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BUYING OR SELLING A BUSINESS? DON'T BE RIPPED OFF!

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Be sure the price is right if you are buying or selling a business. Here are three proven ways of arriving at the best price for everybody.

Accumulating and preserving capital is tough these days. Therefore, when buying a business, the purchaser has one thing uppermost in mind – getting value. To some, that may even mean "getting a deal;" to all, it means "not getting ripped off." When selling, the vendor, having spent time and energy developing the business, has the same thing on his or her mind – getting value. In the vernacular, that means "not leaving money on the table."

Terms such as "deal," "ripped off," and "leaving money on the table" may be convenient deal-ese, but it is much easier to utter the phrases than to make a meaningful estimate of what they mean in the context of underlying value. To start with, the astute vendor knows that getting maximum value requires selling the business to a purchaser to whom the business is worth most. (Or, perish the thought, finding a purchaser who is prepared to pay more than the business is really worth, which was not all that unusual in the dot com mania.)

On the other hand, a prudent buyer is keenly aware that there is no "satisfaction guaranteed or money refunded." There are countless examples of transactions that commanded purchase prices well in excess of their real worth; Snapple and numerous acquisitions made by

Nortel are good examples. Whether driven by greed, sidetracked by excessive optimism, or misled by advisers whose interests were served by getting the deal done, many purchasers now face suffocating debt, having seen their equity, if any, severely erode or disappear. Could these situations have been avoided? The answer clearly is Yes!

It would be folly to pretend that the subject of business valuation is only of concern to a purchaser and suggest the vendor can rely solely upon the two truisms, "*caveat emptor*" and "a business is worth what someone will pay for it." According to that logic, sellers of businesses could then put this article aside and walk the dog, switch to the ball game, or whatever.

We think two factors should prompt sellers and buyers to continue reading, however. The first is that there has been a backlash to the insanity of 1999 to 2001. Plus, the prevalence of high profile fraud and mismanagement have led buyers to be not only prudent, but cynically cautious. In this current demanding environment, it is absolutely critical that a vendor have realistic expectations. Otherwise, he or she will be tempted to hold out for a larger pot of gold than is warranted, only to get no gold at all.



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The second reason for vendor attention is that, to be able to say “No” with confidence to a lesser offer, it is essential that the vendor go through a disciplined valuation in the context of determining full worth to an ideal buyer. Then the astute vendor is in a position to hold out for the right offer from the right buyer – in some cases, the full synergy buyer to whom the business has maximum worth, and in all cases, a buyer who is not bottom-feeding – trying to pay below market.

Determining the True Value of a Business is Not Simple

The matter of business valuation cannot be dealt with solely in the narrow context of the financial statements if true value is to be determined. Whether for buyer or seller, the valuation effort should be directed down two distinct streams: prudent valuation must conduct an exacting analysis of historical performance, and make a realistic assessment of the current strengths and weaknesses of the business in both quantitative and qualitative terms. Many people are most comfortable with the first one, the pulling apart of the numbers, often to many decimal points (too many), because on the surface it appears to be more precise. Such analysis can be more comforting because it is historic, providing a full understanding of what has happened. And that is important as far as it goes.

Unfortunately, what has happened is only interesting as a predictor – and not necessarily a very good predictor – of what will happen in the future, which, after all, is what the vendor is selling and the purchaser is buying. A prospective buyer must, therefore, develop an understanding of what has happened to the business, why it has happened and most importantly, the range and probability of future events. Numbers – the exhaustive analysis of the records and forecasts of the business – are an essential ingredient, but only one. The more important analysis must focus on understanding what makes the overall market tick, and identifying, the success drivers – those few key essential strengths a business requires to succeed in the future. More on these later, but first, a look at the quantitative analysis.

People talk about rules of thumb, which are supposed to be very simplistic measures to allow one to assess a business based upon a single calculation based on EBITDA, gross sales, net profit, number of patients or circulation. In our experience, there is no reason to question the reliability of these rules of thumb, but even if they are based upon an adequate representation of recent actual transactions, using them can be misleading. Think of selling your house, and assume that on the average the houses on your street are worth X dollars measured by actual sales experience. Unless the houses are all the same inside and out, you should not rely upon that average when setting your price expectations.



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Three Methods to Evaluate a Going Concern

Rules of thumb may be useful to set broad parameters in a preliminary way, but there are three more valid techniques that should be employed by vendors, purchasers and their advisers to value a business on a going-concern basis. They are: price/ earnings multiples (earnings basis), book value multiples (asset basis) and discounted cash flow (cash basis).

Price/Earnings Multiples are so "Comfortable"

Since it is true that a business is worth what someone will ultimately pay for it, the P/E multiples approach claims to base value on actual prices paid and received for comparable businesses. Although the term P/E is commonly used, P – price per share divided by E – lagging or forecast net earnings after interest and taxes, its usefulness is really to provide a cursory comparative measure of the relative price per share of stock in a public company traded on an organized exchange. As it does not contemplate the purchase of a private company in total, relying upon publicly quoted P/Es for an outright purchase would be unwise. The astute investor will be aware that the value of a business should be calculated on a debt-free basis, and therefore be before interest; since taxes in any time period can severely distort the ultimate bottom line, at minimum a valuation based upon a multiple of earnings should use earnings before interest and taxes (EBIT). The conventional wisdom suggests that today, a value of four to six times EBIT is about right, although aggressive purchasers' admit to considering much higher

multiples when quality businesses are involved, and bottom feeders are always trying to buy at a price below the range.

There are two reasons the P/E multiples approach rarely works in practice. First, in most instances only partial information is reported or available, even with a lot of research. As a result, many apparently otherwise logical thinkers appear to be prepared to accept gross generalizations that may be based on multiples drawn from stock exchange share lot transactions and are not comparable. Further, these comparisons do not reflect the value of a business being sold in its entirety, particularly when applied to a small or medium-size private business. To complicate matters further, the question of a share or asset sale, and the existence of debt on the vendor's balance sheet are fundamental to a valuation, but are often unknown. The information that is in the public domain may be the best available, but that should not be sufficient reason to consider it adequate.

The second reason the P/E multiples approach rarely works is that the identification of comparable transactions is extremely difficult, if possible at all. Comparability should encompass size, product or service, geographic location, distribution of sales and quality of earnings – and equally important, an assessment of success drivers. Rarely are these factors identical for two businesses, let alone a larger number.



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The overwhelming major disadvantage of the P/E approach to valuation is that the underlying strengths or weaknesses of the subject companies are not considered. At a minimum, meaningful value must reflect the state of all of a business' assets – physical, human and reputation-related and the extent of the need to inject significant additional capital as required to ensure future earnings. Obviously, two companies with identical earnings could be dramatically different in the condition of their overall infrastructure and the resultant need for future investment. Yet, a P/E multiple approach would assign the same value to each.

Book Value is so "Measurable"

The second valuation approach solves part of the problem, but shares many of the weaknesses of the P/E multiple method. Rather than considering value in the context of a multiple of earnings, the purchaser is asked to accept a value based upon the balance sheet – adjusted book value, which reflects the fair market

value of the assets, less any liabilities. Most often, scrutiny of accounts receivable and inventory will require the purchaser's focus. Similarly, the market worth of any real estate, irrespective of the balance sheet value, is a major factor in any purchase decision. Obviously, the aware purchaser must scrutinize the contingent liabilities of the subject business, including potential severance obligations, unfunded pension commitments and environmental risk.

Although the purchaser's attention is focused on the underlying net asset values, allowing an assessment of the further investment that would be required to maintain the earning power of the company, again, comparability of transactions is difficult if not impossible. Even assuming the information is available to conclude that the book value is accurate, there is no way to distinguish between a growing business and one that is in its death throes.

AN EXAMPLE LEADING TO SUPER PROFITS

A financial investor in Europe was prepared to pay what appeared to be an exorbitant price for a medium-tech electrical apparatus manufacturer. The acquisition was made, the vendor was ecstatic and the purchaser went on to make an even greater fortune than he had anticipated. He was able to apply a new technology to an established market that resulted in dramatic share gains for the company, and until the competitors caught up, he was able to generate super-profits.



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Notwithstanding the criticism of the P/E multiple approach and the book value approach, the vendor should attempt to determine a realistic asset value. The purchaser will find this information critical, as the financial backer, particularly the bankers, will want to be certain that accounts receivable, inventories and fixed assets are solid collateral for any advances made to the business. Similarly, property values are required to underpin mortgage financing.

Discounted Cash Flow Recognizes Cash is King (and Queen)

The third method of evaluating the business Discounted Cash Flow (DCF) – is designed to deal with the overall question of valuation in a more comprehensive manner. In this case, historic performance, tempered by the purchaser's best judgment of future success, is translated into a forecast of free cash flow, which is all cash generated by operations, less what is required to provide for future capital investment. This cash flow projection may be for the next five or 10 years; the value of such available cash is then discounted to a present value. The terminal value is calculated assuming either the cash flow of the final year will continue indefinitely, discounted to today's dollars, or assuming a projected windup value at that future date discounted to present value. These calculations will use a discount rate that reflects the prospective purchaser's target return on the

equity investment, combined with the cost of borrowed funds.

When employing a DCF valuation, both the purchaser and the vendor will likely estimate the synergy available to the purchaser, and the resulting potential improvement in profit and cash flow. The vendor would like to capture some of that future value via the sale proceeds, while the purchaser's perspective is that such improvements are for the purchaser's account.

Success Drivers Most Important

Each approach to valuation has its proponents and its detractors. Given that valuation is as much art as science, the best advice is to avoid relying upon any one technique and to use all of the information and methodology available, which must include the success drivers - those few critical strategic factors that will create positive results for the specific target company. Although they vary according to the market and competitive circumstances, there is a generic list that anyone involved in assessing value is wise to include at a minimum:

- The nature and degree of differentiation of the product or service offered by the business,
- The company's branding and goodwill,
- The quality of its goods and services,
- Staff, both managerial and workforce.



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Knowing, not guessing, about both financial matters and success drivers is paramount to any buyer to ensure fair value is received. Successful vendors – those who will obtain optimum price for the business – appreciate the importance of the strategic factors and set their expectations accordingly. The prudent buyer must diagnose and understand the particular market within which the business competes, and be confident the basic demand for the product or service will continue.

Sustainability of Market Demand Needs to be Assessed

Since a purchaser is paying for the opportunity to create future performance, not for the historical results, the first threshold should be reasonable certainty that the demand for the product or service will continue at least long enough to provide a return on invested capital, and, over a reasonable period, a return of that invested capital. Some markets are cyclical, some are transient and some are transformed rapidly by

technological advance; an unaware purchaser can pay for a going concern, only to find it has become obsolete capacity in short order.

Product or Service Differentiation is Needed

At least two factors are increasing every business' need for powerful and continuous product or service differentiation and value added to generate reasonable sales and profits. The first is the reality of globalization. A local manufacturing business is as likely to have to compete with a product from half way around the globe as half way down the block. As customers become global, and rationalize their supplier base, they are more demanding as to value received. Similarly, even mid-market companies must approach the market in a global context, and in many cases, be prepared to service their customers' worldwide requirements.

AN EXAMPLE OF AN ENGINEERING FIRM

To the buyer of an engineering firm, the key question revolved around the particular methodology the firm brought to very focused projects within a narrowly defined industry segment. The buyer concluded that the combination of proprietary project management and technical skills really did set the firm apart from its competition and a transaction was closed on terms favourable to both buyer and seller.



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Second, in addition to a plethora of new competitors, many companies are also facing shortened life cycles for their products and services, as new improved offerings are spawned by new technologies, particularly those fostered by computer capability. The capability to continually upgrade to maintain advantage is critical; a buyer must determine how much of that resilience is inherent in the business and what additional is required. The former is part of the value to be recognized in the purchase price, while the latter may be considered negative value as it implies further investment by the purchaser.

Unless the business possesses a meaningful product or service difference and advantage, and ideally, patented procedures, formulae or design, the purchaser must ask what he or she is paying for beyond the market value of the assets net of liabilities. Many businesses in which the true net asset value was substantially less than what showed on the books have changed hands.

A Positive Reputation is Precious

"It takes a lifetime to build a reputation," goes the old chestnut, but it takes even more time and expense to rebuild a positive reputation once it has been lost. Since customers, suppliers and those in the distribution channel will definitely have an attitude toward the business, a purchaser must do whatever is necessary to ensure it is positive. Although the assets, other infrastructure and staff are the tangible values in a purchase, when buying a going concern, the key is the amount of momentum the business has that will allow it to maintain its earning stream. That depends in large measure on the strength of the trademarks, brands or overall goodwill enjoyed by the business.

In a recent divestiture in the food industry, the purchaser concluded that the brand franchise that was strictly goodwill and was dominant in its market, warranted over 80% of the purchase price, as his future plans called for the expansion of the label to other related wares.

AN EXAMPLE OF SYNERGY

A Canadian conglomerate found that one of its subsidiaries could not afford the continuing capital investment in R and D; nor could the subsidiary's limited volume provide enough economy of scale to produce goods at a cost comparable to the larger American firms that were selling globally. After an extensive search, a potential buyer with the best opportunity for synergy was identified and a sale was completed.



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People are a Valuable Asset

Except in the rarest circumstance, a company's human assets, both managerial and hourly, are the root of its value. Business success is a function of doing things right today, while always preparing for tomorrow. Productivity, innovation and quality are the sine qua non and they are created by people who have the training, attitude and motivation to excel. A large share of a purchaser's cheque on closing is in recognition of a capable and dependable staff. If the managerial competence has to be rebuilt, and the workforce retrained or replaced, the purchase price should reflect an appropriate discount as the process of improvement will take time and money, and the risks are high.

As is often the case, the owner/operator(s) of a private company builds up essential relationships with customers and suppliers. For example, an entrepreneur buying her first business, found that the

major challenge in the overall valuation and negotiation process was working out terms and conditions that would ensure the vendors would continue to be committed to the business after the closing. She required the vendor's full dedication during the transitional period to transfer both their knowledge and their relationships. Ultimately an earn out and incentive bonus program were agreed upon, and although it is early in the post-sale period, the transition appears to be proceeding smoothly.

Knowing, not guessing about both financial matters and success drivers is paramount to any buyer to ensure fair value is received.

Successful vendors – those who will obtain optimum value for the business – appreciate the importance of those same strategic factors and set their expectations accordingly.



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