EXIT for Success Series

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The only reason to go into business is to build something of increasing value that will someday be sold. *Unfortunately, only one in six business owners are successful in finding a buyer. In this article, we examine the underlying reasons for this dismal statistic.*

There are some fundamentals that every business owner should understand. By understanding the following information and acting on it, you will not only improve the probability of sale by 80%, you will maximize the value received and minimize risk.

You've worked years building your business...

Are you positioned to receive the value you've earned?

Value versus Salability

Most business owners are familiar with the term "Business Appraisal". What they don't understand is that the underlying reason for the appraisal will cause the resulting "value" to differ. *For example, there is Fair Market Value, Investment Value, Intrinsic Value, Going Concern Value, Asset Value or Stock Value. In each of these examples, the final value will differ by as much as 50% or even more.*

Value

Typically, when a business owner prepares to market his or her company, the appraiser will utilize a "going concern" approach to value. This approach first looks at the past ability of the business to generate "free cash flow". Free cash flow, often called discretionary cash flow, is typically defined as net income before taxes plus any non-cash expenses, such as depreciation and amortization, non-recurring expense items like one-time repairs or unforeseen legal expenses. Other adjustments will include all compensation to the present owner and any "discretionary" expenses that accrue to the present owner. These items might include payments on an automobile lease or loan, gas, insurance, country club membership, credit card payments and the like. Sometimes, when the business owner owns the real estate that houses the business, he or she might charge the business an excessive rent payment, which a knowledgeable appraiser will pick up and make the necessary adjustment based on comparable market rents in the area. The aggregate of these income and expense adjustments will constitute the "free or discretionary cash flow."

The second step in the appraisal process is to gauge the trends of historical cash flow generation. This trend line suggests the nature of inherent risks that exist within the subject company. *For example, has the business witnessed steady growth, stability, decline or ups and downs that show no recognizable trends?*

The following is a limited list of the risks that can affect value:

How do these risks figure into the final value?

- **Customer Concentration Levels** Are 10% of sales (or more) to one customer?
- **Supplier Dependency** This reduces bargaining power and increases cost risks.
- **Employee Turnover** This is very costly and indicates inherent "people problems".
- **Lack of Management Layers** A single owner-manager represents a higher risk of "operational continuity" following transition of the business.
- **Competition** Is it stable, increasing or declining?
- **Price Margins** Are margins tracking with sales, or declining even as sales are increasing?
- **Location** Is it suitable to the business? Does it require higher transportation costs?
- **Lease** Is the lease unfavorable? Does it offer future expansion possibilities?

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Both the number and degree of risks associated with a subject company have as much to do with the final value as does the cash flow.

For this reason, two companies, within the same industry, with comparable cash flows, could have very different values.

Consider one of the many valuation tests BIZ*MACH* uses to arrive at a value. It is called the "Weighted Multiple of Cash Flow Method."

This method calculates the "level" of risk that is associated with generating the cash flow levels previously discussed. *For example, a single customer concentration of 12% of sales will have a negative risk value, but that value is far less than a company that has one or two customers that account for 30% of sales.* Therefore, each risk category has a value that rises or falls depending on the degree.

We apply these values to approximately twenty different risk areas and take an average of the total. It is this total that represents our multiplier, that is, the number we multiply our "free or discretionary cash flow" by to arrive at a business value.

Salability

The major drawback of the average business appraisal is the absence of salability testing. The final value may be $1.2 million – but will this business sell? Just because the report states the company is worth $1.2 million, it doesn't mean a buyer will be interested.

Suppose the subject business has witnessed declining sales trends, has several high-risk areas and has incurred a heavy debt load of $800,000 in bank loans. If the sale of the business cannot be financed due to the heavy risk and declining trends, any buyer will need a down payment in cash; sufficient to cover the bank debt ($800,000) plus the seller's cash sufficient to cover any brokerage costs (typically 8% or $96,000). Therefore, a buyer is needed with a minimum of $896,000 in cash to buy a $1.2 million company that is in decline and will not qualify for financing. *This is a $1.2 million company that is not salable.*

The BIZ*MACH* Answer

"Every business owner must understand that it takes an average of 2 years to prepare a business for sale"

⇒ **Step One** is completing a full business evaluation to determine where the business is today, both in terms of value and risks. By working backwards, certain adjustments can be made to each risk area to portray the new business value assuming specific risks are mitigated based on the implementation of specific strategies. The evaluation should include an industry peer comparison to see how the subject measures up against its peers. This will tell if the company's prices are adequate, whether the company's assets and liabilities are mismatched, etc.

⇒ **StepTwo** is the industry life cycle analysis. Is the subject in a growth, mature or declining industry? Each life cycle has its own set of proven strategies which, when employed, will improve growth and cash flow, and provide the company with a competitive advantage – which is where the real value is. The better the competitive advantage, the lower the risks and the greater the likelihood for continued growth and improved cash flow.

⇒ **Step Three** provides the most valuable piece of information that most business appraisals and owners miss -

"Who is the most probable buyer?"

There is one more variable in the determination of value - the buyer type. There are three main buyer types and each will pay a significantly different price for the same company:

1. The Individual Buyer, or the new owner operator;
2. The Financial Buyer, typically an investment group that specializes in the assemblage of companies;
3. The Strategic Buyer, typically another company that views the acquisition as a competitive advantage.

<u>The Buyer Type is Critical to Salability</u>

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Suppose an individual seeks to buy the company. This individual will be stepping into the shoes of the departing owner and receive the same financial benefits that accrued to the present owner. Now, suppose the company was deemed to have "strategic value" - meaning the company might be attractive to another as an expansion or diversification play. A strategic buyer might pay a far higher price because they see economies of scale.

For example:

- The buyer has sufficient excess capacity such that the subject's operation could be moved into the buyer's existing facility, thereby saving occupancy expenses.

- By moving the operation in-house, several employee positions that are duplicates could be eliminated, saving payroll and benefits.

These are but two examples of the numerous motivations that drive a strategic acquisition. Many strategic buyers are not actively looking to acquire. They must be approached with the concept and benefits and convinced of the value such a purchase might bring.

Conclusion

Every business owner considering an exit from the business within the next few years should begin to plan immediately. Not only will this process result in maximizing the value and potential for sale, it will also create interim growth and improved performance.

"Remember, companies are not bought, they're sold."

Biz*MACH* is an association of highly skilled consultants, evaluation experts and merger and acquisition specialists. We take ordinary companies and create extraordinary value.

Best of all, we only work with lower mid-market companies and our fees reflect our confidence. Ninety percent or more of our fees are contingent upon the successful transition of your company – even if that sale is years away.

If you're not working with

you're not using the BEST!

*(**B**usiness **E**valuation and **S**alability **T**ool)*

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