

Real Estate Due Diligence is Essential to Identifying Opportunity and Risk When Planning a Business Sale



*Advisors to CFOs,
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A large, publicly held multi-billion dollar company wanted to sell its West Coast subsidiary, along with the building that housed it. But after putting the unit on the market and identifying a buyer, the negotiations nearly broke down during the 11th hour — the would-be buyer refused to include the building in the transaction, and demanded a reduced price for the subsidiary. Scrambling to separate the assets at the last minute, the seller did manage to find a buyer for the building, at a \$30 million discount, while losing considerable value on the final sale price of the subsidiary.

"A major sell-side goal in an M&A is ensuring that the transaction is completed within a reasonable timeframe, with minimal cost, and at a sale price that reflects an appropriate enterprise value," counsels Andrew Zetas, Strategist & CEO of Real Estate Strategies Corporation, a New Jersey-based national corporate real estate advisory and transaction services firm.

For a seller, an intelligent M&A strategy starts with the recognition that potential buyers generally fall into two broad categories:

- Financial buyers: private equity or other investors who may not be in the same line of business as the seller, but who believe they can enhance operations and achieve a better ROI; and
- Strategic buyers: operators in a similar or related business who seek to expand or enhance their current product or service offering by acquiring and operating other companies.

"Financial buyers are generally interested in the cash flow that a business generates, and they have a predetermined exit strategy," observes Zetas, who is also the Host, Publisher & CEO of *CFO Intelligence* magazine. "Consequently, they may not have the expertise needed to run the business in a highly efficient manner, and will probably look for companies with an effective management structure and employee base already in place."

They will likely expect the purchased business to continue operating without much modification and, because they are interested in a rapid ROI, "Financial buyers may be less inclined to take over the ownership of a building or other real estate," he explains. "Instead, they generally prefer a lease. This can have significant implications for a seller, whether they own or lease the real estate associated with the business that's being sold. So before they even go to market, an owner who is targeting a financial buyer should consider a number of important issues. The particular approach may depend on specific circumstances."

One example is when the underlying real estate is owned by the seller, and it's a core part of the business. "If that's the case, the financial buyer will likely want to retain the right to stay in the building," according to Zetas. "But they are likely to do so as a tenant, and will want the purchase of the property excluded from the transaction."

For the seller-owner, this means negotiating such issues as the length of the lease: year-to-year or other short term, or long term, he adds. "Renewability and termination rights should also be considered, along with discussions about leasehold improvements; and which party is responsible for paying taxes and insurance. Additionally, the seller should consider what they will do with the property at the end of the lease, when it reverts back to them."

Things change if the seller leases the underlying property that is core to the business. "In this case the seller should, before going to market, consider such issues as their right

Andrew Zezas

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to sub-lease the property to the purchaser of the business," says Zezas. "Assuming they have that right, the question is whether the seller's current lease and renewal terms will match the buyer's timing and space needs. If they don't, then the seller may have to try to renegotiate the underlying lease, adjust the sale price of the business, or the buyer may not accept the property and seek to relocate."

In some cases, though, the underlying real estate is not a core part of the business. "If the property is an ancillary asset, the financial buyer may seek to maximize their returns by moving the operations to a lower-cost location," he explains. "This brings up a new set of considerations for the seller of the business. Should they reduce the lease pricing in a bid to keep the building occupied? Or market conditions may be such that it's better to remove the real estate from the M&A agreement, and have the business purchaser vacate the space — even if the sale price suffers a bit — since this would free up the seller to seek more value for the property, through a sale or lease to the developer of the property or to a separate party."

Different issues may arise if the target purchaser is a strategic buyer. "The buyer may already have real estate that can accommodate the addition of the newly purchased business operations," says Zezas. "In that case, the strategic buyer should consider the advantages and disadvantages of a) putting the property up for sale; or b) putting it up for lease and becoming a landlord; or c) knocking the buildings down and either redeveloping the property for another (sale or leased) purpose, or selling the land to a developer or another investor."

When seeking to sell to a strategic buyer, if the seller does not own the underlying property but instead occupies it under a lease, then Zezas says that other questions need to be explored. "The seller must determine whether they have the ability to a) terminate the lease early (and if they do, any associated financial or other penalties should be considered); b) sublet the property — of course, first determining if any sublet restrictions exist, or c) transfer the lease to another party, if that is permitted and if doing so makes financial sense, and if such a party can be identified."

He points out that these and other scenarios need to be considered before going to market, "Since a seller cannot identify potential challenges and craft appropriate solutions unless they understand the various types of potential buyers and the issues that are likely to arise. Putting a business up for sale without taking these vital step may delay, devalue or derail the transaction. In contrast, forward-looking M&A sellers who engage in intelligent pre-market due diligence may reduce potential risk, minimize the chances of a last-minute surprise, and increase the likelihood of achieving enterprise value. In the next issue, we'll explore Buy-Side M&A Real Estate issues.

