# The EXIT Planner

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## WHAT'S INSIDE


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## BEAUTY IS IN THE EYE OF THE BEHOLDER

I doubt there is a single business owner who doesn't frequently wonder, "How much is my business worth?" Followed immediately by, "How much can I sell my business for?"

These are two critical and very different questions. Exit Planning cannot being in earnest until you begin thinking about how much your business is worth and for how much it can be sold.

This issue of *The Exit Planner* deals with business valuation: what you need to know in order to answer these two questions. The kind of answer you receive depends not only on whom you ask, but more importantly, on *why* you ask the question in the first place. Let's look first at possible motives for asking, "What is my business worth?"

If you want to give your business to your children, the answer you want to the question, "What is my business worth?" is: the lowest possible defensible value (in the opinion of your valuation expert). Using the "lowest value" minimizes gift taxes and other transfer taxes such as income and capital gains taxes. Even if you need money from the business to finance your retirement, you can reap what you need more easily when the purchase price is minimized by using other, more tax-sensitive, cash distribution techniques. This is true whether you transfer the business to your children or to key employees (another class of individuals which does not have sufficient funds to pay cash for your business). For a complete discussion of the techniques used to maximize the money you get from your business by minimizing the value you place on it, you may wish to read Chapter Seven of my book, *The Completely Revised How To Run Your Business So You Can Leave It In Style.*

On the other hand, if you wish to sell your business to an outside party, you want you ownership interest to be valued at the highest possible amount.

So the answer to the question, "How much is my business worth?" depends not only on the "intrinsic value" of the business, but also on the reason for valuing the business in the first place. In short, your **motive** for valuing your business influences the **method** used to value that business.

Likewise, the answer to the question, "For how much can my business be sold?" depends not solely on the "intrinsic value" of the business, but on the perception of the potential buyer. Just as your motivation helps determine value when transferring the business "internally" to children or key employees, the motivation of the buyer helps set the value in outside arms-length sales. In this issue of *The Exit Planner*, Investment Banker Joseph M. Durnford, CPA, CVA will discuss the factors that determine the value of a business in an actual sale. Mr. Durnford focuses on what factors influence a buyer's perception of value and why the actual sale price is often very different from the fair market value that your CPA or other expert may have given you. I think you will find this article most helpful even if you now intend to transfer the business to children or key employees.

# THE EYE OF THE BUYER

by Joseph M. Durnford, CPA, CVA

Like most things in life, beauty is in the eye of the beholder, or in this case, value is in the eye of the buyer. This simple concept is often overlooked when experts attempt to determine the fair market value on which a hypothetical buyer and seller would agree. In all my years as an investment banker, I have never met a hypothetical buyer, nor a hypothetical business owner. Furthermore, I have not worked in situation in which both buyer and seller have knowledge of all relevant facts. In real transactions, both buyer and seller are making decisions with limited information, and rely on their own perspectives and biases.

The reason why the valuation methods used by most CPAs and business appraisers fail to relate to sale price is that most valuation approaches assume the value of a business to be *as it is*, in the hands of its current owner operating as a stand alone enterprise.

An excellent example of how value can differ from sale price is a transaction that my firm recently completed. We were engaged by the owners of a construction material distributor who had been approached by an interested buyer. For estate planning purposes, our clients' CPA had previously valued the business at approximately $2 million, based on a capitalization of the three year average historical earnings. The CPA was competent and experienced in business valuation. His valuation approach and the conclusion he reached were technically correct and suitable for the intended purpose (estate planning).

The interested buyer offered to pay $1.8 million, an amount close to the CPA's value, but not enough to satisfy our clients' needs. Rather than jump at the first offer, the owners hired my firm to identify other potential buyers who might pay a higher price.

Based on our discussions and industry research, we determined that the most logical buyer was one of the manufacturers of the product that this company distributed. Given that the three largest manufacturers in this industry were attempting to consolidate the distribution channels for their products, and, given their desire to control sales to the ultimate customer (thus blocking the sale of competitive products), we determined that at least two of the three manufacturers would likely be very interested in buying. Our clients' hand was strengthened by its dominant position in a growing market and the excellent reputation of its management team.

We succeeded in bringing both of these strategic buyers to the table and ultimately sold the company to the highest bidder. **The sale price was $6.5 million.** The buyer was willing to pay this premium price because it believed that control of the distribution channel would lead to significant future profits. It also sought to prevent a competitor from gaining control over one of the leading distributors in the Rocky Mountain region. This example clearly illustrates the fact that a business's true fair market value is best determined through negotiation with a real buyer with real motives.

The factors that drive the negotiation over the price at which a business will actually be sold include:

- **Expected Future Performance** The buyer's expectation of the future performance of the business under his ownership significantly influences the price he is willing to pay.
- **Investment Return** A prospective buyer will compare the investment return he expects to achieve through the purchase of your business to alternative acquisitions that have similar risk.
- **Individual Needs** Each buyer will place a different value on your business based upon his unique needs and objectives.
- **Timing** The timing of the sale is critical because the market for business acquisitions changes based on a variety of economic factors.

With all these factors, and more, how can you know what a real buyer will pay for your business? Well, until you actually negotiate the sale of your company, you won't know the final selling price or its true fair market value. However, you can prepare yourself for negotiating the highest price by understanding what is important to buyers.

*The primary determinant of what a buyer will be willing to pay for you business is the future cash flow that he expects to realize from the business.* The anticipated cash flow determines the internal rate of return that the buyer will achieve from the acquisition of your business. Cash flow also determines how much debt can be used to purchase your business. Therefore, the greater the anticipated future cash flow the greater the value. The important items for the business owner to understand during negotiations over price are (1) the buyer's motives, and (2) how the business might benefit the buyer.

To understand the value of a business and its cash flow from the buyer's perspective you need to examine several factors that are generally not considered by CPAs and other business appraisers when they value a business. These factors include:

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- Strategic fit with buyer's business objectives
- Timing of the sale and industry cycles
- Current condition of the merger and acquisition market
- Availability of capital
- Experienced managment
- Financial synergies
- Geographic location
- Customer quality and diversification

The buyer's analysis of value will focus on the impact that each factor may have on the future cash flow generated by the business.

## STRATEGIC FIT

As our construction material example illustrates, strategic fit is an important factor in determining what your business is worth to a potential buyer. The better the fit between the buyer's objectives and what your business has to offer, the more valuable he will perceive your business to be. If a buyer has a strong desire to enter your industry or to expand into your market, then he will be willing to accept greater risk to achieve his objectives. Conversely, if your business does not match the buyer's goals, the business will likely have zero value to that buyer.

Let's look at my clients, Tim and Ed (owners of a temporary staffing company) as an example of poor strategic fit. Tim and Ed owned a very successful temporary staffing company that provided contract employees for low skilled manual labor. The company was highly profitable and its operating margins exceeded industry norms. Furthermore, the company was located in an attractive demographic market and its industry was growing very rapidly.

Tim and Ed had identified six companies that were aggressively buying companies in the temporary staffing industry, and they wanted to sell to one of the six. They hired our firm to represent them in the sale and asked that we contact each of the prospective buyers they had identified. After analyzing these prospects we informed Tim and Ed that only one of the six was acquiring staffing companies that specialized in low skilled manual labor. Despite this information, Tim and Ed instructed us to contact all six potential buyers.

Our presentation to these buyers focused on the company's high profit margins, strong cash flow, good management and growing market. All of the prospective buyers were initially interested in the company but, after learning about the type of work that the company's temporary labor performed, all but one declined to make an offer. When pressed to reconsider the acquisition, each of the five who declined cited the same problem: "The company does not fit our strategy and therefore has no value to us." The one prospect that did tender an offer was one that provided the same type of low skilled labor.

This example illustrates the need to pre-qualify buyers and assess the strategic fit between your business and that of the buyer before beginning negotiations.

## TIMING OF THE SALE AND INDUSTRY CYCLES

Timing of the sale is an important variable in determining the value of the business from the buyer's perspective. Generally, most business owners want to sell their businesses at the top of the market. Business owners believe that by doing so they'll receive the highest price and, at the same time, relieve themselves of the burden of managing the business through a down cycle. Unfortunately, most buyers have become quite sophisticated in analyzing business cycles and are not willing to pay premium prices at the top of the market.

I have found that in order to maximize the value of your business in a sale to a third party it is better to sell while the business is on the way up. The reason for this is that buyers must believe that the future cash flow will continue to increase, thus giving them the opportunity to benefit from ownership. I refer to this as "leaving some cookies in the cookie jar for the next owner." In my opinion the single most important factor in closing a sale of a business is the buyer's

belief that future cash flow will continue to grow, thereby increasing the value of the business.

## ☞ CONDITION OF THE MERGER AND ACQUISITION MARKET

The condition of the M&A market impacts the value of your business due to the principle of supply and demand. Basic economics tells us that when supply is limited and demand is high, prices increase. If you are selling your business at a time when the number of buyers exceeds the number of quality sellers, you are likely to receive more money tan if the situation is reversed. Fortunately for the owners of high quality companies, the current M&A market is very strong because interest rates have been increasing and the number of buyers far exceeds the number of high quality businesses for sale. As noted in the February 20, 1996 *Wall Street Journal* report, because the healthy M&A market has put upward pressure on prices, owners of privately held businesses received 13 percent more for their companies in 1995 as compared to 1994.

## ☞ AVAILABILITY OF CAPITAL

One of the primary factors that determines the health of the M&A market, and thus the price that a buyer is willing to pay for your business, is interest rates. The cost of borrowing money has a direct impact on the investment rate of return that a buyer will realize from the purchase of a business. The buyer's expectation regarding future interest rates will also have an impact on his perception about the future performance of your business. Even if your business is not interest rate sensitive, a buyer will likely pay a lower price if interest rates increase. This is due to the impact higher borrowing costs have on the rate of return on an investment. If your business is interest rate sensitive and interest rates increase, the value of your business may take a double whammy, because the buyer's expectation of future cash flow decreases at the same time the cost of capital increases.

Interest rates reflect the availability of capital and thus affect what your business may be worth on the open market. Obviously, buyers cannot pay more for your business than they can obtain financing for, either from you or from a bank. If the credit markets are very tight, as they were in the late '80s, buyers have a difficult time borrowing money to pay for the acquisition of your business. Therefore, they need to reduce the purchase price so that the deal has less risk and looks better to the lender.

Similarly, in a tight lending market a buyer may not be able to obtain any outside financing and therefore be unable to buy your business unless you carry back a substantial portion of the purchase price. Since most business owners are reluctant to carry a promissory note for more than 30 percent of the purchase price, a tight lending environment thins the population of buyers which in turn reduces market value. The availability of capital is another reason why capital intensive businesses, like manufacturing and distribution, tend to sell for higher prices than do service or software companies. Capital intensive businesses have more collateral assets and therefore can borrow money to finance acquisitions more easily.

## ☞ EXPERIENCED MANAGEMENT

Another important factor in determining the sale price of your business is the quality and depth of your management team. This factor is typically considered by all three classifications of buyers (strategic, financial and individual) and can impact the purchase price significantly. A business that lacks management depth is typically worth less to a buyer than one that has a solid management team. The depth and competence of management greatly influence the risk associated with an acquisition. Buyers believe that an experienced, competent management team is more likely to sustain the business during down-cycles and more likely to grow the business during up-cycles.

Financial buyers, those that invest primarily for a return on investment, generally will not buy a company that lacks a good management team. Financial buyers generally do not want to run a business themselves so they need to rely on the existing management team. If the owner of the business is the only competent member of management and does not want to remain with the business after it is sold, then a financial buyer is not likely to be interested in buying that business.

Strategic buyers also want to buy companies with good management teams. Although strategic buyers may have significant industry knowledge and employ people who could run your company, they know good management is hard to find. Therefore, strategic buyers also look for and pay more for businesses that have solid management teams that can continue to run the operation. A strategic buyer who is actively buying companies across the country, recently told me that "companies with good management teams already in place deserve a premium price." His reasoning was that good management in his industry was very difficult to find.

## EP FINANCIAL SYNERGIES

When a buyer performs an analysis to determine the value of your business he will usually consider the financial synergies that can be achieved after the sale. Financial synergies are those elusive cost savings or increased sales that can result when two companies become one. Financial synergies can occur after the buyer's operations are combined with those of your business. Synergies can include reduction of costs, such as administrative overhead, distribution, product development and other cost savings. Synergies can also include increased revenue which may result after the sale or merger is complete. Revenues may increase as a result of the buyer's ability to sell your product to his existing customers—often a much larger market than you currently reach.

In determining what your business is worth, buyers will project future cash flow taking into consideration both the increased revenue and reduced costs that may occur. Thus, the future cash flow to the buyer may be significantly more than what the business can generate on a stand alone basis. From the buyer's perspective, as the future cash flow increases so does the value of your business.

The potential for financial synergies is the primary reason that strategic buyers are able to pay more for your business than either financial buyers or related parties. The challenge for you when negotiating a sale to a strategic buyer, is to create a situation in which the strategic buyer is willing to pay you for some of the benefits that he brings to your business. I've found that the most effective method is to negotiate with more than one potential buyer so that the strategic buyer understands that he may have to out-bid a competing buyer to gain the benefits of the potential synergies.

## EP GEOGRAPHIC LOCATION

Another factor that will influence the price a buyer is willing to pay is the geographic location of your business. Geographic location may be the part of the country where your business is located, or it may mean which street corner your business controls. The location of your business can influence a buyer to increase or decrease the purchase price depending on his perception of the value of your location.

The value of a location can be easily illustrated when you think about a gasoline station that controls the intersection of Main Street and the interstate highway. Because of its location, this gasoline station is likely to have a high degree of traffic and hence have greater revenue and cash flow than a similar gasoline station that resides on a back street ten miles from the nearest interstate. In this case, location determines cash flow which in turn determines value.

The geographic location of a business has a significant impact on what a buyer is willing to pay for a business, because it influences his perception of the future benefits to be realized.

## EP CUSTOMER QUALITY AND DIVERSIFICATION

To illustrate how customer quality and diversification impact value let's examine my client William Klass. Mr. Klass owned a contract manufacturing company that had an excellent reputation in provided parts to the computer industry. The company had been operated by Mr. Klass and his wife for nearly 20 years and was very successful. so successful, in fact, that the operating margins for the company were well above industry norms, and the company was highly profitable.

The reasons for the company's success were its excellent business systems and the quality of the employees and managers. This company had seemingly done everything right, both from an operating perspective, and from the perspective of the timing of the business sale. Mr. Klass had built a rapidly growing company with an excellent customer base, geographically proximate to an attractive customer base in a growing market, managed by an experienced management team that would remain with the business. Mr. Klass had also timed the sale of the business to coincide with an expansion of the computer industry, and at a time of record activity level for mergers and acquisitions. Finally, Mr. Klass had left open some growth opportunities that a new buyer could leverage for creating additional future cash flow. This company was well prepared for sale because Mr. Klass had spent 15 years building the company, and five years planning for the day he would ultimately sell the business.

In selling the company, I sought out both strategic buyers who could take advantage of synergies and financial buyers who could appreciate the company's exceptional financial performance. Most of the potential buyers that I approached were very interested. No surprise there.

Predictably, the interested buyers preferred to pay the least possible amount. Therefore, they focused on the company's sole weakness; namely, it had one customer that accounted for more than 50 percent of its business. From my perspective, this one customer was an ideal customer because it had a long-term relation-

ship with Klass's company, had integrated its own manufacturing into the company's operations, was one of the largest companies in the world, was growing very rapidly, paid its bills on time, and was moving more of its contract manufacturing business to Klass's company. Tough to view that situation as a weakness, but buyers were concerned that the customer could take its business elsewhere after the sale.

Many of the potential buyers became so focused on the customer concentration risk that they lost sight of the consistency and predictability of the company's cash flow. They also lost sight of the company's significant growth opportunities and the quality of its non-owner management team. This group of short-sighted buyers placed a lower value on the company than that of buyers who could see the forest for the trees. The difference between the two groups' offers was in the tens of millions of dollars.

Fortunately, Mr. Klass had decided to sell the business via a controlled bid process (a topic for a future issue of *The Exit Planner*). Therefore, he was in a position to evaluate multiple offers from multiple real buyers. This sale process eliminated "hypothetical value" and determined "actual value." The process also eliminated those buyers who ignored the big picture and enable Mr. Klass to negotiate exclusively with buyers that truly understood his business.

The business was ultimately sold to a strategic buyer who enjoyed a similar business relationship with the same major customer. The sale price that was paid for the company far exceeded that which would have been justifiable using traditional valuation techniques that focused on historical earnings.

## CONCLUSION

All of the factors I've discussed are inter-related and influence the buyer's perception of the risk associated with the purchase of a business. The greater the buyer's perception of risk the higher his demand for reward. Thus, if a buyer perceives a high degree of risk associated with your business and is uncertain about the future cash flow that the business will generate, he will pay less for it. Conversely, if a buyer has a high degree of confidence in the future of the business and the stability of the cash flow that it will generate, he is willing to pay more.

The perception of risk is the reason that large diversified companies are more valuable than small, mom and pop businesses. Basically, a large diversified company is perceived to have the ability to continue producing positive cash flow in the future and the ability to transfer that cash flow to a new owner. A small business may or may not have the ability to continue to generate cash flow in the future and that cash flow may not easily be transferable to a new owner.

To maximize the value of your business and to obtain the highest possible price upon sale, you need to plan for and manage those factors that influence the perception of risk. This planning should begin the day you start your business, and continue until the business is sold. Factors that you can control include:

- developing a good management team
- building excellent internal systems
- documenting historical financial success via an audit of your financial statements
- investing in new products or markets
- diversifying your customer base
- paying attention to external factors that influence value including: interest rates, the availability of capital, economic forecasts for the locations where you conduct business, and the level of merger and acquisition activity in your industry.

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