ensure successful pre-IPO readiness and post-public life:

Phase 1: IPO readiness assessment

- Assessment of current versus future-state gaps
- Observations and recommendations
- Preliminary IPO work plan

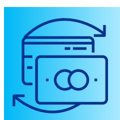


Phase 2: Design

- Design detailed IPO workplan, timeline, and resource requirements
- Design SEC-compliant accounting policies, financial reporting manual, and processes
- Design a scalable future state and change control process for the IT environment
- Design compensation strategies
- Design corporate governance enhancements and processes

Phase 3: Implementation

- Implementation of detailed IPO workplan
- Implementation of SEC-compliant reporting calendar and processes
- Drafting of the S-1/F-1 prospectus
- Due diligence assistance
- Modeling and forecasting assistance
- Assistance with tax planning for impact of the IPO
- Establish governance structure and implement internal controls framework



Phase 4: Ongoing support post-transaction

- Support with periodic filings
- Support with new transactions
- Support with implementation of SOX 404 program

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For an M&A transaction, our specialists offer:

Sell-side assistance

- Pre-sale due diligence to assess financial, tax, compliance assessment, and coding audit, as applicable
- Preparation of deal-basis information to support teaser, CIM, and management presentation
- Preparation of focused analysis to address buyer concerns
- Supporting management in responding to buyer diligence and related requests and inquiries
- Tax structuring

Buy-side assistance

- Pre-deal evaluation and bid services
- Transaction evaluation and due diligence
- Acquisition assistance
- Structuring advice
- Contract assistance
- Integration and separation

Corporate finance assistance

- Analyze strategic options
- Assess value and structure of the deal
- Manage transaction process from strategy to deal close
- Negotiate and secure optimal terms for a successful closing

Debt capital structure assistance

- Capital advisory and structuring
- Access to institutional debt markets
- Private debt capital, market raising
- Restructuring of debt
- Hedging and ratings analysis

Financial integration assistance

- **Day 1 planning:** Prepare transaction-related financial statements, focus on Day 1 critical changes, and identify transition period functional integration opportunities
- **Business stabilization:** Manage integration risk by adopting common policies and controls and execute core processes
- **Reporting alignment:** Develop foundational reporting needs and capabilities and implement sustainable financial reporting and consolidation processes with technologies
- **Business optimization:** Integrate core processes, implement shared services, and enhance technology solutions

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Rebecca has extensive experience acting as a financial adviser on numerous transactions, including mergers, acquisitions, corporate divestitures, financings, fairness opinions, strategic assessments, and valuations. She has worked with companies of all sizes, ranging from large multinational publicly traded companies to private/family-owned businesses.

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Thank you to our contributor: Colleen Miller

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