Value Management Inc.

The Investment Banking Resource

THE M&A RESOURCE

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In This Issue

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Is The Business Ready To Sell? (Part II)

After having made the decision to sell (hopefully via a professional, thorough analyses of all relevant issues) and after having secured the right to sell, preparing the business for sale is the next step in achieving the sale objectives (the most common of which is attracting maximum value). The owner and his/her team of professionals should identify and be proactive in addressing all potential issues as early as possible. Doing so will help the seller to avoid unwelcome surprises or disappointments during the process and to prevent an outright derailment of the transaction. Existing and contingent liabilities and litigation, environmental issues, collectability of accounts receivable, and deviation from generally accepted accounting principles are just some of the issues that may crop up. It's better for owners (with the help of their professionals) to perform their own in-depth due diligence so as to anticipate and correct problem areas and present the business in the best light to potential buyers.

Reliable financial statements are critical to buyers and can smooth the way to a successful sale. Audited financial statements are generally viewed as the most reliable followed by reviewed statements. If a company's financial statements are not audited, a "Quality of Earnings" report might be considered. This report provides a detailed analysis of all the components of a company's revenue and expenses. Boards of directors of strategic buyers and investment committees of private equity buyers more frequently seek such reports as they try to assess the sustainability and accuracy of historical earnings as well as the achievability of future projections.

Generally speaking, business dependencies detract from value. A company's dependency on a small group of customers, suppliers, or individuals has a downward impact on value. For example, consider a business where a key person at the company generates one-third of its business. Even though he/she may be a long-time, loyal employee with no plans to leave or retire, circumstances beyond the seller's and/or key person's control (a death or disability, change in personal circumstances, offer by a competitor) can sever the relationship. This dependency can heighten the risk or uncertainty associated with cash flow. Since buyers are purchasing the future, eliminating or reducing such dependencies and/or uncertainties will help increase company value.

In preparing the business for a successful sale, identify the key factors influencing the company's performance and outlook and, where possible, make adjustments to reduce or eliminate negative factors. These adjustments and changes don't happen overnight; to be effective, they require the appropriate attention, which often demands structured planning, adequate time, and unwavering determination.

In summary, it takes time, effort, and commitment to get a business ready for sale. Closely-held business owners could benefit by following the lead of professional business owners by planning and preparing for the decision to sell and for the sale itself. Once the owners are ready to sell, they should work with their professional team to identify and address company factors that may detract from value. Owners can get the best deal by making an informed decision to sell and by preparing the business for sale in time to benefit from favorable market conditions.

Ten Ways to Get The Most Value When Selling a Business

1. Plan Ahead – The owner(s) may want to sell now, but businesses are rarely ready to be sold "as is"; preparation is needed to bring full value. Time spent assessing and addressing a company's readiness for a sale will enhance its value to buyers.

2. Clean Up Your Act – Owners sometimes squeeze extra benefits from owning and operating a privately-held business; personal, non-operating items (e.g. personal expenses such as club dues, travel, auto, etc.) run through the business should be stopped well in advance of a sale and any "off the books" activities should cease.

3. Hire Professionals – Much value is gained from getting professional assistance with: setting and qualifying objectives, pricing the business, setting acceptable terms, developing a sale strategy, implementing the sale process, coordinating communication and activity among the players (including: buyers, lawyers, lenders, accountants), and closing the deal.

4. Track the Market – It seems easy enough: buy low and sell high. While a good company can always find a buyer, the prices paid fluctuate and are subject to market conditions. Value is impacted by economic cycles and existing and anticipated industry conditions (among other factors). During downturns in the economy, banks tighten lending policies, businesses postpone expansion, and stock prices drop. The opposite occurs when the economy is on an upswing: banks lend more, businesses expand more aggressively, and stock prices increase.

5. Sell at the Right Time – Timing is crucial to maximizing value; it has to be the right time for the business and the right time in the market. Ideally, the business will have grown (revenue and income) for at least three years prior to the planned sale and will be projecting increases during and after the sale. As mentioned above, market timing can make a big difference.

6. Put Financial Statements in Order – Buyers have little tolerance for incorrect financial information so at the very least, correct inaccuracies and verify earnings. Upgrading the level of financial reporting may bring returns far exceeding the cost.

7. Strategize for the Best Terms – It's not just the price that matters, the substance of a deal is found in its terms, which can include: cash, stock, notes, warrants, earn-outs, non-compete agreements, consulting agreements, working capital targets, escrows, real estate and/or other leases, among other items. Owners may also care about non-quantifiable terms, such as guarantees of retaining all or key employees.

8. Business as Usual during the Sale – Owners should continue doing what they do best: running the business as usual during the sale process. The company should not slow down to facilitate the sale process (another good reason to hire professionals!)

9. Know your tax situation – While price and terms are important, the estimated amount of net proceeds should trump both in significance to the seller. Knowing the implications of the various tax scenarios arising from a deal will help sellers and their professionals craft an optimal deal structure, directly increasing the net to the sellers.

10. Consider Options for Reinvesting Sale Proceeds – Now that the business is sold, what will happen with all those millions? To get the most value from the sale, it makes sense to have a plan to put the proceeds back to work as soon as possible. The time to start thinking about reinvesting the proceeds is when you decide to sell.

Working Capital: What is It & Why is It Important?

For businesses, the term "capital" generally refers to financial resources that are available for use. To a company, capital is more than just money. Capital is part of that which is used to help generate income. The term "working capital" refers to the financial resources of a business that are used in its day-to-day operations, and is calculated as the amount of current assets minus the amount of current liabilities.

Operationally, working capital is crucial because it reflects a company's ability to pay its creditors in the short term. Each business determines its optimal level of working capital. Working capital can fluctuate throughout the year, and it may change with time and circumstances. In the sale of a business, it's not uncommon for working capital to initially be defined as: "sufficient working capital at closing." As the potential transaction progresses, a specific target dollar amount for working capital is agreed upon. A price adjustment will then occur for amounts above or below the target. Additionally, an escrow account is often established where some of the proceeds to the seller are held until a final accounting of working capital is completed.

Buyers typically purchase companies on a debt-free basis. Current assets which are commonly transferred as part of working capital include: a normal level of cash, accounts receivable from clients/customers, inventories, and prepaid expenses. Current liabilities transferred include current obligations to vendors, other payables, and accruals (tax, bonus, vacation, etc.)

There is no commonly accepted level of working capital that is applicable to all businesses. Even in the same industry, levels of working capital can vary from business to business. For some companies, working capital is seasonal and can vary significantly throughout the year. The nature of business can also cause volatility and lead to erratic levels. Also, growing companies will need increasing amounts of working capital as the business expands.

Given the above, there may be difficulty in establishing a level of working capital acceptable to both the buyer and the seller. To avoid unwelcome surprises, it's better to address the issue early. Doing so can avoid misunderstandings and give the seller a better idea of the net proceeds that will be available to them.

Five Things You Should Always Consider When Thinking About Selling a Business

1. Value – When considering a sale, value (or what the business is worth) is commonly one of the first thoughts that comes to an owner's mind. Owners tend to make incorrect assumptions about value, which are often based on hearsay and fueled by emotional attachment. Also, they may be dealing with stale information. Yesterday's valuation multiples may be significantly different today. Having an accurate assessment of value can be the first step in the decision process.

2. Vulnerability – Identify the company's flaws and weaknesses; the buyer is going to identify them so it's better to address them upfront. Regardless of the sale decision, the business will benefit by acknowledging and then addressing these issues.

3. Destiny or The Big Picture – While the value of a business is important to owners, other questions arise that may rival the significance of company worth. The owner may have founded the business, grown it over the years, and have a large part of their identity tied to it. They consider their workforce as "more than employees" and have true concern for their welfare subsequent to a sale. Additionally, they may be challenged to give earnest thought to when, if ever, they will stop working and what they will do afterward.

4. Objectivity – The success of the business may be attributed to the drive and skills of the owner. He/she may be the "go to" person for all major decisions. However, what works for a $10 million company may not work for a $25 million company. For example, businesses often outgrow the skill set of the owners. This can limit further expansion and profitability. It is helpful to have an objective view of the attributes and shortcomings of the company.

5. Timing – The market for and the value of companies is dynamic. There are numerous factors that impact the supply and demand for businesses. It's best to plan for a sale years in advance of when you would like the sale to occur. This allows for consideration of the relevant factors and appropriate adjustments inside the company. Also, being flexible on timing will enable owners to take advantage of more favorable markets.

Five Reasons Why Now May Not Be The Right Time to Sell Now

1. Company Performance – There is not a good story to tell buyers right now (financially speaking.) A history of continued growth and profitability with high expectations is one of the best simple stories. Telling a tale of missed projections and/or expected decreases or setbacks weakens a seller's negotiating position.

2. Market Conditions – The law of supply and demand is at work in the marketplace. The market for companies changes over time. It is impacted by economic cycles and existing and anticipated industry conditions (among other factors). It is also affected by individual company performance, which is also impacted by the economy, prices and supply of raw materials, competitive pressures, new product releases, among other factors. Low demand results in low valuation multiples and low prices, making it the wrong time to sell.

3. My Baby! – The market and the business may be ripe for a sweet deal but the owners are not ready to let go. For many owners, the business is more than a way to make a living, it's a way of life. They become emotionally attached to their business and to being the business owner. They started the business, nurtured it, and many of their personal relationships are attached to it. Such feelings are important and may be an indication that there is more at stake than money.

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4. Good or Better – Maybe it is a good time to sell, but with some improvements, you could do much better. The more effort devoted and lead time given to preparing for a sale, the more likely an owner will be able to negotiate a relatively better deal. Of course, delaying a sale to improve the company's position and attractiveness to buyers must be weighed against future risks and market conditions.

5. Over the Rainbow – Something big is looming on the horizon. Value and demand can change dramatically with the circumstances of the company. Big, new contracts or clients can add significant value. Securing the next level of business prior to a sale can change the face of the company. If a delay in selling fits in with the owners' objectives, it may make sense to make the big news happen before going to the market.

Deal Multiples By Industry & Level of Profitability

A recent Pepperdine University survey ("Capital Markets Report – 2015", by Dr. Craig Everett, director of The Pepperdine Private Capital Markets Project at the Graziadio School of Business and Management) examined the behavior of senior lenders, asset-based lenders, mezzanine funds, private equity groups, venture capital firms, angel investors, privately-held businesses, investment bankers, business brokers, limited partners, and business appraisers. Presented below are the median multiples for transactions reported by the investment banker respondents (there were 104) as occurring in the prior 12 months (primarily in 2014). Take note of the impact of size (as measured by EBITDA) on the valuation multiples. Also noteworthy is the range of multiples for similar-sized companies in different industries.

MEDIAN DEAL MULTIPLES BY EBITDA

EBITDA	MFR	CNSTRCT & ENGNRG	CNSMR GOODS & SRVCS	WHLSL & DISTR	BSNS SRVCS	BSC MTRLS & ENRGY	HLTH CRE & BIOTECH	IT	FNCL SRVCS	MEDIA & ENTRTNMNT	AVERAGE
$0M - $1M	4.0	3.5	4.0	4.5	4.0	3.3	5.5	6.5	5.5	NA	4.5
$2M - $5M	5.0	4.5	5.5	6.0	5.3	4.0	6.0	8.0	6.5	5.0	5.6
$6M - $10M	6.0	5.5	5.8	6.0	7.0	5.0	7.0	8.0	7.0	7.5	6.5
$11M - $25M	7.5	6.0	6.0	6.3	8.0	5.5	8.0	9.5	9.0	8.3	7.4
$26M - $50M	7.5	6.5	7.0	NA	9.0	NA	8.0	10.0	10.0	NA	8.3
>$50M	8.0	6.8	9.0	8.0	10.0	7.3	8.0	10.0	10.0	NA	8.6

ABOUT VMI INVESTMENT BANKING. VMI's investment banking division is a boutique financial consulting firm focusing on selling businesses and identifying acquisition targets in the lower middle market while also providing strategic merger & acquisition consulting services. VMI's investment banking professionals are experts in financial analysis who have been involved in over 100 transactions, and have worked with thousands of family-owned and other privately-held businesses, partnerships, trustees, boards of directors, and other corporate owners and advisors. Our newsletter is published quarterly and does not constitute legal or financial consulting advice. It is offered as an information service to VMI's clients and friends. Those interested in specific guidance for legal and accounting matters should seek competent professional advice. Inquiries on specific transaction matters are welcomed.

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