

WHAT'S THE BUSINESS WORTH?

Greg Charney, President of Lone Star Investments Corp, USA, ponders the many values of a pipeline business.

What's the business worth?" is a question that has been asked many times over the years by business owners, their family members, creditors, CFO's, insurance companies, management groups and private equity groups. The answer to the question is easy and one we are becoming familiar with hearing out of Washington; "It Depends".

Now that everyone understands there is not one answer to the question and merger and acquisition work is an art and not a science, let me explain four things: the reasons for differing valuations, valuation and types of buyers, what you as a business owner can do to help maximise the valuation of your business and when is the best time to sell.

Reasons for the differing valuations

This should start with a simplified definition of just what does make up fair market value (FMV). FMV is the amount of money or goods proposed to be exchanged between a willing buyer and a willing seller, neither under any compulsion to buy or sell and both fully aware of all the relevant facts. This alone would tell us that the same company with the same seller and a group of different buyers will result in variations in valuation as they will all have different opinions. If we were dealing with real estate,

it is much simpler as an appraisal is ordered, comparable sales are considered, then market forces of supply and demand factor into the final sales price. Publicly traded companies will not be discussed in this article but it should be noted that they are unlike privately held companies, in that they have liquidity through the stock exchanges and are valued daily by the market forces.

Most buyers of a private business start the valuation process by researching the financial accomplishments of the business as displayed on the income statement and balance sheets compared on a three or five year basis. In addition, many buyers pay special attention to the twelve month trailing statements and any forecasts or Contracted backlog work. If these were the only factors in valuation, the ultimate value most likely would result plus or minus within a few percentage points by each buyer that looks at the books. The fact is, this is only one factor to consider. In addition to the books, we need to consider the motivation of the seller, is it a distressed sale (divorce, health, death of a partner, financial) and thus must find a buyer quickly. Is the sale due to retirement reasons or estate purposes and is the seller willing to stay on in a management position, sign an employment contract or retain some percentage of ownership?

The size of the business is usually a reason for different

valuations results and varying methods that will be used. There are three primary segments when considering revenues that are looked at differently, US\$ 1 - 5 million, US\$ 5 - 50 million and then US\$ 50 - 250 million. Many times, these three revenue plateau's will dictate what kind of buyer will be interested. This combined with the Sellers motive and financial results has everything to do with the ultimate sale price. Let me explain sellers' motive in depth along with the types of buyers.

Valuation and types of buyers

Sellers have many reasons for selling and also have as many concerns. Some are concerned with the legacy of their life's work and refuse to sell at any price to a company that plans to split it up in pieces and sell off the assets. Many are concerned about their employee's and then some are only concerned about the highest value. There are several types of buyers (family member, management group, investor, private equity group, synergistic buyers) and they all make up what is known as the Value World, each one will most likely result in a different value for the business.

Value, starting with the low end of expected value results would be the seller dealing with preserving their legacy and selling the company to a family member or friend. This typically results in a much lower value result (asset value or a small premium) and can keep the seller saddled with substantial risk through personal notes from the buyer.

The next value world deals with selling the company by way of a management buyout. In a management buyout, the seller can be personally attached to the group or want to protect and reward these managers for years of loyal service. Legacy can also play a roll in this choice by the seller and they may be willing to negotiate a price that is based more on the managers financial abilities than the fair market value.

Next we find that a buyer can look at the company as an investment and will look at the books, develop a value that they expect will yield a proper return on investment over time. This can be accomplished by income capitalisation which involves calculating future income based on historical data with a variety of assumptions or using the income multiple on normalised earnings before interest, taxes, depreciation and amortisation EBITDA. Normalised EBITDA defined, means adding back to EBITDA the owner's salary, additional owner perks and any one time or non-recurring expenses. Lastly, many buyers will just use a rule of thumb multiple obtained from past like kind transactions which have been made public.

Private Equity Groups (PEGs) then come into play and will take a look at the books, business model and expected future revenue, then use income capitalisation, income multiple or rule of thumb to develop a purchase price.

The last predominant value world which will typically pay the highest value entails what is known as a synergistic buyer. This buyer will typically own another business that may be in the same industry, have a like kind product,

want in the sellers market or have interest in the sellers technology. The synergistic buyer will typically pay a premium over all other buyers as they expect to cut costs through utilisation of similar assets or resources. They could also justify the premium by increasing revenues more quickly through lowering the cost barriers of entry to a new market or decreasing the amount of time needed to enter.

Maximising the valuation of a business

Maximising the value of a business requires an immense amount of work and proper planning by the business owners, management teams and their employee's. It requires proper representation by a competent M & A intermediary that is familiar with the company and their industry. This person will prepare the offering documents, insure the seller understands the process, will solicit buyers and offers, then will serve as the facilitator. The intermediary will be hands on and work between the seller and buyer on all issues, requesting and providing information between the parties and dealing with any problems. They will also provide access to a number of professionals that will be used to insure a smooth transaction and maximise value received in the sale. These professionals include business valuers, attorneys (transaction and tax), CPA/accountants for normalisation of financials and other work along the way. Additionally, a wealth advisor will help mitigate taxation and structure along with the CPA how best to receive the sales proceeds.

What you as a seller can do to maximise the value of a business is first and foremost have in place a solid accounting process which means a clean, consistent set of books with periodic reviews or audits done by an independent accountant. There needs to be several years of history (five plus years) with a consistent growth trend in revenues and profits while at the same time controlling costs.

With many businesses, the owner runs the company and is virtually irreplaceable. This can kill a deal quicker and or lower the potential value of a business as quickly as anything I am aware of. It is very important that there be a management team in place with delegated authority and most importantly a succession plan as none of us are promised tomorrow. Key managers should also be under contract as in today's world people are very mobile with very little loyalty to their employers. Processes should be in place with regard to human resources and there should be employment hand books printed and followed.

To maximise the value, an owner should be prepared to maintain up to a 20% stake in the company and be willing to stay on for as long as two year to help transition to new leadership. If there are minority shareholders in the company there should be a strong legal buy/sell agreement in place and everyone should be in agreement with the proposed sale. There should be a solid long-term plan for growth, forecasts or projections should be displayed in pro-forma financials with reasonable expectations that they are attainable. When it comes to clients and accounts receivable, there should not be a large concentration of

business done with one customer (40%+).

When is the best time to sell?

The best time to sell a business could be when the financial results are revealing consistent growth over a several year period. Alternatively, when someone knocks on the door and has interest in purchasing the business could be a good time as well. When a client asks me when should I sell, my answer typically revolves around when they have achieved the majority of what they set out to accomplish in business or financially. Before a sale is recommended, the items laid out in the 'maximising' section should be addressed and proper exit planning should be undertaken which in some cases includes retirement planning and always should include tax planning.

In retirement planning, an owner should consider things like the loss of income or health care when they leave the business, will the sale result in enough proceeds to fund the retirement needs of the family.

Tax planning if not done properly and in advance of selling the business, can result in the loss of a large portion of the selling proceeds. Proper planning would entail looking into and considering how best to mitigate the following; Is the business an S-Corp, LLP or a C-Corp and will there be double taxation resulting from the sale. Should the owner retain some of the assets and then lease back to the new company. If the business is to be sold to a management group, should an employee stock ownership plan be used which can when properly done, help the managers with financing and shelter the seller or at a minimum delay their taxation from the gain on sale. Should the sale be an asset or stock sale, is a 1031 like kind exchange an option. Should the owner take the stock of the acquiring company and delay their taxation. Maybe a structured pay out over time will result in the best answer. There most likely will be an estate tax problem with the sale of a business, should the owner consider trusts and generational skips or even life insurance to cover the eminent death taxes, is the spouse properly taken care of and should philanthropy be considered.

Conclusion

My hopes are that each reader will take away a general knowledge of what the business could and should be worth and why there are so many answers and outcomes. I hope that each of you have the tools and knowledge needed to maximise the value of the business, choose the right buyer and have your exit plan properly in place when the opportunity comes to sell. Please align yourself with an M & A Intermediary that you know or are referred to, feel confident in and proves knowledgeable in your industry. This person could be in your office and a part of your life for as much as a year or longer as transactions can take some time to complete depending on how fast a suitable buyer is found and engaged. Good luck and I hope each one of you can realise your dreams of selling or purchasing an existing business and realising your dreams.