Subtle Factors that Dramatically Impact the Value of a Business

Examples are legion where long established businesses simply close their doors. Many others are sold under duress because of ill health, divorce, partner disputes, owner burn out, business slow down and death. A business sold under adverse or distress conditions does not command much value. Many are sold for mere liquidation value. Most businesses, like old soldiers, just fade or are given away.

Conversely, we all have heard stories of companies selling for fantastic prices, and often reportedly for all cash! The *million dollar question*, (perhaps literally) is "Why?" After much thought, and almost twenty years of experience gained in selling several hundred companies, the answer appears quite simple yet, beneath the surface, complex.

The simple answer, in a word, is *preparation*. As with most projects, the quality of the preparation in large measure determines the quality of the results. What preparation involves is a combination of dynamic and subtle factors, many of which are so obvious they very often are overlooked.

The Winning Strategy

- Decide that you will sell someday
- Prepare yourself for the sale
- Identify your ideal successor
- Realize buyers primary motivations are not financial
- Avoid the "I'll do-it-myself" urge and obtain professional assistance
- Understand the unique rules involved in small and mid-size company valuations and sales
- Understand the factors, financial and non-financial, that drive the value of your company
- Position your company properly

To Sell or Not to Sell

Perhaps the most difficult decision, as a business owner, you ever have to make may be your decision to sell. Unfortunately, many business owners agonize over the many variables involved in selling without ever making the decision to sell. Others will wait too long to sell (businesses are seldom sold too soon), and a significant number feel they cannot afford to sell their only source of income.

Nothing stays the same. Over time a business changes and so does the owner. Eventually, demands and needs of the business grow to conflict with an owner's perspective and skills. Something has to give. Will it be the owner's personal life and health, or will it be the business that suffers? Perhaps both?

- **Only two end game options exist:**
  - the business is sold to family, employees or outsiders
  - the business is closed.

By failing to prepare for eventual sale, the business owner allows the end game to be determined by external forces. The result--usually an attempt at sale under conditions of personal or business distress.

Poor health, divorce, slumping sales, creditor demands, poor employee relations, lack of operating or expansion capital very often are the symptoms of an owner who could have sold, but failed to heed "early warning signals." Indecision or lack of proper planning and preparation can prove to be very costly. Costly not only to you, the business owner, but also to your family, employees, vendors and customers.

To avoid this situation a business owner should first make the decision that the business will be sold, someday. Then, begin preparations and, when appropriate, set the process in motion. Once the decision has been made, professional help can be obtained to address the multiple variables, and implement a plan.

Prepare Yourself for the Sale

This seemingly obvious step in preparing a business for sale is very often overlooked or given only superficial attention. It seems that no matter how strong a grasp one has of the business, given enough time, that very grasp will turn into a stranglehold. We witness this dynamic occurring in large public companies all the time--Smith at IBM, Olsen at Digital for example. Make sure your business is not ready for a change before you are prepared to make a change as well.

Remember, in business it is either Grow or Go--there is no such thing as Status Quo. When a business owner decides to "coast," in what direction is the business headed?

- **Decide what you will do after the sale of your business**

Most great men and women in history have had more than one career. Most have enjoyed several careers and, in addition, developed many diverse non-business interests and hobbies. Perhaps you want to devote more time developing other business interests. Maybe you want to change your avocation into your vocation. You might decide to devote six months, or maybe a year, after the sale to choose your next course of action.

- **Invest money outside of your business**

If retirement is your choice, can you afford to retire? Take advantage of the several retirement plan investment options allowed under IRS rules. Keogh Plans and Individual Retirement Accounts (IRAs), Defined Benefit and Defined Contribution Annuities are all examples of financial vehicles, other than your business, in which you should be investing for retirement. Few businesses will command the dollars required to allow for a comfortable retirement from sale proceeds alone.

- **Develop outside interests**

Owning a business can be an all consuming experience. "All work and no play makes Johnny a dull boy." If your business represents your identity and, if you "are the business", you have two problems:

  - First, you probably are unprepared to lose your identity.
  - Second, your business will be difficult to sell and probably will not command a premium price.

Identify Your Ideal Successor

Your business is a vehicle. How far and fast you have driven it will not predict its performance in the future. The future of your company depends upon whom you allow behind the wheel. Whether your successor wins the "Indy 500" or, runs your baby into the ground, depends, in large measure, on how well you choose.

- **Choosing a successor**

When you understand where your business is today you can see what it could be tomorrow. Finding the right buyer starts with a review of where your business is and who you are. Ideally, your successor will have talents and skills that compliment yours. Also, it is imperative your successor appreciate, and be able to maintain, the strengths of the business you created. In other words, recognize the strengths and build upon the opportunity.

Your buyer should recognize existing problem areas as opportunity. The right buyer will see that "all the right things are wrong." Only the right buyer will pay the "right price." Only the right buyer will fully capitalize upon the opportunity you have created.

Recognize Buyers Primary Motivations are Not Financial

Both buy and sell sides are motivated by personal, rather than purely financial, factors.

If you are considering the sale of your business, you probably will agree that your primary motivation to sell is to allow you the ability to do something else. Money expected from the sale is important to you but not your chief motivation.

- **Motivation to Buy**

Buyers primary motivations to buy or own a business revolve around issues of control and self expression. Money to be earned is important but, not the prime motivation. Buyers want to "show their stuff" and "do it themselves."

Buyers really do not want your business, they want a business they can make their own. That is why, as one of your first steps in preparation for sale, you attempt to identify your ideal successor. Buyers want the opportunity to make your business better and, in the process, make it their business--oh, and make money doing it.

- **"The Numbers" Will Not Sell a Company, but the Opportunities The Business Represents Will**

Financial data alone will not allow buyers to recognize the full opportunity your business represents. Actually, financial statements and tax returns, for most small and private businesses, are more like mystery novels. They certainly are not operating manuals. Tax returns seldom highlight the opportunities a business represents. Why is it then that historic financial data is the first information expected to be exchanged?

- **Prepare a Profile or Prospectus That Highlights the Opportunities**

Financial statements alone may not sell your business, no matter how profitable they indicate your business is or has been. The opportunity your business represents will. Do not assume your "numbers" will accurately reflect the opportunity your business represents. Remember, money is a secondary motivation, capitalizing upon opportunities is a buyer’s primary motivation.

Avoid the "I’ll do it Myself" Urge and Obtain Professional Assistance

Unlike management of larger corporations who can draw upon many resources for support, information and operational advice, the management of small private companies must wear all the hats themselves. Competition, and the many financial drains facing small business owners, mandate that these owners "do it themselves" whenever possible. The luxury of drawing upon outside resources is generally restricted to limited accounting and legal advice.

Most business owners have received unsolicited inquiries from potential buyers. It would seem logical therefore that attracting an appropriate buyer would be easy. To the successful do-it-myself, selling the business might appear simple, especially to the owner who has experience in successfully selling his company’s product or service.

Actually, an owner making this assumption is partially correct. Finding buyers is relatively easy. In fact, everyone "has a buyer". Buyers hire firms to search for companies, network actively with lawyers, accountants, bankers and others searching for the right business. The typical aggressive buyer will look at scores of companies, make several offers and still be looking for a company.

Buyers constantly report to us that most sellers are unrealistic -- don’t know what their business is worth, often don’t know how much they are making or loosing. They also report that getting adequate information on the business is usually difficult and frustrating (like pulling teeth).

What really happens is that the businesses have not been adequately prepared for sale, and are being exposed to the wrong buyers, or are positioned as less than attractive opportunities. Selling a business should not be a do-it-yourself project.

Where to Obtain Assistance in Selling Your Business

Finding the right buyer for your business can be time consuming and frustrating. When your business demands your full time and attention, and its sale is important, professional assistance may be a wise consideration. Obtaining assistance may be a necessity if maintaining confidentiality is important.

Help comes in several forms, and depends upon the type of buyer most appropriate for your company as well as the size of your firm.

- **Investment Bankers**

It is unlikely that the audience for this book will have companies large enough to warrant the use of an Investment Banker. Company revenues generally have to be in the range of $30 million to meet the minimum size requirements Investment Bankers set.

- **Merger and Acquisition (M&A) Specialists**

M&A Specialists serve the "Middle Market," that is, businesses with revenues ranging from $10 to $100 million.

- **Business Intermediaries**

Business Intermediaries serve companies whose sales generally are under $20 million.

Fees by both the Intermediary and M&A Specialist involve an initial retainer plus commission, or success fee, from which the retainer may or may not be deducted.

- **Business Broker**

Business Brokers serve businesses where revenues typically are less than $1 million.

- **Law and Accounting Firms**

Many Legal and Accounting firms are entering the M&A arena. Typically, they target the same companies served by M&A Specialists and Intermediaries.

Finding a firm or individual with whom you will be comfortable generally means interviewing several and, of course, checking their credentials and references.

Understand the Unique Rules Involved in Small and Mid-Sized Company Valuation and Sale

Public perception of how, and to whom, one should sell a company comes from several sources: newspapers, movies, television and hearsay. Unfortunately, these sources provide information that is misleading, inappropriate and wrong, particularly when applied to small or mid-size companies.

These sources report about, or depict, public company events that tend to be much too grand a scale for smaller private companies. There is a significant world of difference between the two. No one person owns a public company, many shareholders do. Public company accounting focuses on maximizing profits to satisfy shareholders demands, and allow management to retain their jobs. Private company accounting focuses on *minimizing* profits to reduce the owner’s tax bill.

Private company owners need not be concerned with hostile takeovers, junk bonds, P/E ratios, or loss of a job because the company did not show appropriate profits in recent quarters. Most observers agree that major differences in management convention and culture exist between private and public companies. Because virtually no public information is available regarding the sale process and selling prices of private companies, many business owners, and their advisors, attempt to apply public company methodology and Price/Earnings ratios to the sale process of private companies.

- **A few examples of unfortunate results:**

Wrong Buyer: Most public company acquisitions appear to occur within their industry or one tangential to it. Therefore, uninitiated private company owners very often approach competitors, major vendors or customers when attempting a sale. Unfortunately, private sector, "Industry Buyers" pay prices based on selected hard assets, which produce low prices.

Result: Generally unproductive: confidentiality is destroyed with its attendant problems (employees, creditors, competition, etc.) or, if successful, the company is sold for essentially its hard asset value.

Wrong Price: Public Company stock prices are published daily and Price Earnings (PE) ratios of 15 times earnings, or more, are common. Assuming that a Private Company's value can be calculated by applying Public Company PE ratios will produce unrealistic prices.

***Results*:** When priced too high: possible loss of the best buyer and the business stays on the market for a lengthy period of time. Exposure to many potential buyers results in loss of confidentiality. If sold, done so at shop-worn price, usually after several costly attempts (legal and accounting fees) to put a deal together have failed.

When priced too low: the owner obviously fails to receive full value for the company. Not so obvious is the loss to employees, vendors and customers. Buyers pay prices proportionate to the opportunity they perceive, hence, buyers paying low prices generally have not recognized the full opportunity the firm represents and therefore cannot capitalize upon it. The firm's full potential is never reached, and those it serves are shortchanged.

Understand the Factors that Drive Your Company's Value

Financial results surprisingly are not the most important factor to drive a company's value, therefore, knowing your customer is the driving force! The person, or firm, recognizing the highest value, will pay the highest price. To identify your best buyer or customer for your business, you must first understand both objective and subjective elements within your company. How does your firm appear from the outside in? To whom will your problems appear as valuable and exciting opportunities?

The value of a company lies in the buyer's view of its future. Financial results reflect only the past.

- **Customer or Buyer Identification** should be the first item on a list of important factors that drive a company's value. Unfortunately, this factor usually does not receive the attention required. This is understandable since few of us are able to view ourselves, our business or anything else we are very close and emotionally involved with objectively. Also, business owners and most advisors, although immersed in the business climate, are not familiar with driving marketplace forces or the various types and categories of buyers operating therein.
- **Opportunity** is an obvious factor that must be on everyone's list. But what is opportunity? Opportunity is different from potential. Buyers will pay for opportunity but not for potential. Why? Opportunity is perceived as having been created by the business owner and potential is that which will be created by the acquirer. Buyers will not pay you

for what they will do (potential). They will pay for what you have done (opportunity). Perception of opportunity will vary depending on the type of buyer viewing it, emphasizing the critical need to know your customer.

- **Earnings** factor high on most observers list of important factors. Since most private companies financial statements are driven by the owners desire to minimize taxes, reported earnings are usually misleading. The numbers alone, even after recasting or normalizing, will not adequately reflect a firm's true value. The value of a company lies in a buyer's view of its future

Position Company Properly

Positioning is similar to attitude in that proper positioning will produce positive results, just as a positive attitude produces a richer and fuller life.

To properly position a company for acquisition one must first objectively determine the company's strengths and weaknesses. Identify the firm's *uniqueness and hidden values*. Understand the subjective environment that surrounds the business. Gather data and research information from outside sources to substantiate and ratify opportunity. Quantify subjective data so as to give credibility to expectations of future profits. Weave the gathered information and data into a comprehensive prospectus on the company and highlight the opportunity the firm represents.

A properly positioned firm sells for a premium price to a person or entity able to enhance its operation. Everyone wins. The owner receives an optimum price. The buyer acquires an exciting opportunity. Customers, employees and vendors continue their beneficial relationship with the firm.

Summary

Face the reality that both you and your business are constantly changing. Eventually the needs and requirements of your business will conflict with your personal life-style needs, perspectives and abilities. No matter how good you are, if you stay around long enough, your grasp of the business will turn into a stranglehold.

- **Develop** some non-business interests. Find time to develop these outside interests.
- **Begin** to establish financial resources independent of your business.
- **Start** sooner, not later. Transition takes time. You have a lot to do before you can let go.

- **Identify** your ideal replacement. What skills, interests and resources must succession management possess in order to capitalize upon the opportunities your business represents?
- **Prepare** the business for transfer. Take stock of those areas where your personality, skills or influence are the key elements of your firm's success. Begin a program to transfer these activities to others within the company.
- **Review** the company's financial statements. In most private companies the need to show bottom line results is overridden by the owner's desire to minimize taxes. Make sure your accountant has not done this job too well. It is important for wary suitors and advisors to be able to easily identify discretionary and non-recurring expenses that can be added back to profits.
- **Trim** or eliminate those activities, expenses and personnel that exist essentially to satisfy your personal and/or ego needs.
- **Seek** and use advisors. Succession is a very personal and emotional process. It's not unlike giving your daughter away in marriage, or to some, putting a child up for adoption. This is a once-in-a-lifetime decision. You need every advantage you can garner.
- **Determine** the optimum value of your company. In order to accomplish this you need to understand the differences between the various types of buyers in the market-place today. To some, your company may be worthless. To others, it may be worth millions.

Obtaining the best results begins with a timely decision to commence the planning and preparation process. Every good general has a retreat plan. Before you act, you should have a plan. To formulate the very best plan you need to know what your business requires of its succession management. You should know what the company is worth and that the timing is right. You must identify the attributes of an ideal successor, the one who will recognize the full opportunity you have created, pay the optimum value and move the company up to the next level of profitability.

Doing it yourself should be limited to the decision to sell only. Thereafter, professional assistance should be obtained in order to maximize value, maintain confidentiality and avoid costly mistakes.

Major corporations engage "pros" to enhance the value of their products in the marketplace. Professional athletes use their promoters, actors their agents, and public companies use their investment bankers. An unfortunate fact is that most small to mid-size companies are never sold, or when sold, transact for much less than they should. Perhaps this indicates that owners of family businesses and private companies need professional assistance also.

Ultimately, one of two options exist for every business owner: either the succession of your business will be a planned event controlled by you, or it will be an unplanned occurrence brought on by outside factors. For the good of your business, your employees, customers, vendors and family - decide! Decide to begin your succession planning NOW.