Dr. Tom McKaskill

MASTERCLASS FOR ENTREPRENEURS
on
Financial Exits

INSIGHTS ON HOW TO SELL YOUR BUSINESS TO ACHIEVE HIGHER EBIT MULTIPLES

BREAKTHROUGH PUBLICATIONS

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Insights

The EBIT multiple should be abandoned as a method of business valuation.

You need to remove inherent risks in the business.

Prepare the business for new ownership including making yourself redundant in the process.

The buyer is not interested in the past. They are buying the future of the business and it is the future potential of the business which creates its value.

There are many ways in which the current levels of profit can be improved but it must be done on a sustainable basis.

Profit growth has a huge impact on valuation. Look closely at how further growth can be added to the business.

A better funded buyer may be able to expand the business and will be looking for ways to do that. Find projects which you can demonstrate how the future of the business can be enhanced.

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Dr. Tom McKaskill

Global serial entrepreneur, consultant, educator and author, Dr. McKaskill has established a reputation for providing insights into how entrepreneurs start, develop and harvest their ventures. Acknowledged as the world's leading authority on exit strategies for high growth enterprises, Dr. McKaskill provides both real world experience with a professional educator's talent for explaining complex management problems that confront entrepreneurs. His talent for teaching executives and his pragmatic approach to management education has gained him a reputation as a popular speaker at conferences, workshops and seminars. His approaches to building sustainable, profitable ventures and to selling businesses at a significant premium, has gained him considerable respect within the entrepreneurial community.

Upon completing his doctorate at London Business School, Dr. McKaskill worked as a management consultant, later co-founding Pioneer Computer Systems in Northampton, UK. After being its President for 13 years, it was sold to Ross Systems Inc. During his tenure at Pioneer, the company grew from 3 to 160 people with offices in England, New Zealand and USA, raised venture capital, undertook two acquisitions and acquired over 2,000 customers. Following the sale of Pioneer to Ross Systems, Dr. McKaskill stayed with Ross for three years and then left to form another company, Distinction Software Inc. In 1997 Atlanta based Distinction raised $US 2 million in venture capital and after five years, with a staff of 30, a subsidiary in New Zealand and distributors in five countries, was sold to Peoplesoft Inc. In 1994 Dr. McKaskill started a consulting business in Kansas which was successfully sold in the following year.

After a year as visiting Professor of International Business at Georgia State University, Dr. McKaskill was appointed Professor of Entrepreneurship at the Australian Graduate School of Entrepreneurship (AGSE) in June 2001. Professor McKaskill was the Academic Director of the Master of Entrepreneurship and Innovation program at AGSE for the following 5 years. In 2006 Dr. McKaskill was appointed the Richard Pratt Chair in Entrepreneurship at AGSE. Dr. McKaskill retired from Swinburne University in February 2008.

Dr. McKaskill is the author of eight published paperback books for entrepreneurs covering such topics as new venture growth, raising venture capital, selling a business, acquisitions strategy and angel investing. He conducts workshops and seminars on these topics for entrepreneurs around the world. He has conducted workshops and seminars for educational institutions, associations, private firms and public corporations, including KPMG, St George Bank, AMP, AICD and PWC. Dr. McKaskill is a successful columnist and writer for popular business magazines and entrepreneur portals.

To assist Angel and Venture Capital investors create strategic exits for their investee firms, Dr. McKaskill conducts seminars, workshops and individual strategy sessions for the investor and their investee management teams.

Dr. McKaskill completed six e-books for worldwide distribution. He has also produced over 150 YouTube videos to assist entrepreneurs develop and exit their ventures.

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Preface

If you have spent most of your life as the owner/founder/partner of a business you will have some understanding of business valuation. Almost without exception that mental model will be based on the concept that your business worth is based on some multiple of your current EBIT (Earnings before Interest and Taxes). My experience and research has shown me that this is a fundamentally flawed view of the firm which often greatly undervalues the value of the business.

Our business training and the professional advice we receive in business has conditioned us to accept that we can have little influence over the final exit value because we are mentally locked into a historical EBIT multiple model. We are told that the only marginal impact we can have on the value is to reduce the inherent risks in the business. However, the buyer can have a very different view of our business because their value of our business is conditioned on what they expect to do with it not what we have historically undertaken. Thus a better funded buyer with greater skill levels, networks and strategic relationships may be able to exploit underlying potential in our business in a manner which we never could. Thus, clearly the business is worth more to the buyer than the value we would put on it based on its historical performance.

We basically need to be reprogrammed. We need to start to see our business through the eyes of a highly capable buyer and understand how they will operate it and exploit it. We then need to prepare our business to be attractive to the best buyer not simply the one who replies to a business for sale advertisement.

Our task in preparing our business for sale is three fold. Reduce the inherent risks in the business, prepare the business for a change of ownership and then create a platform of business potential which can be exploited by the buyer.

Fundamentally, selling a business successfully is simple about building a business which will attract the best buyers and then creating a competitive bid process to ensure you extract the highest value. It is the focus on the buyer which makes the difference. Also it is an understanding that you can change the future of the business. You need not be locked into the past or constrained by what the business has historically achieved. Valuation is simply about the future of the business and thus it can be changed.

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PART A: FUNDAMENTALS

The process of selling a business should start with awareness of the fundamentals of valuation and of the process of selling a business. Too often the entrepreneur suddenly decides they have had enough and throws the business into a sale process without really bothering to work out how best to extract value from all their hard work. Once the decision to sell is made, they want it to happen tomorrow not recognizing that a good 12 to 24 months is really needed to extract full value from the business.

Preparation for selling the business should really start when the business is created. You do not know when you might get into trouble and you do no know when someone might make an offer for the business. Thus being prepared to sell the business is the only strategy that really makes sense.

It is only by understanding how business are valued by the buyer that you can really extract full value from your business. Thus time spent understanding how to reduce risks in the business, improving profits and growth prospects is time which will be greatly rewarded by an increased sale price.

VALUATION

How to value your business

Whenever I get into this specific topic I sometimes think that I am entering the world of art rather than science. Certainly, from what I have seen over the years, there seems to be more guess work in the process than science. Most business owners will be familiar with sales of businesses in their own sector and will know what the typical valuation formula is. Generally this is some multiple of profit (normally referred to as time EBIT, earning before interest and taxes), but some sectors will be a multiple of revenue or a value per client or per member. Few will, however, understand why a specific multiple applies in their sector.

When I have asked for clarification of the specific multiple which is being applied, I usually get the arguments that it is 'typical' in the sector, that it reflects industry volatility and risk or that it includes adjustment for industry growth. The truth of the matter is that most business owners, business brokers and business advisors don't know why a specific multiple applies. They just know what norm has been established over many years and many sales. When you ask 'How can I get a higher multiple?' the answer will be 'grow faster!'. "How much faster? – well more!! Not very useful and certainly not very scientific.

Excluding liquidation or break up value, there are only two fundamentally different models for establishing a value for an operating business. The first is based on the future stream of free cash flow generated by the business and the other is the strategic value of the business to a large corporation.

Most conventional businesses, such as retail, wholesale, transport, property, and services businesses, achieve value by producing profits (EBIT) for the new owner. It is the size, duration, growth and likelihood of that profit stream that creates the value. By the way, it is only ever future income streams that create value never past ones. You don't put money into a savings account to get the interest rate the bank paid last year, the only relevant rate is the one they are going to pay. Thus, it is only projected future profits that are relevant. While past profits may give you some indication of the likelihood of future profits, you can dramatically improve your valuation by creating a different future.

Conventional valuation theory can be applied to business valuations. This is based on Net Present Value (NPV) of a future stream of income relating to the initial investment. Once we know the income streams and the discount (risk rate) to apply to them, we can calculate the value of the investment (or the business in this case). It then follows that conventional valuation using EBIT multiples should be able to be expressed in a NPV formula. Thus 2 x EBIT is a 50% discount rate, 4 x EBIT is 25% and 6 x EBIT is 15%. A business valuation can therefore be improved by reducing the applied discount rate and improving the visibility and probability of future income streams.

You reduce risk by improving recurring revenue, account penetration, customer and employee churn and by implementing better systems and processes internally to set and monitor performance. Visibility of future income streams is improved with long term contracts, greater recurring revenue and deeper account penetration as well as establishing good competitive advantage around patents, brands, trademarks and deep expertise. This should gradually improve the EBIT multiple. Further increases in valuation will come from increasing sustainable profitability and building income (EBIT) growth in the business.

This process is fairly conventional. Now comes the clever part! To gain a premium on the sale you can build growth potential into the business which the buyer can exploit. Can you identify how a much better funded, more skilled, more able buyer could grow your business and can you provide the framework or template for that growth? Where you can set out a path for higher growth and profits and clearly demonstrate how that can be achieved, it is possible to gain some of that increased profit in your valuation. You will need to find the right buyers and you will need to put the business into a competitive bid in order to extract that premium however.

A business which has underlying assets and/or capabilities which a large corporation can exploit is a very different proposition. These are business based on patents, brands, copyright, trademarks and deep expertise. The valuation in this case is not based on what your business can generate in future profits but how much profit the buyer can generate by exploiting your underlying assets and capabilities. Imagine a very large corporation which has a customer base one hundred times yours which would be highly receptive to your product or service. The large corporation may be able to quickly sell your product or service into an existing customer base reaping ten times your revenue, or greater, in the first year of the acquisition. Therefore, what would your business be worth to a large corporation which had a ready market for your product or service? The value of your business is based on what they can do with your business not what you can do with it. In fact, your own revenue, profits, customers and numbers of staff may be quite irrelevant in putting a value on your business. It is now all about them and not you.

Working out a valuation based on strategic value is very difficult but not impossible. What you have to do is estimate the revenue and profits that the acquirer will generate from your business. Thus, if they have a customer base one hundred times yours, then it might be fair to say that the value is one hundred times your conventional valuation. Will you get that for your business? Probably not but you will gain some portion of that value if your set the deal up correctly with the right potential buyers and ensure you have a competitive bid running when you come to sell. With strategic selling the task is to work out what you have or do which could be of interest to a large corporation, identify the potential buyers, set up a relationship to educate them on your potential and then manage the final competitive bid. Generally strategic buyers are prepared to pay many times the conventional value of a business.

If you compare these two models, what you will see is that the value of your business is solely in the eyes of the buyer and especially in the manner in which the buyer can exploit its potential. What this should be telling you is that the identification of potential buyers is one of the most critical aspects of gaining the best price for your business. The best buyers are the ones which have the experience, willingness, capacity and capability to best exploit the potential in your business. Your task then is to create that potential and then find the right buyers.

NOW OR LATER

Should you sell your business ?

There are very few entrepreneurs who would say that they sold a business at the right time. Many will tell you that they sold the business and then discovered that the market improved and they would have received more if they had hung on longer. Others will tell you that they sold the business after the market peaked and received less than they would have earlier. So when is the right time to sell your business?

Economic cycles are somewhat predictable, although few economists would be willing to state exactly when the downturns will occur. Layered on top of general economic cycles are industry trends which can confuse the picture. This is further complicated when you try to predict the possible future performance of the individual firm. There are numerous internal and external pressures that can influence both short term and long term profitability of any business. For most businesses, the future cannot be predicted with any degree of certainty. You only have to read the daily financial press to see how often public corporations miss or exceed their forecasts.

You might argue that you run a very effective, growing and profitable business and that you should hang in there for a higher valuation however you would be overlooking factors beyond your control. Recall the impact that the terrorist events of September 11th and the Bali bombings had on sectors of our economy. Natural disasters are unpredictable but can devastate sectors of our economy. Consider the impact of the recent drought on our agricultural sector or the impact of the recent floods in Queensland on local businesses. Few of us would have predicted the fall out from the collapses of Ansett, HIH and Arthur Anderson. Basically, no matter how well you manage your business, you can still be seriously impacted by bad luck.

Your business can also be seriously effected by new competition, the loss of key employees, a major cost imposed by changes in regulations or by a major customer being acquired and switching to another. Business is about risk. You can sit in there and take the risk of the business increasing in value or you can sell out and take whatever value has been achieved to date and then think about taking it easy or putting some of the money back into a new venture.

Many business owners are concerned about whether they will have enough funds to finance their retirement and how they will spend their time. Imagine how sad it must be to get to retirement and find that you left it too late and you ended up with a fire sale. Sometimes it is better to take what you can and have the comfort of having the money in the bank. You can always work for someone else or spend your time working in the not for profit sector as a volunteer.

The bottom line – you probably have an equal chance over the next several years of growing the business or suffering some form of setback. Predicting the state of the business in the next few years should not be the major determinant of when to sell the business.

First, look at your next best alternative. If you currently take $150,000 in benefits from the business, what could you earn if you became an employee? Lets say, $90,000. After tax you are worse off by about $30,000. If you could sell the business and pick up $300,000 net, it would take you 10 years to equal that. If the net proceeds were greater, this may mean a good standard of living for the rest of your life. Take the money!!

Alternatively, you might be bored or the business may have outgrown your ability to manage it effectively and the business may be suffering as a result. Not everyone is suited or has the desire to manage a larger business. Your skills may be more effectively employed by selling this business and starting again. Many entrepreneurs are best at business creation where their passion and energy are best utilised. They are often not good at the detail or the day to day management. If you are not having fun any more then sell out and start again.

Even where the business has considerable potential, you may not be the right person to manage the business or you might not be able to capture that potential. Every business has to change dramatically as it grows in order to cope with the increasing complexity of the operations. You may not want to manage a more formal and more bureaucratic business. At the same time, the potential of the business might be limited by your ability to manage or to finance the growth. Sometimes it is better for the business and for it's employees to sell out to a firm that can better exploit the potential and perhaps offer the current employees better career prospects.

OVERSEAS BUYERS

Selling out to an overseas corporation

Policy makers like to see entrepreneurs grow new ventures to develop innovations which can create employment and hopefully generate export income. They are not so keen on seeing our local entrepreneurs sell out to overseas corporations. How many times have we been told that we are selling our birthright, exporting our best people or denying ourselves the opportunity of creating the next Microsoft. However, the truth is that the vast majority of entrepreneurs should sell their businesses even if it is to an overseas corporation. In my opinion, in most cases, the nation is much better off as a result.

The problem is that you cannot have a 'one size fits all' policy. There are many types of entrepreneurs with a wide range of skills, experience and motivations. At the same time there is a vast range of product/market situations, some of which can be exploited from a small market like Australia and some which need to be developed in larger markets.

Few entrepreneurs are capable of taking a business through its various stages of growth to the size of a substantial entity employing thousands of people. In fact, this is a very rare individual indeed. Most entrepreneurs have a range of skills, experience and capabilities which are suitable for a only certain phases of a venture's growth. The ones I see everyday in my classroom and in my work with the Young Entrepreneurs Organization are what I call passionate starters. These people have the vision, energy and determination to create something new and bring a new product or service to market. Most will create a small organization of between 8 and 40 staff. At that point they start to get bored, they are not especially good at the detail and, as a result, the business is unlikely to reach its full potential with them at the helm. Some are interested and capable of taking a business to the next stage but most are not.

Others are better suited to mid-size growth. Perhaps they have better industry networks, have worked for a larger company and understand the formal processes better and are more comfortable with having a larger employee base to work with. They are more willing to delegate authority and to work with external investors and directors. However, the next stage of growth which takes the business into the hundreds of staff, often involves multiple locations, overseas markets, significant numbers of external shareholders and perhaps a public listing. Few entrepreneurs are capable or even interested in working at this level.

Another important consideration is that most start-up ventures do not have the right products and services to support a large scale organization. Most large businesses have multiple products and services across multiple, although complimentary, markets. Few businesses grow large organically. Most attain significant size through acquisitions or mergers. Few businesses are able to fund significant growth internally which means accessing venture capital or listing the business on the stock exchange. Since only a small fraction of new ventures ever achieve either of these outcomes, most entrepreneurial ventures are constrained by access to growth funding.

So on the one hand most entrepreneurs do not have the skills, experience or perhaps the motivation to grow beyond a certain point and on the other hand, most products/services are not able to fund significant growth. Rather than limit the growth opportunity, the entrepreneur should sell out to a corporation, even an overseas one.

Entrepreneurs who sell out a successful business are most likely to put their money into another venture or act as an angel investor in early stage ventures. This should create more jobs, fuel more innovation and, in turn, generate more local risk capital.

Businesses that are sold normally provide continued employment for most staff, receive additional funds for product and market development and thus, in turn, create further employment. Some ventures that require significant funding for commercialization, such as those in biotechnology, would not be able to complete product development without access to overseas acquirers. The Australian market is simply too small to fund more than a few and we don’t have the global distribution channels to exploit the finished products. Without access to global acquirers, Australia would not be able to participate in some sectors.

Some entrepreneurs and some products and/or services are capable of building large global corporations, but they are rare. For most selling out is the logical path both for the entrepreneur, for the employees and for the country. In some cases, the products and the key employees will be moved overseas, however for the vast majority the business will continue to grow locally and may well offer staff a more secure and broader career opportunities. Thus knowledge based ventures can only be truly exploited by keeping the staff and probably investing more in them. Not only have we not lost good people, we have actually gained additional foreign investment.

In my opinion, smart entrepreneurs will do it again and again. They innovate and create jobs. We should encourage them to sell out if they are not the right person to take a business forward. In most cases their staff will be better off and the nation will have one more cashed up entrepreneur investing in new ventures.

UNDERSTANDING EBIT

Where does the EBIT multiple come from?

How frustrating it must be for a smart entrepreneur who runs an efficient and profitable company to be told that their valuation is no different to a competing business which is run in a sloppy manner. Yet this seems to be what happens in business valuations. There is an industry norm and it is very hard to argue around it. It is as though some distant tribunal has deemed that all businesses in a specific sector look the same and therefore should be valued the same way.

Most business owners accept the imposition of a valuation method based on a multiple of earnings, often expressed as x times EBIT (earning before interest and tax). When you ask them what this means, they cite industry practice, prior deals and advice from their accountant and business broker. If you ask them how they can influence the multiple, they will normally state that they need to grow faster – how much? they are not sure - just more!! Not very helpful advice to the entrepreneur who wants to build more value in the business.

However, if you apply some investment theory to the problem of improving valuation, it becomes dramatically simple to see how you could dramatically increase your value on sale. Any investment is simply a discounted stream of future cash flows. If you use the net present value (NPV) formula in your spreadsheet, you can see how projected earnings impact the investment value. Try setting out a constant annual income and see what impact different discount rates have on the NPV. The discount rate reflects the inherent risk in the investment. Thus, the higher the risk of future earnings being achieved, the higher the discount rate which is applied to future income streams.

Using this approach, you will discover that an EBIT multiple of two equates to a discount rate of 50%, a multiple of 4 is close to 25% and a multiple of 6 is about a 15% discount rate. You will also see that future values count more towards the NPV with lower discount rates. Thus a 50% discount rate heavily penalizes incomes beyond 6 years in the future whereas a 15% discount rate still has a reasonably positive effect on the NPV out as far as 15 years.

Armed with this new insight, the business owner has much greater influence over how value can be impacted. Clearly the discount rate, a means of accounting for risk in the venture, can be reduced by taking risks out of the business. Thus good internal systems, good governance, increased competitive advantage, customer loyalty, recurring revenue and account penetration as well as decreased turnover of employees, suppliers and customers will reduce the discount rate. Bring the discount rate down from 50% to 15% and you will improve the valuation by a factor of three.

At the same time, you also need to improve the visibility and reliability of future earnings since more distant earnings now contribute positively towards the valuation. Longer term customer contracts, more stable revenue patterns, increased recurring revenue and customer loyalty will all help improve the reliability of longer term forecasts.

And don't forget growth. A 10% cumulative growth will double your valuation while 20% cumulative growth will increase valuations by five. Try doing some of these calculations – you will be amazed at what you learn about how to improve your business value.

GROWTH

How does growth factor into the EBIT multiple?

Most industries have a valuation norm expressed as an EBIT multiple. While some specialized niche sectors might replace this with a value per account or multiple of revenue, these are only surrogates for the conventional EBIT method. Most experienced business owners who are sensitive to business sales within their sector will normally be able to tell you what the valuation norm is within their own industry but few can explain why a specific multiple is used.

When I have asked groups of entrepreneurs to explain why their sector has a specific multiple they will normally cite industry risks, product life cycles, economic conditions and industry volatility. Basically they don't know why and can only guess. Much like getting a valuation on a house, the business advisors look to comparables within the sector to establish the norm.

However, when I ask them to state how they would move the multiple up, say, from four to six times EBIT, most of them will say that they need to grow faster. But how much faster? Generally they don't have any feeling for the impact of low or high growth on the multiple – just that it will help.

An EBIT multiple is really a reflection of an underlying net present value calculation where future net earnings are discounted by a discount rate to gain a value for the initial investment. Thus a four times EBIT is a close approximation for a 25% discount rate. If you use the NPV method to derive your valuation, the impact of growth can be calculated with some accuracy.

Buy simulating a 10% cumulative growth (year on year growth of 10% in net earnings) you can show that the valuation will double. If you try a 20% cumulative growth rate, the valuation will increase by a factor of FIVE. Growth has a huge impact on valuation but is normally underrepresented in conventional valuation processes because buyers, sellers and business brokers are unsophisticated when it comes to valuation theory. Of course, even if you understand how to do these calculations, you may have difficulty convincing both your advisor and your buyer. If you are able to demonstrate significant growth, you need to work with a more sophisticated advisor, one who is used to working with larger, more complex deals which often use NPV to derive valuations. Then you will need to find more sophisticated buyers who can appreciate the underlying commercial impact of such high growth rates on their investment returns.

In order to get paid the higher multiple you will need to be able to demonstrate sustainability of the high growth rates but if you have a well established competitive advantage, a well defined capacity in your channel to market and a good historical track record, you will have a good case.

Even if you are only able to show evidence of forward growth for a few years in the future, that alone will kick up your valuation. At the end of the day it is all about the evidence you produce, the reliability of the forecasts and the probability that your buyer can achieve the growth projections.

BUSINESS CONCEPT

What business concept is needed to sell?

"You have to be able to prove your business model to get the highest price for your business!" How many times have you heard that and what does it mean? The underlying message is that value is created in a business if the business can demonstrate its ability to generate revenue and profits. A valuation can then be derived by projecting revenue and profit trends and calculating a net present value for them. If the underlying business model is weak, unproven or volatile, the projections themselves will be heavily discounted and a much lower valuation will result.

There is a good bit of truth in this advice providing of course that what you intend to sell the business you are managing today to someone who will continue to manage it the same way and in the same product/market environment. However, there is a fundamental assumption at work here which is that the future will be the same as the past. We can make significant changes to our business valuation if we change this statement to; "Your business will have the highest valuation if it has a business model which can best exploit its potential". What if instead of me trying to create the right business model, I seek to insert my business into the right business model through finding the right buyer.

Too often we are caught up in trying to do everything ourselves instead of taking advantage of what others before us have already created. For example, I can connect into a large customer base through a strategic partnership instead of building my own channel to market. I could buy in critical technology rather than building my own. I could build a virtual business by outsourcing those things I don't do well and concentrating on those things which are core to my competitive advantage.

What I have to demonstrate to a potential buyer is that they will have the ideal business model to exploit my potential not that I already have it. The future of the business will be created by them and not me. Thus their capabilities and capacities are critical in exploiting the business. If they are able to remove constraints to my business model – I will have created the ideal business model through the sale.

You can see this happening in the biotechnology sector. Many drug discovery and development firms do not have sales channels. Instead of pursuing revenue they concentrate on R&D to create something which would be attractive to the large pharmaceutical companies. When they have a drug at the right development level, they sell out to a business which has the capability and capacity to take it to market. It is the business model of the pharmaceutical company which is critical to ultimate revenue generation, not that of the R&D firm.

When you sell a business, you need to seek out a corporation who can best exploit the potential in the business. At that point, your business model may not be relevant.

EARNOUTS

Should I agree an earnout?

Earnouts are normally used to overcome the gap between what the vendor thinks the business is worth due to its future potential and what the buyer feels is a reasonable price for the future earnings which the buyer can reasonably expect. Sometimes it is simply optimism on the part of the vendor however there are often situations where the buyer is willing to pay more if future events or outcomes validate the vendor's projections. Working out the basis of such an earnout is however very problematic.

An earnout is often settled upon where the vendor is not prepared to sell at the firm price offered by the buyer and the buyer is unwilling to walk away from the deal. The buyer will argue that just because the vendor thinks the business will generate higher profits in the future is not sufficient in itself to justify a higher acquisition price. The vendor, on the other hand, will try to show why the higher future earnings can be expected to materialize. In order to conclude a deal both parties agree that the buyer will pay an additional amount based on some agreed schedule of events occurring and/or on the basis of some agreed achievement of revenue, earnings or performance. The work involved in meting agreed targets can be performed by the vendor alone, by both parties, by the buyer alone or even by an external party.

Earnouts are most often based on earnings or some combination of revenue, gross or net margins and budget. The difficulty experienced in meeting earnout conditions are numerous. The buyer may hinder the vendor by limiting resources, by interfering, by changing strategy or failing to provide adequate support. The vendor my manipulate expenses, revenue and resources to achieve the targets and in doing so breach the agreement or disrupt the future of the business. External events may hinder progress or the vendor may be incapacitated in some way from putting in the effort required. Concentration on the earnout over an extended period may frustrate the buyer from achieving progress in a situation where business conditions have changed but the earnout conditions are not able to reflect changing priorities.

The most workable earnout agreements are those where neither the vendor nor the buyer have a significant effect over the outcome of a target event. Where items in progress are destined for final decisions, such as a large contract, grant of rights or a license, these may be determined without much intervention by either party but may have a significant effect on the future potential of the business. In such circumstances both parties may be wiling to agree an additional sale value component to the vendor. Where significant effort is required by either or both parties to achieve the performance or event targets, the earnout is likely to end in dispute or being renegotiated due to unforeseen circumstances.

Where possible the vendor should try to avoid an earnout situation or at least put it on a basis where the buyer has little influence and where the outcomes are not subject to interpretation.

PAYMENT

Shares or cash – which is best?

In many acquisition situations the buyer states in what form the consideration will be made. Generally, high growth corporations like to use their shares as these are often at a high earnings multiple. The disadvantage for the acquirer is that the issue of new shares will dilute the existing shareholder's equity. The alternative of using cash is preferred if the buyer is cashed up with surplus cash but few high growth businesses are in this lucky position. In some cases, the buyer will be somewhat indifferent to the method of payment and will allow the vendor to choose. Leaving aside tax issues which can sometimes have a material effect due to the timing of when a capital gain might be realized, the choice may depend on the vendor's objectives in selling out and their view of the likely price direction of the buyer's hares.

It is fairly rare for a vendor to take an unlisted share as consideration although it does happen where a consolidation strategy is being undertaken with the aim of listing or selling the larger entity. Few vendors would, however, be willing to end up as a minority shareholder in an unlisted business. Not only do they not liquidate the value in their business but they end up losing effective control of what happens to that wealth in the larger entity.

Cash may be a preferred option where the vendor has little expectation of a share price increase of the buyer's shares or where the vendor has an alternative use of the funds. Entrepreneurs often will sell a business in order to develop, acquire or start another. Having immediate access to the cash proceeds from a sale may be more important than taking a chance on an upside in the acquirer's fortunes. Even where the vendor had no immediate use of the cash, they may prefer to spread their investments rather than tie their sale proceeds up in shares of the acquirer.

On the other hand, the vendor might consider that shares in the acquirer have a greater potential than a retail fund. If the acquirer has a significant public listing then the vendor can always sell down later if he or she changes their mind. One trap to watch out for is when the entrepreneur joins the corporation and is then locked in with blackout periods or possibilities of insider trading if the shares start to fall. The vendor could end up not being able to sell shares and watch the new found wealth slide away.

Some vendors take a diversified approach. They take part consideration in cash allowing them to have ready access to cash to improve their lifestyle and perhaps to invest in a new venture. Some proceeds might then be invested in an investment portfolio to spread their risks. The remaining part might be left in shares in the acquirer where the vendor anticipates a significant increase in price.

Where the vendor already has significant wealth, taking a risk on the acquirer's shares may not be overly important; however, if this is the major investment of the entrepreneur, then serious consideration needs to be given to securing the benefits of selling out. There is little point in swapping one risky investment for another,

FIRESALE

What happens if I get into serious trouble and have to sell?

Few businesses can guarantee that they will never get into trouble. Early stage companies frequently fail in the first few years but even large corporations have been known to disappear. Look at the household names which failed – Enron, Ansett, Worldcom, HIH and so on. Of course, if you do get into serious trouble then just getting enough cash in the door to cover payroll can be a challenge. At the same time, staff will be deserting, suppliers will be hounding you for payment and you will be chasing customers. Not a great time to start thinking about selling out.

The truth is that many companies end up on the auction block at the worst possible time, sometimes due to their own failures but often just because external events went against them. Whether it was a change in industry regulations requiring a major investment, a new aggressive competitor or a natural disaster, there are many events and circumstances which can derail a business. Planning for such an eventuality should consider the possibility that the business should be sold to recover as much of its value as possible.

However, it is very difficult to sell a business when the business itself is under pressure. The executives will be busy fighting fires and there will not be time to identify and court prospective buyers or time to engage the best advisors. Clearly, if you haven't put the time in to develop a robust exit strategy for this set of circumstances, you will have left it too late to be anything but a fire sale.

Value in a business is related to its potential in the hands of the buyer, thus even a business heading for insolvency can be a great acquisition for a buyer who is not constrained by the situation facing the vendor. The key to a quick sale, which still gains a premium on sale even when the business is in trouble, is to have identified in advance those buyers who can develop the underlying potential in the business. The entrepreneur should set out to identify a small group of such buyers, engineer a situation where those prospective buyers are informed of the potential in the business and then kept up-to-date with the progress of the business over time. The aim of the entrepreneur should be to have each prospective buyer understand what they could gain from an acquisition when the entrepreneur wishes to sell.

Of course, in the unfortunate situation where the entrepreneur is forced to sell, it would be much better if he or she could quickly bring into a competitive bid a number of prospective buyers who were already apprised of the potential of an acquisition. The competitive bid process should then protect as much of the value in the business as possible.

As part of the preparation for such an event, even if unlikely, the business needs to be put on a basis where the buyer can quickly undertake due diligence. This means that the business has to be fully prepared for such an investigation. If the entrepreneur has also ensured that the business is run effectively and efficiently and has few risks for the buyer, the due diligence process will conclude quickly and the buyer will be more willing to negotiate a deal.

EMPLOYEES

Employee upside

Have you ever considered that your employees may be better off if you sold the business. I don't just mean that they might cash in their equity or options or get a bonus on the sale, but that they may actually have better employment prospects with the buyer. This should not come as a surprise since most small and medium sized growth businesses are bought by larger corporations who can offer better career prospects and, often, better pay and conditions.

Most smaller firms pay less and offer less generous conditions than large corporations. While they have a greater intimacy about them and perhaps a more 'family' feel, smaller businesses typically do not offer the generous level of fringe benefits, maternity leave, health benefits and holiday and sickness entitlements as large corporations. When it comes to career development and benefits like educational entitlements, skills development, professional training and job rotation, the gap is even wider. Thus a transition to a larger company through an acquisition can actually benefit many employees, something that should not be overlooked in the sale preparation.

While change is always problematic in the sale of a business, it could be given a positive spin if the seller sets out to find a buyer who can enhance career prospects for employees. In fact, this will often be the best outcome for the selling shareholders. If the value of the acquisition investment is dependant on key employees transitioning to the new owner, then both parties will be keen to ensure that there is a good match and that employees will look positively on the change of ownership.

Such benefits can be sold to employees during the sale process. If a key objective of the sale preparation is to find a buyer who can exploit the future potential of the business and that potential can only be realized through active participation by current employees, then it follows that finding the right buyer is critical. It follows that such a buyer would be attractive to current employees. If they can anticipate better employment conditions and improved career prospects, the chances of them supporting the sale process are considerably enhanced. All parties win.

Most M&A research shows that the loss of acquired management and key employees in the nine month after the sale is very high. If you as the seller are trying to improve your sale value by emphasizing the future potential of the business, then you need to ensure that those employees who have to execute on that potential stay long enough with you and the new owner to do so. Only by showing them that they will do better off through the process than leaving for another job, will you be able to deliver on that objective. Thus finding a buyer who can demonstrate improved employment prospects is critical to you being able to achieve a higher sale price.

You need to always keep in mind that an acquisition investment represents what the buyer expects to achieve in the future not what you have achieved in the past. Thus creating a platform which will enable the buyer to achieve their objectives in the only way to gain a sale price premium. Your employees who transition to the new owner are critical in that activity, thus looking after them before and after the sale makes ethical and financial sense.

NEW OWNERS

Entrepreneur in transition

The goal of most entrepreneurs is to sell their business but few seriously consider life after the sale especially where it involves working for the acquirer. While most buyers see the business knowledge and personal connections to customers, suppliers and employees as an asset worth holding onto, they also recognize that the new environment in which the business exists may be incompatible with the motivations and desires of the former owner. Yet for some entrepreneurs the move to a larger business entity opens up new possibilities and new challenges. Understanding what motivates you, what you are good at and where you will find satisfaction is an important consideration in deciding how to prepare for the sale and for deciding how to approach the decision of whether to seek employment with the buyer or not.

The typical scenario of a trade sale is a small entrepreneurial firm being acquired by a public corporation because it has assets or capabilities which the larger entity can leverage due to its access to funding, large customer base or distribution channels. However, in order to exploit the potential in the acquisition, the business entity needs to be assimilated into the organization structure of the large entity. In the process, the former firm will most often be subject to new reporting lines, new bosses and a more hierarchical way of making decisions. The entrepreneur will find that decision making takes longer, they can no longer do as they want and they now have someone that they answer to. Their time is now taken up with committees, filling in forms and trying to get things done in months which before was done in days. It is not surprising that many entrepreneurs leave soon after the takeover.

On the other hand, some entrepreneurs enjoy the ability to make things happen inside a larger business where more resources are potentially available for product development, market penetration and good innovative ideas. Instead of being endlessly frustrated at not being able to see their dreams come alive, they now have the opportunity to use the power of the larger business to get things done. They might also see a promising career managing larger business units than what they could have built in their previous venture. At the same time, their salary and other benefits may be much better than what they were able to afford in their own firm.

There is often such a relief at being able to cash up and to be relieved of the burden of meeting the monthly payroll, that the entrepreneur may too readily accept an offer to stay with the acquirer without seriously considering whether this move is the right one for them psychologically. The move from owner/manager to mid-level employee is dramatic and should not be undertaken without some serious consideration of what you are good at, what you enjoy and how you are going to maintain self esteem in the new role. Moving from day to day total authority over a few staff to being a middle manager in a large corporation is a bit like moving from a rural village to the center of a large city. Everything around you is different and not everyone can or should make the transition.

You might first consider what roles you are good at and what role the corporation wants you to play. Few people can make an effective contribution in more than one role. Dr Nita Cherry, Professor of Organisation and Leadership at the Australian Graduate School of Entrepreneurship argues that the entrepreneur in transition needs to match one of the following roles:

- Management of key external relationships
- Development of key business strategy
- Acquiring and maintaining the core capabilities of the business; or
- Leading or encouraging innovation

"If the role selected by the corporation does not match both the capabilities and aptitude of the entrepreneur, the likely result will be reduced self esteem through a sense of failure, frustration in being in the wrong position and probably a fall in productivity of the business unit. Unless the entrepreneur is willing to speak out and negotiate a better fit for themselves, they will soon leave"

Acquiring corporations are knowledgeable about the frequent early departure of entrepreneurs. Rather than avoid this issue the entrepreneur should be prepared to bring this out in the purchase discussions. How can you assure the buyer that the benefits of the acquisition can be extracted whether you stay or go? Are you the type of person that would be happy working with a larger company where you would be reporting to a senior manager and would not have the same freedom of decision making you have now? How would you feel about being dependent on people (that you didn't recruit) to achieve results that you will be held accountable for? What role could you be most effective at in the buyer's organisation and what roles would you be least effective in? Finally, where do you want to be in 3, 5 and 10 years and would working for the buyer help you achieve your personal objectives?

Buyers are very wary when it comes to employing former owners. If you want to work for the acquirer, then knowing what would work for you, aligning that to what you are good at and being able to honestly present the case, may make a big difference to whether you are offered a future role in the merged company.

PART B: STRATEGY

An outstanding exit value does not happen by accident and nor should you be planning on HOPE to be your strategy. It takes time and it takes resources but there is nothing to say that implementing a good sale strategy should not also be good for the current business. Reducing risk, improving profits, enhancing growth and looking for ways to improve the business will add great value to the current business as well as set the stage for a good exit.

It takes time to put a good exit strategy together - plan on 2 years to the sale and you will give yourself the time to implement the strategy properly. Plan on involving mangers and key employees as well as external advisors and professional services. This is not something which should be done on a shoestring - too much of your future depends on getting this transaction right.

WHY SHOULD I SELL

Continue the business or sell

Most business owners accept the fact that they will sell their business sometime, usually in the distant future when they plan to retire. Some anticipate passing the business down to children while others plan to sell it to their managers and employees. However, there are some very good reasons why selling out now might be a better option.

Firstly, consider the risk of the business getting into difficulty and being forced to sell out and receiving much less than what the business is worth right now. Can it happen to you – certainly! The rate of failure of early stage ventures is quite high, estimated to be around 50% in the first 6 years. Even older businesses still have a 2% failure rate. If large businesses like Ansett, Enron, Worldcom, Arthur Anderson, HIH and other large well established corporations can go under, what makes you think you cannot?

If you were like me, then you may have the greater part of your wealth tied up in your business. When my business started making losses during a recession, I recognized that it could easily be sold out from under me and I would end with very little for the risks I had taken, the low salary I had received for many years during it early stages and the long hours I had put in. Sometimes you need to capture the wealth in your business so that you get the rewards for those efforts. If you are any good at what you do, you can always start another one or buy a small business and develop it and make the money all over again.

Then consider whether your business is the best place for your hard earned wealth. Even if you are taking $200,000 a year out of it in income, what could you sell it for and continue working? Say you could get $2 million after tax for your business and you could continue working as an employee for $80,000. While you are worse off by, say, $70,000 net, you would need to keep your business for another 20 years to be as well off. But of course you now have $2 million to invest which could be invested across a range of investments and provide a very secure future for yourself and your family.

Family businesses have their own dynamics but few founders fail to educate their children to be better educated than themselves. Thus their children end up being dentists, doctors, lawyers and so on. Many don't wish to go into the business of their parents or want to go into a new technology business, a very different proposition to the old technology business of the parents. The founder should seriously think of selling out all or part of the original business in order to create an investment fund for new business ventures which tap into the passions of the next generation.

Successful entrepreneurs are capable of developing several ventures throughout their working lives. No doubt some will be more successful than others. Seriously consider whether it is time to take some money off the table from your current venture and then have a go at the next one. In this way you will have put some wealth aside for your future and taken considerable risk out of your life. You might even find that the next one is much more successful than your current one.

WHEN TO SELL

What is the right time to sell my business?

I am often asked ‘When should I sell my business?”. Usually they want me to give them some highly professional, probably, theoretically reason based on the state of the share market and their industry. Almost as if I could predict what the Reserve Bank is likely to do in two years time. While I am sure there are advisors out there who would be willing to speculate on such an alignment of stars and planets, I have come to the conclusion that selling a business is more to do with the interests and motivations of the entrepreneur than the state of the business.

Assuming that the business is making a profit and growing and has reasonable potential, when should you sell? One would hope that the value in the business is growing with increased profits, however, value in a business need not be based on profits. For example, when you sell based on strategic value, the value is determined by what a large corporation can extract from your underlying assets and capabilities rather than on your current or potential profits. Thus your current revenue, profits, staff numbers and customer base may be irrelevant in terms of extracting the premium price. In fact, value may be lost by getting bigger or delaying the sale.

On the other hand, a conventional business does generate value through increased profits, but the right buyer who can exploit the business much better than the current owners may be willing to pay well beyond conventional EBIT multiple to have that opportunity. It might be better to sell now to someone who can better exploit it than you.

Also clearly the future cannot always be predicted with any accuracy. Look at the likes of Ansett Airlines, Enron, Arthur Anderson and so on. Who would have predicted their demise?

Instead focus on your own motivations and potential. Is this the right business for you or should you put your effort into a different business? Could someone else take your business to a new level thus providing a better workplace for your employees? Do you have passion for a different type of business? Are you physically and mentally able to continue with the business or would you be better off getting out of this one and reshaping your life?

Ask the personal questions first. What do you want to do with your life and is the business giving you what you want? Would you enjoy life better if you took the money and did something else? Where is your passion and your interest and are you following that in your business?

Business for entrepreneurs is their life. Find a business which you have a passion for and then spend your time there – don't waste your life and your passion where you don't have fun.

WINDOW DRESSING

Why not just do some window dressing

Most business owners leave preparing their businesses for sale far too late to do any serious changes. Generally they decide that they wish to sell out and it becomes an imperative that they do it as quick as possible. If you think about this a little, you can readily understand why selling quickly is foremost in their minds. For many years they have been working diligently in the business and their efforts has been focused on the future of the business, now, all of a sudden, their focus is on life after the business and their willingness to put the same energy into the business reduces – thus the quicker the sale the better.

Suddenly faced with the prospect of selling, they quickly realise that they really should have spent some time increasing the profits so that the valuation on sale would be higher. This is almost certainly based on their expectation that their business will be sold for some multiple of earnings and that the earnings number will be, most likely, the most recent full year result or some variation on it. With this in mind, they quickly try to find ways of reducing costs as increasing revenues rapidly is generally not possible. As they search around for costs to reduce they imagine that they can take some infrastructure costs out of the business which won't have an immediate effect on revenue generation. This often leads to cutting back on advertising, marketing expenses, research and development, delaying equipment replacement, deferring maintenance of plant and so on. This window dressing takes costs out of the business and immediately improves the bottom line. They now feel ready to put the business on the market and feel confident that the increased profits will gain them an extra kick up in the valuation.

This could not be further from the truth. In fact, what they are doing is rolling the dice on whether a smart or a dumb buyer comes through the door. If they are really unlucky, only the smart ones will be interested. However, smart buyers know these tricks as well and they will diligently go about looking for such adjustments. Smart buyers are looking for sustainable profits. As soon as they see window dressing cost cutting they will simply add back the expenses to get a better view of the long term profitability. However, they will also probably increase their assessment of the risk in the business predicting that they may not have found everything and that the business may need additional investment or time to bring it up to the estimated profits. The increase in risk reduces the earnings multiple thus further reducing the value of the business. The window dressing which the seller had undertaken to improve valuation has now reduced the valuation below that which the seller could have achieved before the cost cutting occurred.

If you want to protect the value of your business on sale make sure the buyer only sees changes in the business which improves the long term profit potential.

IMPLEMENTATION

Can you implement the strategy?

Selling a business is in many ways the same process that all entrepreneurs use to sell a product or service. You design and manufacture your product to meet a need with a specific problem or customer in mind. Mindful of the value of getting it right first time and ensuring you protect yourself against any negligence claims, you set out to ensure your product is 'fit for purpose' and of 'merchantable quality'. Basically this is the essence of creating a profitable, resilient business. You ensure there is a match between a quality product and the right customer. It is getting that match right that enables you to charge the highest price for your product or service. Selling a business is exactly the same, only you only do it once!

What this means is that you already have the basic understanding of how to create value in your business for a buyer. This is what you do – now just do it for your business. But what if you are not conversant with the legal and financial rules governing selling a business or you feel unable to deal with the selling process itself. Not everyone has the desire, capability or capacity, or even personality, to undertake the selling process. What do you do then – just hand it over to a business broker?

Whatever you do, don't hand over your lifetimes work to someone who doesn't understand your business. By all means use external service providers to assist with legal and accounting advice and professionals to help with other aspects of contacting buyers and negotiating the deal but ensure that you stay in control. Almost without question, you will be the best person to understand the risks in your business, where value is created through your products and services and where the potential in your business lies. That being the case, you are also the best person to articulate who the best buyer is. That is, what would the buyer look like that had the right capability and capacity to best operate and exploit your business potential. It is the buyer who can do this who is most likely to offer the highest price for your business.

It is also the entrepreneur who can best identify such buyers, contact them and build a relationship with them and it is the entrepreneur who is the best person to explain the potential in the business to a prospective buyer. You should start with this strategy as the ideal process for achieving the highest price and then work from there to resolve impediments, shortage of resources to undertake the process or a lack of skill or confidence to undertake the tasks involved. These can be outsourced or delegated providing that the overall process is still managed by the entrepreneur.

Handing over the sales process to someone who will do it on commission is unlikely to get you the best result. There is considerable embedded knowledge of the firm, its capabilities and its potential that needs to be harnessed to select the best buyer and to ensure the buyer appreciates the underlying value and potential in the firm. You need to ensure that whatever process you follow to sell the firm capitalizes on that knowledge. Generally the best way is for the business owner to be central to the entire process.

BUSINESS ADVISORS

Should I be using a Business Advisor?

The three critical things you need to do to maximize your sale price are to reduce the inherent risks within the current business, make it easy for new ownership to be established and enable the buyer to exploit the potential of the business. If you don't think you have the knowledge, time or motivation to undertake the changes to your business to optimize those three characteristics, then you might think seriously about bringing in a business advisor to help you.

Business advisors come in many different flavors so take your time in selecting one who has the appropriate experience, especially within your industry. It makes sense to work with one who has experience in selling and acquiring businesses, even better if they have had success in selling a business to a large corporation for a premium. Undertake some due diligence on their prior clients and check that they really did contribute to the improvements they cite.

Fundamental to positioning the business for sale is to ensure that the underlying business is managed efficiently and effectively and that this is done is such a way that it produces documentary evidence to show that is the case. Thus good internal management reporting systems, performance setting and monitoring systems and a quality assurance system are important aspects of a well run business. Ask your business advisor for advice and assistance on implementing broad based systems across these aspects of management. You might also undertake a vendor due diligence to provide a checklist of things which need to be fixed or improved. The objective is to convince the buyer that the business is relatively free from risk and is able to be transitioned easily to new ownership, especially without the presence of the former owner.

A buyer does not want to spend time and money cleaning up a business after the sale. Any problems or delays which are incurred after the purchase simply delay the time until when the business potential can be exploited. The longer the delay and the higher the costs to stabilize the business, the lower the current value of the business to the buyer.

Ask your business advisor to help you construct various scenarios for how the business could grow or develop so that you can project how a well funded buyer might develop the business. Once you understand where the growth opportunities are, spend some time considering how the business might be restructured or repositioned to provide a better platform for such development. The business advisor would be able to assist with growth scenarios as well as with the systems, processes and organizational changes needed to provide a better platform for future growth.

Smart sellers reach out to get the best advice and assistance they can in preparing their business for sale. If you estimate that you might be able to, at least, double your sale price by better structuring and positioning your business, then spending money on an experienced business advisor to achieve that outcome should be a good investment. In the interim period, you should achieve a more profitable and resilient business.

PROFESSIONAL ADVISORS

Should I be using a business broker, professional advisor on investment bank?

While every entrepreneur knows how to properly package a product or service to achieve a profitable sale, few would claim that they have the same competence when it comes to selling a business. The fact of the matter is that selling a business is a specialist activity with its own set of legal and accounting issues and this is one area where experience does count. That being said, the entrepreneur knows his business and should understand better than anyone where it has growth potential, the basis for a higher sale price.

Should you use a business broker or investment banker to help sell your business? The answer really depends on how well you understand the process of selling a business, whether you already have willing buyers in your sights and whether you have prepared the business for sale. If you are unsure about how you should prepare your business in order to achieve the best offer, or if you are uncertain how to attract the right buyers, then getting help from professionals who undertake those tasks on a regular basis makes sense. Even an experienced entrepreneur who has sold several businesses might like to have an advisor in his team to assist in the negotiations. There is considerable benefit in having an objective, knowledgeable person on your team to provide feedback, suggestions and to keep the negotiations process moving forward.

The key to the use of such professionals is, however, to use them to assist the entrepreneur in the process, not to take control. Too often business owners have allowed professionals to control the process and the negotiations not recognizing that their primary motivation is the commission on a quick sale. The entrepreneur who understands his or her business well and spends time identifying and connecting to the best potential buyers, will generally achieve a much better price for the business. The best buyers will be those individuals or corporations who can best exploit the potential in the business. Positioning the business with these potential buyers and preparing the business so that it can support such potential is best undertaken by the entrepreneur. It also takes time and thus cannot be undertaken properly if the business is rushed into a sale.

At the same time that the entrepreneur is preparing the business for sale and positioning it with potential buyers, professional legal and accounting firms need to be appointed to assist with both preparation and sale transaction support. Better sale prices are achieved where business risk for the buyer is minimized. This process often requires the business to undergo a vendor due diligence as part of the preparation process. By proactively undertaking their own due diligence review, the entrepreneur can discover risks in their business which can be addressed long before a potential buyer turns up. Not only does such an activity improve the current business but it significantly reduces buyer due diligence costs and time during contract negotiations. A business which is well prepared for buyer handover will attract better buyers and a better sale price.

The smart entrepreneur gets good advice and smart people to support the sale process. The result usually is a much better price.

PRIVATE EQUITY INJECTION

Is it worth getting an external investment to prepare my business for sale?

More often than not, the business which you should be selling is not the business you are currently managing. Why is this? Simply because the business you are managing may not be the business which offers the buyer the best potential for future profit. Your business is built around you; your knowledge, skills, networks and resources. The business which the buyer will manage will be built around their knowledge, skills, networks and resources. The objective in selling a business is to find an individual or a corporation who can gain more out of the business than you can.

Many businesses have untapped potential or can be better managed and exploited in the hands of better resourced or more knowledgeable buyers. There is nothing wrong with recognizing that and using that potential to leverage a higher price. However, premiums are normally paid where buyers can quickly execute on growth potential in the business. This means that the business itself has to structure itself to enable such growth potential to be rapidly exploited.

Entrepreneurs tend to forget that the value of an investment comes from what it can earn in the future, not what it earned in the past. Thus a new owner who can gain a greater return out of the business is likely to value the business more because of its higher potential in their hands. In a strategic sale, the whole basis of the sale depends on finding a large corporate buyer who can exploit the underlying assets or capabilities of the acquired business to drive large scale revenue. The reason why large corporations often pay a strategic premium is because they recognize that they can release untapped potential from the business by connecting it with their own large customer base.

The maximum value of sale is thus achieved by identifying those buyers who can best maximize the underlying potential in the business. The current owner maximizes the sale price by preparing the business so that those buyers can aggressively exploit its potential. However, the business today may not be structured appropriately to maximize the sale price in such a deal. Often a business needs changes in its organization structure and/or in its products to best position itself for maximum sale price. For example, parts of the business may be making a loss and need to be closed down. The company may have patents filed in one country but not in others. Deep expertise may form the basis of the business's competitive advantage but may not have been documented. The business may need to be broken up into several businesses to find the best buyers for the individual parts.

If the anticipated increase in final sale price due to restructuring or preparing the business for sale is significant, it is worth bringing new equity investment into the business to allow the business to undertake the changes. Such investment can provide funding for restructuring, preparing for due diligence, identifying and building relationships with premium buyers and for professional services firms to support the transaction.

INCREASE PROFITABILITY

How do I go about increasing my EBIT multiple?

You can be forgiven for thinking that the determination of what multiple you might get for your business is more art than science. Just remember that business broking grew out of the real estate industry where comparables is the name of the game. Just compare your business to the last few which were sold and you can pick the multiple. Did I just hear you say ‘But my business is different! Unfortunately, this is a judgment call and you don’t get to participate.

I have conducted seminars where I have asked all the entrepreneurs to tell me the multiple norm for their industry. Usually this will vary from 2 to 8. When asked ‘why?’ they will cite industry volatility, product life cycles and common practice. Not a lot of science! When asked how they can increase their multiples, they have all talked about growth. How much? Well more, but they were unable to provide any substance or calculations.

The problem with the EBIT multiple approach is that we start with the wrong assumptions. Businesses rarely look the same or have the same risk, capability and capacity profiles. The fatal flaw in all this logic is that the buyer is not buying history, they are buying futures. It is not what the business has achieved which is relevant to the calculation of value but what it can generate in the future, possibly under different management which often comes with different capabilities and capacities. Thus it is not comparables you need to be considering, it is the ability of your buyer to properly exploit the potential in the business.

The EBIT multiple is simply a surrogate for a Net Present Value (NPV) calculation which involves discounting future net earnings using a risk discount rate. For example; 6 x EBIT is close to a 15% discount rate. Reduce risk in the business and you reduce the discount rate and increase the NPV. You have just increased your multiple. Similarly, we can use an NPV formula to calculate the impact on valuation of different growth rates. A 10% compound growth rate will double the NPV while a 20% growth rate will increase it by a factor of 5. Now we have science and not art! Imagine going from 6 x EBIT to 30 x EBIT. Is it possible to achieve such sale values? – of course, but only if you have the evidence to support your case.

You need to move your valuation discussion from EBIT multiple to NPV. However, be prepared for some robust discussion because you are going to have to substantiate your future revenue and profit projections. Preparing a business for sale is more than just cleaning up the business. You need to structure your business and its product /market positioning and customer relationships so that future revenues and more predictable, especially if you want to demonstrate high growth rates. But if you can move from a six multiple to a 30 multiple, the extra effort in structuring the business to clearly demonstrate future revenue and net earnings growth will certainly be well rewarded.

NOT FOR SALE

I am not for sale!

If you are interested in selling your business but you fear that competitors will take advantage of the pre-sale time to raid your employees and customers, you might be reluctant to begin the journey. However, at some point it time you need to bite the bullet and get your business sold, but what if you could do this by soliciting an offer while projecting the image that you are not for sale.

Many business owners have insufficient competitive advantage to withstand a determined attack from a close competitor. A small chink in the amour might be sufficient for an aggressive competitor to undermine the sales message or create uncertainty in the minds of employees. A prospective customer evaluating alternative products might hesitate to buy from a business up for sale as they may have concerns about continuing supply and support. In a similar manner, current employees might be concerned about their future with the company if they hear that there could be an ownership change. This is very fertile ground for a competitor seeking to poach good staff. The business owner is now trapped. Any move they make to sell their business could disrupt their business, reduce their current sales and profits and thus damage their sale price.

There are a number of possible approaches to this impasse. Firstly, the business owner should indicate consistently over time that they would always be willing to discuss the purchase of the business to a corporation that had the capability and capacity to develop the business more than the current owners. If the new owner could better support the customers and provide better career paths for the employees, then this would be a good solution for both customers and staff. Such a message is more likely to have a positive than a negative impact on the market.

Another approach is to develop relationships with all the major potential buyers so that an open discussion of the trading environment can take place. Companies working in the same market often have a lot of issues and challenges in common and these can be used as a basis for sharing information. During these conversations, the business owner should take the opportunity to point out how and where their competitive advantage lies and in what way the businesses compliment each other rather than compete. Where possible the owner should seek opportunities to work together on joint bids to show how the combined entity gains revenue. What is being demonstrated is what the competitor or partner could gain through an acquisition.

While maintaining that the business is not for sale, the owner might also suggest other ventures they might pursue or personal situations which are demanding more of their time. The objective of this strategy is to demonstrate how an acquisition would benefit the buyer as well as to stimulate an offer. While the offer can always be rejected, it is far better to have offers coming than to have to go cap in hand looking for a buyer.

CAPABILITY

Do you have the capability?

Very few business owners have ever sold a business and only a few have ever sold more than one. Over my 20 years as an active entrepreneur, I sold four business and acquired two. What is very clear in hindsight is that you get better at the task as you gain experience. If, however, this is your one chance to walk away with a considerable retirement fund, perhaps this is not the time to learn on the job. You might then ask yourself just how much you know about the process and whether you have enough knowledge to get the best result.

In one research project I participated in, we interviewed a number of serial entrepreneurs to ascertain how they had approached the sale of their various ventures. Almost without exception, their early deals were sold to medium sized companies on EBIT multiples while their last deals were sold to large corporations on strategic value. They all achieved significant increases in their investment returns as they developed knowledge of the sale process. Having been through the process a couple of times, they were much more sensitive about having their businesses ready for sale, identifying the potential buyers well in advance and ensuring that their potential buyers understood the value for them in a possible acquisition.

What you need to do to maximize your sale price is to tap into this wealth of knowledge and, unless you have the personal experience, you should be looking to find advisors who do. You need to seek out those lawyers, accountants, investment bankers and business brokers who have good M&A experience in your industry but who also have experience selling your size and type of business. Once you have them on board you will be able to tap into years of deal experience so that you can best position and prepare your business for sale.

However, not everything can be outsourced or at least done so effectively. To improve your sale outcome, someone needs to identify and build relationships with potential buyers. This takes both time and inclination. Not every business owner is comfortable opening doors to potential buyers to sell the merits of their business, especially if the are large corporations. Also, not everyone likes the travel associated with getting to know the potential buyers, especially if they are overseas in a different culture.

It is very important that the business owner familiarize themselves with the best approach to selling their business and decides what they have the personality and capability to undertake themselves. With this determined, they can then discuss with their advisors who can best undertake the remaining activities and how those responsibilities should be rewarded. If a working knowledge of the business is important, the business owner might look inside the business to find someone capable of taking on some of the tasks. Alternatively, they might recruit someone to come into the business who could take on some of the responsibilities once they have a working knowledge of the business.

It is very important that the business owner undertake a realistic assessment of their own capabilities in selling the business. It would be a great pity if the best price was not obtained simply though an unwillingness to admit that they were not the ideal person to undertake the entire sale activity.

ALL OR NOTHING

Do I have the sell the whole business?

Many business owners only think of selling the whole business without considering whether it could be sold off in parts. In fact, the total sale proceeds may be significantly more if the business is sold in stages. Not only will selling off over time potentially make more money for the shareholders, it can be a very useful way of restructuring or refocusing the business.

A lot of businesses grow in an unstructured manner. Investments are often made over time to suit the personal interests of the owners or to solve temporary problems. Often those investments end up with a life of their own and develop into significant parts of the business. Many family businesses grow this way and end up spread across a range of activities which are sometimes only loosely integrated. In fact, when it comes to deciding what makes the most sense or the most money, there are often parts of the business which should be sold off.

One harvesting strategy is to prepare one part of the business for sale at a time. Where there are different parts of the business operating in different markets and with different products or services, this should be relatively easy. The objective is to repackage the business unit as a separate stand-alone business and then prepare it for new ownership. This is often easier to resource and certainly easier to manage if there are very different buyers for the different activities. Proceeds from the sale can either be channeled back into the core business or given to the shareholders. Alternatively, the business can be restructured to allow some shareholders to cash out thus providing a way of concentrating the shareholding or providing flexibility to bring in new shareholders.

One strategy which is becoming more popular is to bring in a Private Equity firm to help with the sale process. This could be as simple as selling a share to the PE firm in order to take part of the wealth out of the business or it could be to engage the PE firm to help fund and execute a breakup and sale process. The PE firm can bring additional resources in both management and funds to the table to assist with the strategy. They may also initiate and fund a roll-up strategy where some parts of the business can be combined with other firms to create a more attractive acquisition target.

Often when I investigate a firm to prepare a sale strategy, I uncover a variety of underlying assets and capabilities which will appeal to two or more very different buyers. In order to optimize the overall sale price, I will recommend that the firm be split up with each part being specifically targeted for a selected set of potential buyers. This process takes time and money and thus a phased approach is often the most sensible strategy. Of course, it is also true that a complex business is often hard to sell because it may not have an obvious buyer. I have also seen situations where one part of the business is worth more by itself than the value which was originally assigned to the whole firm. The sum of the parts is often worth more than the whole.

ALIGNMENT

Alignment on strategy

Imagine you have just been approached by a large competitor who wants to buy your business and is prepared to offer you a 100% premium over your estimated market value. With great excitement you immediately contact your two partners with the intention of arranging the sale. One partner reacts positively but says the business is worth more than the offer. The other reacts negatively and states that he sees working in the business until he retires. While you desperately try to gain an agreement to sell, time slips by. After a month with no resolution in sight the potential buyer withdraws the offer. Your pot of gold has slipped out of your grasp.

Is this situation unusual? Actually no! Few small and medium sized businesses that are profitable and growing contemplate selling out. Perhaps the idea of selling out one day is in the back of their minds but they have never seriously discussed the issue. In fact, it is not just partners who need to be part of a possible conversation; it is shareholders, Directors and key managers and employees. It needs to involve anyone who has to sign off on the deal as well as anyone who is critical to creating value in the business and enabling that value to be transitioned to a new owner.

What we tend to forget is that few businesses are actually sold when the interested parties finally get around to deciding to move on. Many are sold in haste due to an internal or external crisis or quickly when an attractive offer is made for the business. In both these scenarios, the owners do not set out to sell, circumstances either dictate the sale or an external party initiates the process. When such a situation occurs, time is often of the essence and any delay will either erode value or terminate a sale discussion. Only by being able to act quickly on behalf of all the interested parties can a business owner secure the best value.

It is not unreasonable that different parties will have differing views on what the business is worth, how it should proceed in the future and what the ultimate goal is. In some cases these will be very opposed views. Thus one party may desire the security of tenure while another might wish to have the money to pursue another venture. An external Director may see disruption to their local community if the business is relocated while a family investor may be concerned about employment for younger generations. A key manager may be unwilling to work for a large corporate buyer and prefer to leave rather than continue with the firm. Without the conversation, these views are not surfaced and dealt with.

Planning for a possible sale takes the various views of the stakeholders into account to arrive at a consensus. The collective views may be very different when faced with the collapse of the firm compared to a premium sale. Surfacing personal expectations and sale preconditions is critical for any negotiation. Understanding when you can sell and under what circumstances allows the negotiator to ascertain quickly whether an offer is worth considering. It also means that the process of gaining widespread agreement is fast tracked if the timescales are short. At the same time, the discussions can help to bring focus on what to do in a sale situation. When all parties understand how quickly value can erode in a protracted sale, additional preparation work might be undertaken to make sure the firm is ready for such an eventuality.

USING A ROLL-UP STRATEGY

Could a roll up help?

What if you are too small to attract the ideal buyer? It is certainly the case that some corporate buyers have a target size in mind when acquiring and tend to stay away from smaller deals as the transaction costs are a significant portion of the investment which makes it difficult to achieve a good return. You could simply look for a smaller buyer but then you may not get as good a price. Alternatively, you could seek out complimentary firms who can join together to create a larger entity which could attract the ideal buyer. Such a 'roll up' strategy is very common in industries where similar firms are put together to create economies of scale.

There have, however, been many failures of such strategies. It is not just sufficient to bundle a number of firms together, there has to be some logic in the grouping and systems and processes to enable them work together. Larger revenue without discipline is simply a disaster waiting to happen. Also, it is not enough to have a collection of firms and then go look for a buyer. The smarter strategy starts with a pool of potential buyers in mind and works backwards from the ideal acquisition.

With the ideal buyer in mind, work out what the optimum size and structure of the selling firm should be. Is it sufficient to group together like firms or should there be a portfolio of complimentary firms? Is geographical dispersion important or should they be grouped around a small region? Should they be a band of loosely coupled firms working relatively independently or would they attract a higher price if they were centrally managed? Some of these structural decisions can be made by examining the structure of the buyer's organization and by examining the structures of their recent acquisitions.

You need to decide how you are going to drive this activity. Will you take on the operational tasks yourself or will you bring in professional advisors? Some target firms will join for the ride, others will want a partial sell down while some will want to be purchased outright. Will you be funding this process yourself or will you bring in a private equity firm to help? You need to work out how pooled businesses will be valued and managed. Some formulae also needs to be derived and agreed upon in terms of the split of the ultimate sale price.

Using a roll up strategy to sell a business is not an uncommon strategy although it is usually employed by an investor who manages and funds the process. There is certainly no reason why you should not initiate this process yourself if you have an ideal buyer in mind and can see a feasible way in which it can be done. However, getting a group of business owners to join forces to sell their businesses together is a bit like herding cats. More often than not there are too many strong personalities, too many preconditions and a failure to agree on a common valuation and management process.

NEW FAMILY BUSINESSES

The 21st century family business

There is a general consensus that a significant portion of our family businesses are facing a succession crisis as many owners reach retirement age. Fewer children seem interested in following in their parents footsteps in the family business and even less are inclined to want to take on the burden of leadership where they don't have the same passion for the business that their parents have. However this crisis could be averted if families changed their approach to the problem.

Most families see the family business as a fixed entity; a bit like seeing a home as a house rather than the group of individuals that inhabit it. The parents are often fixated on the product or service the business offers and are often consumed by their desire for continuity of the business because they have been intimately involved in its creation and/or development. Their picture of the business is of the bricks and mortar, plant and equipment, customers and suppliers - the minutiae of the business. They see the business as the source of the family's wealth and a place for current and future employment of family members. It is the central hub around which the family is linked and thus the foundation of their existence.

Of course this view is often not shared by the younger members of the family, both those inside and outside the business. They may have their own dreams and passions and these may not be with the family business. It is not uncommon for younger generations to be better educated, more traveled and have more diversified interests than the business founders. Some simply don't want to work for their parents, others wish to pursue different careers or simply have little interest in the specific market of the family business.

However many of the children of entrepreneurs have entrepreneurial talent. Quite often this results in them leaving the family business to pursue other interests, often to the disappointment of the parents. The mistake many families make is not to support and encourage such talent. In fact, supporting and encouraging younger members to start new ventures may be the solution to solving the family business crisis. Trapping them in a prolonged succession path may well stifle their entrepreneurial potential and create the very seeds of discontent that is encouraging them to leave the business.

Family businesses, instead of focusing on the products they produce could focus on the business talent and business resources they have that they can bring to bear on any entrepreneurial venture. When you consider the depth and breadth of business experience contained within most business families, they have a powerful competitive advantage that can be directed to any business venture in which any member of the family might have a passion. Couple that with the business resources that the family has accumulated and any new venture has a high probability of success. The breakthrough is to think of the family as a business capability instead of a specific business entity. The mission of the family should be to create an environment in which the entrepreneurial talent within the family can be nurtured and supported in any endeavor that a member of the family has a passion for.

This approach to a family business creates a pool of business expertise and business resources. Parts of an existing business can be spun out to create new ventures for younger family members to get their feet wet. They should be encouraged to develop the business into new customers, suppliers and markets in addition to their ties to the core business. Business expertise should be consolidated into Boards of Advisors to support each new venture. Parts of the core business that are not contributing, or where there is little future interest, should be sold off and the proceeds put into a new venture development fund. Younger members should be encouraged to put up business plans for their own ventures that align to their own passions. Members of the family that are not entrepreneurial and/or have little talent for leadership may then find possible jobs across a range of different ventures.

The advantage of this business model is that it recognizes the diverse talents, passions, interests and experiences within the family without constraining where these might be used. Diversity itself could bring with it a more enduring characteristic to the family business. Concentration on one business may in fact be the riskier path and a family business without a successor can be a millstone for the aging owner. More family members may be interested in being part of the family enterprise if they have the opportunity to take on the responsibility for an entire venture where the family has little at risk. Those ventures that thrive can receive additional support while those that fail provide real world experience to the next generation of family leaders. Over time, the business evolves and diversifies as each member pursues their own passion, but always with the backing of the family business knowledge and resources.

We need to develop a new view of family business that caters for the 21st century business family. The family business needs to be an enabler of entrepreneurial talent rather than a straight jacket that stifles and frustrates emerging leaders. We need to find a way for family businesses to exploit their accumulated business wisdom and provide a more fluid model to channel resources where opportunities and passions intersect. The family itself needs to see itself as the family equivalent of the venture capital fund, starting and building and harvesting new ventures as their talent pool and interests change over time. Just think how exciting this version of the future would be for younger family members.

HOW MANY BUYERS

How many potential buyers do I need?

It is very difficult to extract the maximum value on the sale of the business if you have only one potential buyer. Generally speaking, the only way you can do this is to be in a position where you don't need to sell but you are willing to do so if your terms and conditions are fully met. Simply by being hard to get, by having a business which gives you satisfaction and not having any great desire to do anything else will provide a basis where you force the keen buyer to do all the running. However, if your business is in trouble and the only potential buyer can afford to wait, you will almost certainly be a fire sale and lose much of the value of your business on sale.

So while one potential buyer is possible, common sense would suggest that several are much better. The question is how many is likely to create an optimum exit? The real issue here is how well you have selected your potential buyers rather than how many. A lot of possible buyers where none have a burning desire or need for the acquisition is almost certainly worse than one keen buyer. Thus an important component of preparation for sale is to ferret out those companies which have the highest need for what you can offer but are also in a position where they have the willingness and capability to go through the acquisition process.

There are some simple rules of thumb when it comes to identifying possible buyers. Most buyers are larger companies within the same industry; they typically have acquisition experience and deal with similar or complementary products. By doing some industry analysis and working with professional M&A advisors, it is not difficult to narrow down a list of possible suitors. The next stage would be to establish contact with them to ascertain their appetite for new acquisitions, especially for a business like your own.

In the end you need at least two keen, active potential buyers, each of which has a clearly expressed need to acquire a business like yours. However, sometimes timing does not always work in your favour. At the time you wish to sell, they might be involved in other projects, fighting internal fires, be subject to external threats or have used up their acquisition funds. Thus you cannot really depend on just a couple of potential starters. What you really need is at least 6 to 8 active interested buyers. With a little bit of luck you will be able to deal with most of them. In the worst case, you can be confident that you will have at least two left to negotiate with. However, your back up plan should be the ability to delay until circumstances bring more potential buyers into the process.

Also be very careful not to have too many potential buyers. The best ones may simply pull out or they may decide the costs of participating in the process are too high. In the end, it very much depends on your ability to help potential buyers understand what you bring to the table and in creating some level of competitive tension at deal time.

AFTER THE EXIT

What am I going to do once the business is sold?

Having a plan for what you are going to do once your business is sold is a key part of selling a business. Don't fool yourself into thinking that you will be going with the business or that nothing will change. Without a doubt, life will never be the same again.

First, let's take a reality check. The M&A research shows that about 40% of senior executives acquired in an acquisition leave within nine months, a further 30% leave within four years. However, this data is taken from mega mergers and does not really reflect the situation in the SME space. If you are like me, almost certainly you will have difficulty settling into a large bureaucratic organization. Instead of deciding what to do and how to do it and having the authority and control over the resources to enact your every whim, you will have to take orders, fill out forms and then implement someone else's ideas. Also don't forget that you will be cashed up and don't have to put up with the petty politics or incompetence. You will be lucky to last the nine months.

The stark truth is that you will almost certainly not fit in and will want to leave, so having a game plan for what comes next is a key part of your exit planning. But don't despair, there are lots of interesting things to do and you would not be an entrepreneur if you didn't turn your hand to another venture.

You could of course start up another business. If you have an idea cooking away in the background or, maybe, have already started the business, you can transition across. Alternatively, think about buying a business. Instead of doing the heavy lifting to get something going, think about buying a business where you can make a difference with your new found wealth and your business experience and connections. There are a lot of businesses out there right now which are looking for a buyer, especially those with older founders who want to move to retirement.

If you expect to make a real killing, consider becoming an angel investor. You can have the best of both worlds. You get to continue playing in the sandpit but other people do the work. Angels are typically cashed up entrepreneurs who take a coaching and mentoring role with an emerging company management team. Providing you spread your funds and time across several investments, the returns are typically better than public equity investments. At the same time, you have the opportunity of working with interesting people and putting your experience to work.

Many business owners are not able to move forward with the preparation to sell a business because they are not able to except life after the sale. Often they define themselves through the business itself and therefore, in a sense, have no identity beyond it. I certainly suffered a crisis of identity when I sold my first business but a few million dollars gives you a wonderful sense of freedom to do many things. In my case it was to start and sell several more business, become a Professor and now write business books. There is life after the sale!

PART C: PREPARATION

Selling a business successfully is a process. It starts with an understanding of how value is created for the buyer and then systematically works through the process to ensure that actions are assigned, monitored and completed. Essential to this process is an understanding of all the stakeholders and how they need to be dealt with. This includes managers, key employees, other staff, customers, suppliers, shareholders and so on.

The preparation process aims to reduce risk to the buyer, set the business up for transfer to new ownership and provide a platform from which the new buyer can achieve their acquisition objectives.

PREPARATION TIME

How long does it take to prepare a business for sale to maximise the value?

Business owners who wake up one day desperate to sell their business and move quickly to put it on the market throw away a lot of value on sale. With a little bit of preparation, the value of any business can be multiplied several times and, in some cases, many times. The key to securing the highest price is to work out how the buyer can gain maximum value from the acquired business and then to prepare the business so that the prospective buyer can see its potential and be willing to bid a higher price for the business as a result.

The basic theory underlying investment value is net present value. Future net earnings are discounted using a risk discount rate to arrive at the net present value of the investment (NPV). Providing the buyer acquires the business for a price equal to or less than the NPV, they should (on average) achieve their target rate of return. This suggests that the vendor can best prepare their business for sale by maximizing the future stream of net earnings and by having the buyer apply a lower risk rate to that earnings stream. Since the future stream of net earnings will be created through business productivity, revenue growth and business potential, any improvement in these components will impact the value of the business. For example, a 10% cumulative growth in net earnings will double the value of a business while a 20% cumulative growth rate will increase the value of the business by a factor of five. With these possibilities in sight, some attention to profitability and growth is worth the effort and certainly worth delaying the sale while the foundations for such growth are created.

In calculating the potential value of the acquisition, the buyer will also be considering how much risk there is in the business and how long it will take to get the business to a point where any growth potential can begin to be exploited. The underlying risk clearly impacts what risk discount rate the buyer will use. Thus a business which is well managed, has good internal systems for performance setting and evaluation and has good governance is going to present less risk to the buyer. A business which is efficient and productive and ready for a thorough due diligence review is going to be much more attractive and considered less risky by potential buyers. A business which is ready for new management and well positioned to take advantage of growth opportunities is also going to represent a more valuable investment by the buyer. Lower risk equates to a lower risk discount rate which in turn increases the value of the business.

Instead of running out to find the nearest business broker who will advertise the business to everyone, the entrepreneur should spend some time to consider what type of buyer could best exploit the potential in the business and how the business should be prepared to allow the new owner to manage the business to take advantage of that potential. Since not all potential buyers are capable of exploiting the potential in the business, the vendor should also consider how to attract the right buyers. It is only by finding buyers who are willing and able to exploit the business potential that the vendor will be able to extract the highest price in a competitive bid.

BUILDING VALUE

Building value in the business

I am continually amazed at how little entrepreneurs know about building value in their business as part of a process of selling their business. Not that I should be that surprised having spent many years now educating business owners on how to best prepare their businesses for sale and how to generate a premium on sale. But the thing that constantly amazes me is the fact that their professional advisors and business brokers know little better.

Fundamental to the sale process is understanding the value which the buyer will extract from the business. Without question, this comes in the future not the past. That is, the value of any investment is derived from a future stream of income. That being the case, why is it that advisors and brokers force business owners to use past profits to value a business – normally using an industry EBIT valuation model which is more guess than science.

When you think about this a little more seriously you can see that a business which makes the effort to provide the buyer with a different, more positive, more profitable future for the business being sold, should get a higher price than simply a multiple of past earnings. This can lead to two possibilities: the buyer can extract more from the existing business than the seller or the buyer can utilize the assets and capabilities within a much larger business thus exploiting the underlying assets and capabilities much more than the seller could.

Clearly, the process of extracting value is to find a buyer who can exploit the business better than you can. The objective is to create future potential for the business way beyond the current owner's capacity and capability. By finding multiple potential buyers who can generate greater value in the business in the future than that which could be generated by the current owner, the seller can readily achieve a premium on the sale.

If you are a business owner, you need to break away from the past and concentrate your preparation on what the future of the business might look like in the hands of a much more capable and better resourced buyer. Then go find those buyers who can best exploit the potential in your business. By setting them up in a competitive bid, you will be able to extract the best price for your business.

However, a word of warning. Make sure your buyer can deliver on the potential – otherwise you won't be believed and their lawyers will come after you wanting to get the money back because they (and not you) failed to deliver on the potential.

PROFITABILITY

How can I increase my profits?

If you are selling a conventional business then you will almost certainly be selling to a buyer who will value it based on some multiple of earnings, usually EBIT (earnings before interest and taxes). Part of the process of increasing the valuation is to generate higher sustainable profits. Easily said but how can this be achieved in a systematic manner? You could spend your life reading all the business books looking for every process and fix but then you would not have any time to actually run your business. So are there some generic processes which you could use to improve profits over time?

The difficulty here is to find approaches which can be used across a wide variety of businesses. What I am going to recommend are a set of processes or approaches which can be applied to any business.

Firstly, simply focus on getting rid of gross wastage. I don't mean to imply that your business might be frivolous when it comes to expense control but you would be amazed how much can be saved with a different perspective. So get rid of obsolete inventory and equipment and review how you use warehouse and office space. Ask the hard questions about your use of travel, marketing and entertaining expenses. Simply adjust your lenses to saving money – you will be surprised what can be achieved.

Now list all your expenses, largest first down to the smallest. Start with the largest. What can be achieved over a 12 to 18 month period if you concentrate some effort on negotiating new agreements, improving productivity or paying more attention? Small reductions in large expenses add up to some sizeable cost reductions over time.

Now find out what you do well and what can be improved. Join a benchmarking program for your industry or subscribe to some benchmarking results. What are you doing which is better than the industry average? What are you doing which is clearly below par? Now look at the industry best practice. Find out how that can be achieved. Once you can isolate practices which can be improved, you might spend some time reading, getting educated, talking to peers or hiring a consultant who can help you with improving aspects of your business which increase revenue or expense productivity.

For those parts of your business which are unique, consider introducing a continuous improvement process. The convention here is that – if you don't measure it, you can't improve it. The methodology behind this technique is to put in performance metrics so you can see what happens period on period. You can expect variation in performance and your task is to discover what creates improved performance. You may need help with implementation but at least you know where the problems are.

Improving profits over time so that you can benefit from a higher valuation is not that difficult but to be sustainable, those changes need to be done in a systematic manner which can be demonstrated to produce reliable long term improvements.

IMPACT OF GROWTH

How does growth potential improve sales value?

Anticipated growth in net earnings can have a significant impact on the sales value of a business but few business owners create a selling scenario where growth potential is demonstrated. Growth potential is often growth which the buyer can exploit but which the owner is unlikely or unwilling to exploit. While most business advisor declare that a vendor cannot get paid for growth potential which the buyer has to achieve, there are ways of extracting a premium on sale from growth potential which the vendor creates.

The value of a business is generally held to be the net present value (NPV) of the stream of future net earnings. That is, the projected profits from the business are discounted using a risk factor to arrive at the current value of the investment. This provides an estimate of what a buyer is likely to pay for the business. That NPV is thus highly dependent on both the estimates of projected future earnings and the discount rate utilized in the calculation. Higher estimates and a lower discount rate will both influence the current value. Normally, the projected earnings are an extrapolation of prior results but changes in the business capacity and/or capability or in the product/market mix might generate a very different future expectation and thus a very different valuation.

Buyers will generally accept projections of future revenue where these are based on revenue generating capabilities already demonstrated by the business, however, they will be seeking clarification that those revenues are reasonable certain. But what of growth potential which the existing business is unable to achieve but which the buyer, with better capabilities or greater capacity, more determination or a willingness to put more energy or hours into the business, might be able to achieve. Surely the buyer would not be willing to part with some of the increased value generated through their own efforts to the seller? Wrong! There are in fact situations where the seller can get paid for such growth potential.

The key to such a premium lies in two factors. Firstly, the extent to which the seller is able to demonstrate that the buyer will be able to achieve growth potential and secondly, having a number of equally able potential buyers compete for the right to undertake such growth. The former is achieved through a clearly articulated plan for growth which is underpinned by good evidence. The task of the vendor is to show potential buyers how the business can be grown to generate higher levels of net earnings and that the higher revenues and profits can be reasonably achieved. Providing the vendor has a number of competing bidders, he can trade one off against the other until he has the best price.

This works. I have been able to identify a number of situations where a premium on sale was achieved where the buyer was convinced of the growth potential of the business even where the vendor was not able to extract that growth themselves. The key to such a premium was that the potential growth had a high probability of being exploited by the buyer and that there were several potential buyers bidding for the opportunity.

BEYOND THE SALE

Why is it important to look beyond the sale date?

When you buy a used car, house or camera, you are not that interested in how the prior owner used the item. What you are focused on is how you are going to use it and whether you will achieve the benefits which you seek. If you decide to use it in an entirely different manner to the prior owner, their experience and use may be completely irrelevant to your evaluation of the item. With this in mind, consider your own business – how is the buyer going to utilise the assets and capabilities within your business? They may be intending to operate the business very differently from you in order to achieve greater profits from it.

The key to a premium on sale is to find the buyer who can exploit your business better than you. If you are able to set your business up so that they are able to generate higher profits from your business than you were able or willing too, you may be able to capture some of those higher profits in your sale price.

There are two possibilities for generating such a premium. The first applies to sales of businesses based on the profit generating power of the business itself. I call this a financial sale. The value of the business is directly related to the net present value of the future stream of profits generated from the resources of the acquired business. The alternative is a strategic sale where a large corporation is able to exploit the underlying assets and capabilities of the acquired business through or in combination with its own resources. Such a situation often occurs where a product or capability is dramatically scaled up to meet the demands of a large distribution network owned by the acquiring corporation.

In both these cases the key to a premium on sale is to create a platform from which the acquirer can rapidly achieve the benefits they seek in the acquisition. Thus a financial buyer will be interested in growth potential in the business while a strategic buyer will be interested in the rate at which the strategic asset or capability can be replicated or scaled. In both cases, the anticipated speed of execution impacts the value of the business to the buyer and greatly influences the willingness of the buyer to pay a premium.

In preparing the business for sale, you need to put yourself in the shoes of the buyer and think through all the activities which the buyer will have to undertake to extract the maximum value out of the acquisition at the earliest possible time. You should then arrive at what your business should look like at the point of sale. This should include its structure, systems, products, location, assets and capabilities. Now, say, that is two years away. What do you have to do between now and then to create the ideal business which will be ready for the right buyer?

Preparing a business for sale is not just getting it ready for due diligence it is also creating a business which is ready to be acquired and exploited. Thus reducing integration time and building the capabilities required for the business to be expanded, replicated or scaled is the key to a premium on sale.

VENDOR DUE DILIGENCE

What is vendor due diligence?

The best deals are done quickly where the buyer recognizes that they face few risks in the acquisition and where they have confidence that they can realize their acquisition objectives. The worst deals and those which collapse due to risks uncovered in the vendor business or where the buyer wants compensation for all the investigative work undertaken to uncover risks in the deal. As the costs increase and as risks are uncovered, the buyer will want to reduce the price to compensate for the additional costs and risks. If the investigative process goes on too long, the mere passage of time might result in the buyer deciding not to consummate the deal. They might have other acquisitions to pursue or simply consider that there might be further risks yet uncovered which would result in an acquisition failure.

While most business brokers will tell the vendor to clean up their company prior to sale, they often fail to explain the psychology of the buyer and why such an exercise not only improves the probability of sale but actually can increase the sale value. We often forget that experienced acquirers have accumulated corporate memory of all the problems which they have experienced in the past. They come into the acquisition negotiation assuming that they will have to spend considerable time and effort looking for risks and then expend money and time cleaning up the business after they buy it. The buyer's objective is to put the business in a state where the potential in the business can be exploited thus delays and costs incurred after the acquisition simply delay the time until the acquisition objectives can be achieved. Any anticipated future revenue and profit which is delayed simply reduces the current value of the business and thus directly impacts what the acquirer is willing to pay for the business.

The objective of the vendor should be to turn this process on its head and create a business which can be readily evaluated and quickly put into a state where the acquirer can exploit its potential. Both these objectives can be considerably advanced if the vendor undertakes a vendor due diligence with the aim of preparing the business for the buyer due diligence investigation. In essence, what the vendor is doing is undertaking a practice run at a buyer due diligence. The vendor engages the services of accountants and lawyers who are able to carry out a due diligence investigation of the type the target buyer is expected to undertake. The results of the vendor due diligence are then used to ensure that any problems are uncovered and fixed and the business made ready for the buyer due diligence.

The advantages of such are process are several. You get to find out problems within your own business and can get honest advice on how to fix them. This alone should make your business more efficient and effective. Then of course you do end up assembling all the information necessary for a buyer due diligence thus greatly decreasing the time and effort you would have to incur during the buyer activity. This also allows you the luxury of continuing to operate your business without the disruption of the buyer investigation. Of course you will have greatly reduced the time and cost of the buyer due diligence and hopefully greatly decreased the risks confronting the buyer. Any unresolved items can be tabled early in the discussion so that the negotiated sale price already reflects known issues.

A well prepared business will be positively received by an experienced acquirer who often will be willing to pay more for the business because of the absence of problems or because it enables the buyer to move quickly to integrate and exploit the new acquisition.

INFORM EMPLOYEES

Should I tell my staff?

If you want to get into a heated argument, put a dozen entrepreneurs in a room and ask them if they should tell their employees that they are preparing to sell their business. What you will find is that they quickly polarize into those who would tell their staff and those who would not. Each group will advance very strong arguments for their case but few will have thought through the longer term implications of their position on the sale value of their business.

Those who argue for not telling employees will argue that the possibility of a sale will create stress and uncertainly amoung employees resulting in a drop in productivity, a loss of key employees who decide to leave rather than face an uncertain future and the possibility of the news reaching competitors who will use the information to undermine the business. Those who argue for informing employees believe that the information will leak anyway and that it is better to inform employees rather than let them imagine worse case situations.

When I have spoken to entrepreneurs who have sold businesses I have been very interested to find out what they did pre-sale and what they would do differently if they had to do it again. In almost every situation where the information was kept from employees, the entrepreneurs regretted the decision. Employees who had worked diligently for the business felt betrayed for being left out of a critical decision which would materially effect their future. In some cases this had the result of undermining the sale process or in key employees leaving the business prior to the sale. Few entrepreneurs who told their employees had adverse outcomes.

My personal view is that the preparation process itself requires active support of key managers and employees. They are required to create the right foundation within the business so that the sale price can be optimized and they are most often needed to remain with the business so that the buyer is able to best operate the business after the sale. Basically you need your best people to support the process before and after the sale. So involving them in the sale process and providing incentives for them to assist you to prepare the business for sale and for being prepared to leave the business if required, or transition with the business if needed, is an essential part of selling a business. Key employees can be rewarded by being given shares, options or bonuses to assist in the preparation process. Those being made redundant can be compensated for their efforts up to the date of sale while those who are needed by the buyer can be given a bonus after some set period after the sale for staying with the buyer to assist the transition.

While competition is always an issue, businesses which are always open to the right offer can simply portray that position. That is, they are willing to sell out to a buyer who can best develop the business. This allows the current owner to position a future sale positively to customers and staff.

MINORITY SHAREHOLDERS

How do I deal with minority shareholders?

When it comes to selling out not everyone will necessarily be happy and some may in fact set out to stop it happening. Any business which has a range of large and small shareholders has to be very careful that all the shareholders are on the same page when it comes to the ultimate decision, selling the business.

Minority shareholders can come in all shapes and sizes. Some might belong to that wonderful group, “family, friends and fools”, while others might be external independent investors or employees. Each one will have their individual reasons for investing and perhaps might not agree with selling out or have the same attitude to the anticipated sale price. Some family might be interested in protecting the job of a favorite relative or be convinced that the business should be developed further to realize its potential.

External investors may have put money into the venture on the expectation of an IPO and be disappointed that the business is not intending to see the strategy through. Other external investors may have expectations of generating additional employment within the community and not want to see the business sold and potentially relocated. Almost certainly there will be some employee shareholders who will fear for their jobs or be disappointed with their share of the sale proceeds. Managing these relationships and expectations is a critical part of the preparation of a business for sale.

I was involved in several business sales where these situations occurred. In one case, mangers recruited into the business who were able to buy shares felt that the business should be developed further before it was sold as they were to receive very little for their recently purchased shares. In another business, one shareholder was adamant that the business should not be sold. Instead, she thought that the business should be scaled back, a new product strategy developed and more investment sought to revitalize the business.

These situations can be explosive. They can be highly emotional, stressful for management and very disruptive to a sale process. Only by involving all these parties in the discussions can they be made aware of the facts, strategy alternatives and likely outcomes and an agreement reached.

It is worth developing a consensus around three scenarios; what if you have to sell, what if you are made an offer to sell and under what conditions you all would decide that it is the right time to sell. You have to sell when you are in deep trouble. At that point you can't waste time discussing it or throwing blame around. When you receive an offer, you should have an agreement on the minimum acceptable price. Finally, you need to come to an agreement as to the conditions which need to occur when you will be all comfortable to sell out and move on.

You should also put in place a shareholder's agreement which will bind the minority shareholders to an agreement made by, say, 75%, of the shareholders for such critical decisions. This prevents a small shareholder from holding the rest at ransom. As long as all shareholders are treated equally in the sale proceeds, there should be no reason for not having such a provision.

PROFESSIONAL SERVICES

Why should I use a big 4 accounting firm?

I have often been asked why I used a big four auditing firm with my last venture given that the business when it started only had a dozen staff and, when sold, had only grown to 30 employees. My answer has always been to show the impact on the final due diligence and deal discussions and to ask whether the person asking the question thought I got value for money.

My last business went into free fall after several large software corporations decided to enter my market with similar products. All my prospects were their customers as our supply chain optimization software sat alongside a large ERP system such as those sold by SAP, Oracle or Peoplesoft. When these corporations announced that they were going to develop their own supply chain optimization solutions, their customers decided to wait for the integrated solution from their main software vendor. Thus I found myself in a situation where I had 30 staff and no prospects. Naturally we decided to sell the business before we were forced to close the doors.

This was my fourth software business and I had the experience of working through the sales process for the earlier ones. I also had been through the due diligence process for raising venture capital twice and taking on a large corporate loan. I knew from those experiences that being prepared for due diligence was a critical part of getting a quick decision. I also knew that the quickest way to get through the due diligence process was to ensure that the professional advisors I used had high credibility. Basically, I wanted to have all my source documents accepted without question. The only effective way to achieve this is to have the biggest and the best.

When you are selling out to a large, perhaps, global corporation they are going to undertake a very extensive and sophisticated due diligence. They will almost certainly use a large auditing firm and a highly respected legal firm. In order to uncover the risks and problems in your business, these advisors are going to review everything. The only way you can speed up this process is to demonstrate to them that they don't need to audit most of the historical information because they will be able to rely on the documents produced by your own advisors. My approach here was to push back hard and state that any additional audit was wasting my time and the buyer's money but that I was willing to provide warranties for the quality of the information presented. In any case, if there was a subsequent problem, they could always go back and litigate against my advisors who would normally have much deeper pockets than me.

This last business of mine was sold for six times revenue to Peoplesoft in a period of just over two weeks. Given that it was losing over $1 million at the time, whatever additional fees I paid to my advisors was well and truly worth it. When you are dealing with large corporate buyers it is best to have good quality advisors in order to be very well prepared for the due diligence and the negotiations.

SUCCESSION PLAN

Why do I need a succession plan?

In my experience, cashed up entrepreneurs don't make very successful employees. In fact, most smart acquirers realize this and so look for a solid succession plan knowing that they are unlikely to want to keep the former owner or that the owner won't want to stay. The logic here is actually quite simple. Your entrepreneur is now cashed up and no longer has the motivation to put in the same level of energy and long hours. Furthermore, this is also an individual who is used to making decisions quickly, often from gut feel and probably dislikes having to justify what they do. At the same time, they probably want to use their new found wealth to take some time out, pursue another venture or become an angel investor. Basically they don't fit in and smart acquirers recognize that.

Using this logic, it is not unreasonable to imply that the same conclusion may well apply to most of the senor management team. It is unlikely that the vendor CFO will want to give up dealing with bankers, auditors and being part of the strategic decision making team. The sales and marketing Director is unlikely to want to go back to being an account manager or branch sales manager. It is also entirely possible that the senior management team will share in the sale proceeds and may wish to pursue other opportunities. While some may transition across to the new owner, the acquirer is probably best to assume they will leave at the date of sale or shortly after. Certainly all the research on mergers and acquisitions would support this conclusion.

Given this scenario, the best preparation for selling a business is for the vendor to put in place a succession plan for the senior management team with employees who are likely to transition to the new ownership. However, it would not be unreasonable for the buyer to foresee risks in keeping these newly acquired staff, so even though there is a succession plan in place, additional incentives are needed to reduce buyer risk.

The buyer needs to have time to transition the inherent business knowledge to employees who are likely to be employed longer term with the acquirer. Since most resignations of newly acquired staff are likely to occur during the first year of the acquisition, putting in place incentives for key acquired employees to stay during the transition period can significantly reduce buyer concerns. Where the vendor has arranged this prior to the sale discussions, the buyer has some assurance that a major risk can be averted. This not only places the vendor in a more positive light but can positively influence the value of the business being sold.

The vendor needs to anticipate buyer concerns and address those proactively. By understanding the motivations and intentions of his senior management and key employees, the vendor can construct a succession plan and a retention plan which ensures that the knowledge in the business can transition across to the buyer. This greatly enhances the likelihood of the buyer achieving their own acquisition objectives and thus should be reflected in a lower risk profile for the acquisition. Lower risk should itself be translated into a higher valuation for the business.

COMPETITORS

I don't want to let my competitors know I am for sale

Most entrepreneurs don't want their competitors to know they are thinking about selling or are actively looking for buyers. They anticipate that their competitors will use this information against them to recruit their staff, undermine their sales activities and create customer and prospect uncertainty. Their fears are not without substance since this happened to me with my first business.

The biggest danger to the business occurs where the effort to sell the business is protracted over a long period of time. During this period the employees are unsettled and competitors use the uncertainty surrounding the future of the business to undermine sales efforts. Existing customers may be concerned about future support and will also delay repeat purchases or fail to provide referrals. Thus the first line of defense is to ensure that the sale process is very short and effective. This can be done by being well prepared for sale discussions, ensuring the business is ready for extensive due diligence and that a short list of competing buyers is waiting in the wings ready to activate. The sale process itself should only be conducted if the entrepreneur already knows he or she can reach an acceptable price and thus the business will definitely be sold.

There are some other steps which should be undertaken to provide the best strategy for selling the business. The first is to acknowledge that the business may be sold at some time in the future if the offer is attractive and that the potential of the business can be better executed by a better resourced buyer. Such a position gives comfort to both employees and customers and acknowledges the reality of business. In many cases, small companies cannot provide the level of support to products and services that larger corporations can nor can they offer the best career paths. The right acquirer can provide both customers and employees with a positive outcome.

You should also be providing your best mangers and employees with incentives to develop the business for an ultimate sale to the right buyer. Incentives might include shares, options and bonuses. This also ensures that you don't lose them in the run up to the actual sale. At the same time, you should be considering how to best transition the business across to the buyer to ensure that customers will be positive about the move. Thus providing retention bonuses to ensure your key employees stay with the buyer for some period of time reduces the risks to the buyer as well as the current customers.

Direct competitors are best dealt with by indicating that the business is not for sale although the entrepreneur would always be interested in discussing the future of the business with a buyer which can fully support and develop the underlying business in the best interest of staff and customers. As long as you don’t need to sell, there is nothing wrong with being positioned to take advantage of a good offer. If you do need to sell, make sure you are well prepared and can execute the sales process quickly.

REPUTATION

Why is reputation important in the sales process?

Rather than simply advertise a business for sale and hope that potential quality buyers notice it and are prepared to bid, the entrepreneur will achieve a better price for the business by proactively seeking out buyers. This is where building a positive reputation pays off.

Most businesses do not have obvious potential buyers. While we know that most buyers will come from the industry in which the business for sale is active, potential buyers may be individuals who desire to own their own business as well as corporations in the industry who are engaged in roll-up or consolidation strategies. While it is easier to generate a list of acquiring corporations, it is not easy to generate a list of corporate executives who might be interesting in buying. The path to the majority of potential buyers is to establish a reputation within the industry so that they know about your business.

Getting known within an industry is actually not that difficult. The majority of industries have their own industry association, conferences, education programs, charity events and trade journals. There are normally specialized magazines which focus in certain industries. By getting firm executives involved in the industry association and industry events, the business puts itself out in the public domain waiting to be noticed. Additional exposure can come through speaking engagements at industry events, writing articles or cases for industry and trade journals and magazines and competing in industry or national competitions.

In undertaking these activities, the entrepreneur has the objective of getting on the radar of acquiring executives and corporations. By saying what you do and, especially, what you are good at, you can bring this to the attention of industry participants. Many larger corporations continually scan for potential acquisitions and you simply have to bring yourself to their attention so that the consider you. If they have an interest, they will start monitoring your activities and are likely to proceed to develop a relationship with the business, perhaps informally, but with the intention of finding out more about the products, markets and management team.

We need to keep in mind that most larger corporations grow through acquisitions and therefore they are on a constant watch for acquisitions which fit into their longer term strategy. Those who take this activity seriously will have full time staff employed to undertake research into potential acquisitions and assist in the evaluation and integration of acquisitions. You job is simply to get on their list. Whether you then wait for an approach or proactively take the initiative of seeking them out, the end result is a potential buyer if there is a good fit. Keep in mind that a good reputation also helps an acquirer justify the purchase to their bankers, shareholders and Directors.

Individuals who are buyers are harder to identify and therefore a PR approach is probably best. Once they understand who you are and what you do, it is then up to them to make the approach. You could also supplement this strategy by getting to know business brokers and advisors who specialize in your industry as this is possibly where a potential buyer will seek assistance.

REDUNDANCIES

How do I deal with staff who will be made redundant?

It is inevitable in a takeover of a business that some staff will be made redundant. While some will be shareholders and be cashed up and have a payout to carry them over until they find something else, not all staff will be so lucky.

I went through several trade sales with my various businesses where some people were made redundant. In a few cases it was because there were duplicate roles and the business did not need to carry the extra resource. In other cases, there was relocation of part of the business and not all the employees were able or suitable for relocation. Sometimes a business will be restructured or refocused following a takeover and this can also result in terminations. What is clear is that it is impossible to predict exactly how the transition to new ownership will work out and thus most staff are exposed to the possibility of termination.

Most business owners find terminations very difficult. Having taken responsibility for employing an individual, they accept that their future with the company is an on-going obligation. Providing they perform well, the employee should have an expectation of continued employment. It is this understanding between employer and employee which provides the fabric of well being within a business. For the business owner, to make an employee who has performed well and been a loyal worker redundant is a stressful event, often seen as a failure by the owner himself.

However, the facts of life are that such terminations do occur in a sale of a business and that, often, many of the employees are actually better off with a larger, better resourced acquirer. How then does the entrepreneur best prepare himself and his employees for this type of disruption.

One method is to ensure that there are financial compensations for the change. This can be provided through shares, options and termination bonuses and redundancy payouts. Those who benefit significantly under such arrangements can probably look after themselves. However, most will not benefit sufficiently to adequately allow them to transition to retirement or find a new job. What is really required is a different approach which actually prepares them for new employment.

My approach to this situation was to acknowledge that I couldn’t guarantee anyone continued employment. It was not just the sale of the business which could force terminations, the ebb and flow of business itself can result in terminations if there is a shortfall of revenue. I always took the approach that, providing staff were well trained, they could readily find new employment. I therefore tried hard to ensure they were provided with good opportunities for education, cross training and new challenges and experiences. What I found was that this resulted in a more interesting work environment, happier staff, greater productivity, lower staff turnover and a willingness to accept higher employment risk. If they were made redundant, it meant that they could easily find new jobs. It significantly reduced my stress and gave them greater confidence in working in the business. It also meant that the people who stayed on considered that everyone had been well treated.

COMPANY SECRETS

How do I protect my company secrets?

Many entrepreneurs fear giving away company secrets during a due diligence process involved in selling their business only to find that the potential buyer has pulled out and then uses that information to compete against them. Since most firms don't have the luxury of unique, patented or protected assets or processes, this is a very reasonable position to take. Imagine how foolish you would feel if you gave away the very competitive advantage which had created the sale value. However, you still need to get through the due diligence process for the honest buyer.

What you need to do is to balance the need of the potential buyer to be able to assess the quality and impact of your confidential information with your desire not to give away the store to the dishonest scavenger. To do this you need to have a process which gets rid of the latter but keeps the former in play. Thus how much can you provide to satisfy the serious punter while protecting yourself against the dishonest or opportunistic competitor?

Your best protection against the theft of confidential information during the sale process is to be very well prepared for the due diligence investigation. This information can then be released in stages subject to your own due diligence on the potential buyer. You should be looking for commitment from the buyer at each stage of the investigation. Buyers who are only fishing will not want to spend much effort in the process and will soon fall away. You should balance their effort with your own. Thus, as they require meetings with management, you should request similar meetings with theirs. As they require more detailed information, you should request similar data from them. If they are not prepared to share information, you can probably assume that they are not serious and terminate the discussions. You can also have them sign a non-disclosure document with damages for use of confidential information.

Your second level of protection is to withhold sensitive information but have it examined and verified by an independent and credible third party. Thus you can cite performance data, market statistics and forecasts but hold back the detail. This data would then only be released to the successful bidder as a final condition of the sale but could be done in such a way that, if validated, the sale would be concluded.

Your best strategy, however, against this type of invasion is to have pre-selected the potential buyers. If you have determined that the potential buyer has a real need for your business, is capable of funding the acquisition and has the capability and capacity to make it work, then you should be dealing with genuine buyers who would rather buy than copy. By ensuring you have several willing potential buyers and being well prepared for due diligence, you can also speed up the sale process and dramatically reduce the exposure period.

In the end you will have to take some level of risk to get the deal done, but with some investigation you can determine the ethical values of your potential buyers. Make sure you steer clear of the doubtful ones.

KEY EMPLOYEES

What compensation should I be paying key employees to encourage them to stay after the sale?

In the pressure to sell a business, the entrepreneur often forgets that it is a team sport. While the business owner might be overjoyed to see keen buyers banging at the door, the rest of the employees may not be so excited. Not only do they face a change of boss but they will be rightly concerned about their future employment, their job responsibilities and even whether their desk will continue to have a window view. If the entrepreneur is to realize the full value of the business, he or she needs to have the full support of the key employees throughout the sale process and beyond into the new ownership.

As a business owner, you need to put aside traditional views of valuation based on EBIT multiples which reflect what you achieved in the business and embrace a more realistic view that the value of the business is what it can achieve for the new owner. Everything we buy, including a business, only has value for what we anticipate we can harvest from it, whether that be an experience or a good return on our investment. Thus preparing a business for sale is simply about anticipating how we can maximize the future value for the new owner. Much of that value may be tied up in the active and positive participation of the current employees in the business under new owners. So what can we do to ensure that the new owner has the full support of those key employees who will help maximize that future productivity?

We need to examine three areas of concern for the new owner; what problems, risks and liabilities are inherent in the existing business; how easy will it be to transfer ownership and, lastly, how confident will the new owner be that he or she will be able to exploit the potential of the business post-sale. Firstly, our current employees can help put the business onto a low risk, profitable and resilient basis. For that to occur we will need their active co-operation. What we don’t want is for them to be antagonistic or hostile to the new owners, or to be disruptive or to undermine the sale process. Certainly we don’t want them to leave because they are concerned about their future with the business. What we need to do here is to involve them in the sale preparation and due diligence process and give them an incentive to work towards a common goal of selling the business successfully.

The next stage involves the transition to new ownership. We need to be confident that the key employees will transition the core knowledge in the business. To do this successfully, again, there should be incentives involved to encourage them to stay around in order for the transition to occur.

Lastly, we want the new owner to have the highest chance of successfully running the business and, possibly, developing it to generate greater revenue and profit. We need to consider how we can structure the business to provide the best platform for that to occur. Again, this may mean some incentives for the key employees to stay with the new business to give it time to settle down under new ownership.

If you do this right, it will require you to allocate some of the sale proceeds to encourage and compensate key employees, however, by preparing the business properly for the new owner, you are going to significantly increase the price you get for your business. Your investment in your employees will be more than compensated by the higher sale price.

ESCROW

What if the buyer requests an escrow?

We can't always choose the timing of the sale of a business and so there are often unresolved issues hanging which can materially affect the sale value. The business owner will not wish to discount the sale proceeds to provide a contingency for the possible worst outcome but, at the same time, the buyer does not want to be out of pocket for negative outcomes which might occur. In order to overcome this impasse, the purchase agreement might set aside an amount or a number of shares that are held awaiting the conclusion of outstanding items. This is an escrow provision.

Both parties need to arrive at a consensus as to which items are being provided for, the method by which compensations or adjustments are to made and the timescale over which the escrow is to be in place. These are problematic agreements as both parties are trying to protect themselves and yet the future outcome(s) might be uncertain. Too often the agreement ends up in dispute where some outcome was not anticipated. Then it is off to the lawyers.

I was involved in one sale where 10% of the sale price was put into escrow and held by a large bank as the escrow agent who would interpret the agreement to give back shares to the buyer or disperse the remaining shares to the seller at the end of the escrow agreement. A number of small items were easily and quickly settled which accounted for a small portion of the escrow shares. We then got into a dispute over a patent infringement that the buyer settled without the agreement of the sellers. The resultant dispute over whether this was a valid claim went on for the next 10 years, well beyond the one year term of the escrow. It eventually wasted away when the shares, originally held at a nominal $10.50 per share, were being traded for 6 cents on the public market. We decided we didn't want them back at that stage!

Sometimes an escrow can't be avoided where there are material issues outstanding, however, like earn-outs they are very difficult to construct to ensure the agreement is workable. Providing there are very clear cut alternative outcomes and the manner of adjustment is seen as fair to both parties, then it can be a useful tool to help close the sale. As a seller, perhaps the best way to approach an escrow is to write off the proceeds and just hope for a windfall gain if things fall your way. Alternatively, work hard to find a way of avoiding the escrow in the first place. There should be strong enough warranties and representations in the agreement anyway to protect the buyer. However, they may have to go back to the lawyers to enforce the adjustment.

Clearly the best solution is to resolve all outstanding issues before the sale. Good internal control and governance systems will help avoid most of the common problems. Then simply find a way of settling everything you can before the deal is signed.

DEALMAKERS

Who does the deal?

I am a very strong advocate of the entrepreneur doing the deal to sell their business. Instead of handing the problem over to someone who does not really understand the intricacies of the business, the entrepreneur should take charge of the process of identifying buyers and negotiating the deal. It is the entrepreneur who best understands how the business works, what risks are inherent in the business and how value can be extracted by the buyer. Unless the buyer can fully appreciate how to exploit the potential in the business, the seller won't get anything like full value for the business. It is highly unlikely that an external party can fully represent the business potential in the same way that a knowledgeable entrepreneur can.

However, not all entrepreneurs have the time, motivation or skill to undertake the process of identifying and contacting potential buyers and then negotiating the deal. How should they approach this critical problem? The first step is, of course, to decide to sell. Then they should gain some insight into the selling process and what legal, financial and operational steps will need to be taken. This can also be assisted through their contacts with accountants, lawyers and advisors. Since the key to generating a good price is to understand both how to extract value from the firm and who can best do that, the entrepreneur should spend some time working through how additional value can be extracted from the business and who the best buyers are who can achieve this. At the same time, preparation for sale should include various forms of risk mitigation.

The most important factor in achieving a premium price for a business is the selection of the pool of potential buyers. If the owner does not feel competent or able to do that due to other commitments, this should be outsourced to a professional advisor, however the entrepreneur should clearly articulate to the advisor how potential in the business can be exploited. Rather than leave the process of recruiting buyers to chance once the business is put on the selling block, time should be spent identifying and contacting possible buyers. In the end, it is the ability of the buyer to understand how to extract value from the firm which determines how much they will pay. By educating possible buyers on how the potential in the firm can be exploited, the entrepreneur is creating a knowledgeable pool of possible buyers. The entrepreneur should develop a list of potential buyers in conjunction with the advisor. An advisor can then make contact with them and assist to build a relationship between the firm and the potential buyers.

When it comes to negotiating the deal, it is worth having experience on your side of the table. Most small firms with potential are purchased by large corporate entities. They will certainly have very experienced M&A advisors. Our advocacy system would suggest that they will work hard for the buyer to extract maximum value. You need your own knowledgeable advocates to work equally hard for you. Make sure your team fully understands the work you have done to prepare the firm and of the potential which could be extracted by the right buyer.

The best deals are done by knowledgeable and passionate entrepreneurs faced with keen and well informed buyers, each assisted by good professional advisors.

DIRECTORS

Should I have a Board of Directors?

One of the key tasks in preparing a business for sale is to mitigate the risks of the buyer. This has a number of benefits in the sales process; it reduces the anticipated costs the buyer expects to spend to clean up the business, it makes the due diligence process smoother and it increase the sales value by lowering the net present value discount rate. Thus any money you spend on reducing risks in the business should, not only give you a better business, but will return the investment back several times in an increased sale price. One activity you should give serious consideration to is whether you should install a Board of Directors as part of your sale preparation process.

You may feel that you alone know enough to adequately manage your business and that the costs and time involved in supporting a Board of Directors is a waste. You would not be alone in that opinion as most small, medium and family business owners feel the same way. But running your business is not the same as positioning it for a sale. In setting a business up for sale, we need to consider the viewpoint of the buyer and what the buyer would find attractive in the business. Our objective is to take away from the buyer any hesitations about the operation of the business as well as reducing the anticipated costs and delays of changing the ownership of the business.

The buyer will be concerned about the inherent risks in the business. If the selling business has systems and processes for reporting to an independent board, it will indicate to the buyer that the owner is prepared to be accountable for performance and is prepared to review the business operations with external parities. If that process is done properly, the buyer can be confident that the underlying systems and reporting processes will enable an easier transition to new ownership. If the Board reporting pack includes operational as well as financial performance measures, the buyer will have more confidence in the quality of the business being acquired.

One of the biggest concerns of any buyer is the fear that the business rests on the personal knowledge and contacts of the owner. To the extent that this exists, the buyer takes the risk that the goodwill and corporate intelligence will be lost with the departure of the owner. To the extent that the business has a knowledgeable and independent Board of Directors, the buyer can have some confidence that the underlying systems are in place to monitor business operations and that some of the corporate intelligence is shared amoung the Board. Thus the buyer has the option of keeping some of the Board members on for some time after the purchase to ensure that knowledge in transitioned to new management.

Perhaps the greatest benefit of having a Board in place prior to the sale is that it indicates to the buyer that governance is seen to be important in the business. It also shows that there are disciplines in place for longer term planning, risk assessment and accountability, all very good signs of a well run business. This will all help to give comfort to the buyer and hopefully speed up the sale process as well as increase the sales value.

CUSTOMERS

Informing current customers

Current customers can easily be lost to competitors during a sale process especially if the business owners and employees are so focused on the sale that they neglect customer service. Also remember that this is the time when competitors will see that you are vulnerable and will take the opportunity to poach customers and staff.

What can you do. Here is a list of actions you can take to protect your customer base.

1. The reason for selling the business.

2. The value in the business is created through customers like themselves and so they have worked hard to ensure that the on-going business recognizes that in the underlying culture within the business and that its systems, processes and customer interfaces support that.

3. The new owners recognize that the price they are paying includes a premium for the goodwill which is created through their good relationships with their existing customers and are thus keen to ensure that they protect that value by working hard to keep existing customers happy.

4. They have sought out a buyer who really appreciates the business, understands how to operate it properly and is keen and capable of developing its future potential.

5. The existing owners will be staying on through a transition arrangement to ensure a smooth handover of the business.

6. No major changes are planned for the business in the short term. The new owners, however, will be seeking customer feedback to identify how additional customer value can be created.

6. The employees of the business support the sale and are positive about the future under new management.

6. Existing owners and the new owners are available to answer any questions.

MANAGERS

Why should I involve my managers in the sales process?

Selling a business involves a series of steps which inevitably involve the senior management team and perhaps the second level managers or supervisors. The major stages are preparation, negotiation, due diligence, integration and on-going post acquisition operations. Within most of these stages, the current management are actively involved and they can either help make it work or scuttle it. Getting their support is, therefore, absolutely necessary.

Many entrepreneurs incorrectly believe that they can carry this process off by themselves and that they can continue to manage the business under new ownership. However, entrepreneurs typically make bad employees and most smart buyers know this and so they look to the management team to provide the transition to new ownership. This view from acquirers is not unreasonable. Entrepreneurs are used to being in charge, making decisions with justifying them, taking shortcuts and accepting risks and thus don't fit well into a bureaucratic structure where they have to report to a boss and take orders. In addition, they are most likely cashed up, want to take it easy or want to move onto their next big idea.

Similar logic can be applied to many in the senior management team. The CFO is unlikely to want to step down to being a branch accountant, the Sales Director to a sales Manager or the Marketing Director to a Product Manager. If they are all used to being part of the strategic decision making process they are likely to want to perform in that role again. Furthermore, they may all have done well out of the deal and want to move onto to another venture. The bottom line – few of the senior managers will go with the deal or stay long after the deal is completed. Smart buyers know this and therefore look to the second level management and key employees to make the transition successful.

The entrepreneur who wants the deal to be successful must find a way of gaining the support of second level management and key employees in both the preparation for sale and in the transition of knowledge across to new ownership.

If the people who have to make the deal work are uncertain of their future or resent the business being sold, they may well leave or work to undermine the process. The entrepreneur thus needs to bring them into the process in such a way that they will actively support the sale preparation and will be willing to transition to the new ownership in order to provide the continuity needed by the buyer.

Incentives need to be provided to management and key employees to encourage them to work towards a sale. This means ensuring that they have sufficient incentives in the form of shares, options or bonuses to do so. Those that will be made redundant need to be provided with a bonus in order to stay until the sale is completed and then provide them with a buffer to allow them to be retrained or look for new employment. Those key employees who need to be retained need to be provided with significant incentives to willingly stay on for, say, a year to transition the business to the new owners.

Business owners who fail to put these incentives in place risk buyers walking away from the deal or facing a significant drop in sale price.

PART D: FINANCIAL BUYERS

There are good buyers and not so good buyers and you need to develop a process where you can pick the best. The best are not necessarily those who will pay the highest price. A great price followed by years of litigation where the buyer attempts to get some or all of the sale price back is not the best way to retire. What you are looking for is a corporation which can fully exploit the potential in the business and clearly has the capability and capacity to do so and has a culture where your good employees will be willing to stay on to make it all happen.

Finding the right buyer can be problematic but with a good set of criteria and some help from professional advisors and enough time to execute the strategy properly, this is highly achievable. It simply cannot be rushed.

VALUATION

What is your business worth?

Entrepreneurs generally disagree with conventional valuation methods. They will almost always argue that it unfairly values the future potential of the business represented by their investment in R&D, market development and people. In most cases they are right, but only in the context of getting the right buyer to purchase the business from them. So how should you approach the valuation problem?

The two most basic categories of valuation methods are 'going concern' and 'liquidation or break up' methods. Liquidation values are simply the sum of the sale price of the individual component of the business if it were broken up and sold off. This valuation method is most appropriate to a lender who wants to ensure adequate coverage and protection of their debt. It might be of relevance to the entrepreneur if they wanted to know the worst case fire sale value of their business.

Conventional valuation methods are based on the assumption that the business will continue to operate in a similar manner to current operations. The valuation derived is typically referred to as the Fair Market Value (FMV). However there may be a number of acceptable methods of arriving at FMV and they will all result in somewhat different values for the business. The reason why there are several approaches is simply because each method involves a series of assumptions about the on-going performance of the business. Change the assumptions and of course you arrive at a different value. Since the future is always uncertain to a degree, estimates of future income and profits by parties with different interests will vary.

Going concern valuation methods are most often attempting to estimate the return to an investor who buys the business that is assumed to continue to operate as it has done in the past. Profit after tax, or free cash after meeting all normal expenses, is discounted back at the investors required rate of return to give a net present value of the business. This assumes that the business will continue operating along the same lines as before and will experience the same trends of growth or decline as recently experienced. The reason why entrepreneurs dislike this method is that they typically invest in R&D, market development and people to build a better base for long term growth. Short term valuation methods are not able to adequately account for such potential.

A going concern valuation can be manipulated by cutting back on R&D, reducing growth investment and cutting costs where possible. But you also put the business at risk by doing so. Since you can't predict competitive forces accurately, continuing to develop products, markets and people are your best long term protection against being undermined by competitors.

Successful entrepreneurs build growth businesses. Only very few businesses are able or even suited to a public listing; the vast majority will be sold in a trade sale to a larger corporation. This is where having the right strategy can achieve significant premiums over FMV. This is also where the investment in R&D, market development and people can really pay off.

The optimum trade sale buyer is called a strategic buyer. They are often prepared to pay a premium over FMV because the acquisition solves a strategic problem for them or provides them with a strategic opportunity or competitive advantage which they can leverage to achieve value in excess of the price they are paying for the acquisition. However, unless you are lucky, achieving a strategic sale requires an investment in developing assets or capabilities which are targeted at identified potential strategic buyers.

A proactive trade sale strategy requires you to put in place the following;

- An agreement between shareholders, management and directors that a trade sale is a business objective
- Operational systems that allow you to plan, delegate and monitor business performance in both financial and non-financial terms
- Fair and equitable and industry standard contracts and agreements with management, employees, customers and suppliers
- Compliance systems to ensure regulatory requirements are fully satisfied
- The potential buyer is able to readily scale the strategic capabilities of the business
- Several potential buyers who are willing and able to leverage the value in the business are identified and a relationship developed with them

The valuation achieved through a strategic sale should be greater than FMV and can be many times FVM if the right buyer is found. However that value can be seriously threatened where the business is poorly managed. The due diligence that is undertaken by the potential buyer before the purchase agreement is signed aims to uncover any weakness or risks in the business. It also aims to determine how the strategic value in the acquisition is to be exploited. The more problems that are found, the greater the cost and time the acquirer will incur before they can leverage the strategic value for the business. If too many problems are found, the buyer may decide that the trouble is not worth the effort and they will not proceed with the purchase.

Maximum value can be obtained for the business by ensuring that the acquirer can quickly and easily extract the strategic value for the business. At the same time entrepreneurs need to understand how conventual FMV is determined so that they are able to demonstrate how their business can create additional value to the buyer and thus justify the premium on the purchase price.

SYNERGY OR PROFITS

When do you choose between developing strategic value and profits?

I often confront entrepreneurs with a stark choice – what is the best strategy to prepare your business for a sale – build up the profits or develop underlying assets and capabilities for a strategic sale. You might well ask ‘Why can’t you do both?”. I am sure that some companies can, but when you look at the processes involved and the priorities which will place on where to use your surplus cash, you often see is a clear choice – you don’t have the resources to do both so you need to decide which strategy is going to give you the highest exit price.

Companies which are sold on an EBIT multiple are those which provide the buyer with a platform which enables the buyer to generate a stream of future earnings through the use of the resources contained within the acquired business. While these might be augmented by the buyer through the insertion of better processes, more capable management and better funding, essentially it is the same underlying business which is generating the profit stream. Thus any acquisition valuation will be based on net present value of those future earnings. Most businesses fall into this category. Thus financial buyers typically buy retail, wholesale, light manufacturing, transport, property and services based businesses.

You increase the value of such businesses by reducing the inherent risks for the buyer, improving the visibility and reliability of future earnings forecasts, improving on-going profitability, building growth into the business and finding ways to create growth potential for the buyer.

By contrast, those businesses which appeal to strategic buyers have some underlying assets or capabilities which a large corporation can exploit through the buyer’s own organization. Small companies will often develop products or services which can be sold by the acquirer through the buyer’s very large distribution channels. In the right circumstances, a buyer might be able to scale the revenue by 50 to 100 times that of the seller just by having the right access to global customers. The key to a strategic sale is to find a large corporation who can exploit the underlying asset or capability of the seller to generate very large revenues. In these situations the size, revenue, number of customers or employees or level of profits of the seller may be entirely irrelevant. It is the size of the revenue opportunity of the buyer which is the key to a strategic value.

Thus a business which has the right type of assets or capabilities which can generate such strategic value may be much better off by putting additional effort into developing those assets and capabilities to provide greater or earlier revenue generating power for the intended buyer. A higher exit price will be achieved if the buyer can scale or replicate the asset or capability faster and can integrate the seller's business quicker. The only size consideration for the seller is to be big enough to provide the launch platform for the buyer to fully and quickly exploit the strategic value.

Strategic sales normally generate much higher exit values. Take the time to consider how you might develop your business to generate more strategic value.

THE BUYER

What is a Financial Buyer?

Most entrepreneurs would like to know that they can sell their business for a good price when they are ready to move on or retire but few actively plan for the event. For the majority of businesses, the sale of the business will depend on an evaluation of the income generating power of the underlying business yet few owners build a revenue and profit profile that supports an attractive valuation. However, with some advance planning they could easily achieve three to four times more than originally expected.

Most businesses are copies of similar businesses in other locations and service a local customer base. Generally they have some local competitive advantage in one attribute of their business, although this is often simply a stable of loyal customers. The potential buyer often has many similar businesses to choose from or may even be indifferent to the type of business they buy. Given that they have choice, the bargaining power is mostly on the buyer's side, especially if the owner has a need to sell. The valuation of the business will be substantially based on the current level of profit and thus the owner that has to sell in a hurry without preparing the business for sale can be highly disadvantaged in the process.

Typical business valuations are based on a measure of sustainable net profit after adjusting for the owner's salaries and benefits. The future net profit may also be adjusted to compensate for old equipment and other investments needed to provide an effective on-going capability. The future income stream will then be adjusted down where revenue and profits are volatile or can't be shown to be sustainable. The current value of the business will also be adjusted down where outstanding problems, risks and actual and potential litigation are present. Where the owner is key to the profitability of the business, the lack of a successor, a lack of adequate business process documentation or inadequate performance metrics and reporting systems will cause the future potential income to be adjusted downwards.

Protecting the value of the existing business can only be achieved if the entrepreneur puts in place systems and processes to assure the new owner that the forecast income stream is highly achievable and that the business has no inherent risks. The first step in the preparation plan is to undertake a vendor due diligence. This means that the business will be examined from head to toe by professional accountants and lawyers to uncover any failures in compliance, reporting and control systems. They will advise the owner on how the business is best prepared for sale and for the acquirer's due diligence process.

The next step is for the entrepreneur to build resilience into the business so that future forecasts are more achievable. This is assisted greatly by building up recurring revenue. This can best be achieved by concentrating on the top 20% of customers. Where possible they should be moved to long term agreements and you should be seeking opportunities to increase penetration of the accounts through cross selling and loyalty schemes. Less profitable customers should be put on low touch relationships to improve productivity and profitability. Supplier arrangement should be strengthened to ensure continued supply of key components and services.

The whole business should then be examined for cost reduction. Every dollar saved can have a multiplying effect on the sales value. One useful approach is to remove as many operations that add no value to the customer. Another is to use value engineering and activity based costing techniques to identify wasted resources. The objective should be to increase the gross margin on every sale and to reduce administrative and overhead costs where possible.

The final stage in the plan is to put in place the foundations for future growth. Since the sales value is based on the present value of the future income stream, increasing the growth rate of the business will directly impact the sales value. The projected income from current products and services will already be built into the base sales value. What the entrepreneur has to do is provide convincing evidence that the business of the future can tap into assets and capabilities that have yet to be exploited. These could be prototype products, new business relationships or untapped resources in the firm. For example, these could include new distributors, new alliance partnerships and innovations in products or services that will open up new markets and so on. It is growth potential that is important.

Valuation of a business is often said to be more art than science. This is often because many adjustment need to be made to account for uncertainties in the ability of the business to operate efficiently and effectively without the current owner. At the same time, the revenue potential of the business is doubtful because the owner is not able to produce forecasts that have any degree of reliability to them. Only by reducing the risks in the business, reducing the volatility of the business income, ensuring the business can be operated effectively without the presence of the prior owner and by building a platform for growth can the seller maximize the sale value of their business.

FINDING THE BUYER

How do I find the right financial buyer?

When you decide to sell your business you can do what the vast majority do and hand the process over to a broker who will simply advertise the business to solicit the highest offer in the shortest possible time with the least effort on the part of the broker. However, this is hardly likely to find the buyer who can best exploit the potential in the business, an essential requirement if you are to gain the highest price for your business. Instead of giving the task to someone who knows little about your business and probably even less about who the right buyer could be, take charge of this process yourself.

For a business where the value is based on its ability to generate future profits, the highest price on sale will be obtained by finding a buyer who can fully appreciate the potential in the business and is able to exploit that potential. That is, you really need to find a person or corporation who can develop the business and who has the capacity and capability to do so. Simply advertising the business in the hope of finding someone or some corporation which can best develop the business is as reliable as tossing your hat in the air to see if it lands back on your head.

The right buyer is almost certainly a corporate executive within your own industry who wishes to transition into their own business or a corporation in your industry undertaking a roll-up or consolidation strategy. That being the case, your best strategy is to become known within your industry and get yourself on the target list for those companies looking for acquisitions. The best corporate acquirers are frequent buyers, have very good processes for integrating new acquisitions and will be able to fully appreciate the preparation work you have done and the potential you have built into your business.

You need to get on the radar of corporate executives who might be interested in buying a business and on the target list of corporations undertaking acquisitions. Time spent supporting the industry association, developing a high profile through industry media and industry events and getting known through local and national public relations won't be wasted.

Other ways to put yourself in front of the right buyers include tracking acquisitions activity within your industry to discover who is buying and ensure you get know to them and making contact with industry specialist investment banks, business brokers and corporate finance departments of the larger professional firms. Over time you need to build up a list of potential corporate acquirers and business advisors who have good contacts within your industry.

When the time comes to sell your business, you can then be proactive in contacting those on your list, some of which will by then already know who you are and what you do and will be able to quickly evaluate a potential purchase. You can still use a business broker or an investment bank but you can have confidence that the best potential buyers will be contacted during the sale process.

REDUCE RISKS

How do I reduce risks to the buyer?

Many business owners rush around cutting expenses and pushing revenue generating activities just before a sale of the business in order to pump up the profits. Their objective is to increase the valuation at the time of sale, however, they neglect to reduce the risks in the business for the buyer which often negates all their efforts.

Smart buyers anticipate problems in an acquisition and set out to find them before they agree to buy and set a final purchase offer. They are looking at three areas of risk; inherent problems within the business, problems which they will encounter on integrating the acquired business into their existing activities and constraints which will prevent them from achieving their target return on investment. In order to protect the value in your business, these are areas which you need to address in preparing the business for sale.

Any corporation which has undertaken a number of acquisitions will probably have made mistakes and almost certainly will have acquisitions which failed to provide them with the anticipated benefits. They have been burned, probably more than once and so they are looking for problems. They will have a very long due diligence checklist of all the things which their accountants and lawyers tell them to watch out for and they will have their own experiences which will add to the list. They will sniff out every discrepancy, irregularity, missing information, potential liability and risk which they can before they agree to move forward.

Any extensive due diligence process takes time, uses up administrative resources and creates stress and disruption. It distracts senior managers from running the business and takes attention away from running the business. If the investigation uncovers problems, it normally leads to a reduction in the offer price and more delays as the due diligence is extended.

The only way to counter this negative impact on your sales price is to be fully prepared for due diligence. Probably the best preparation is to have your own accountants and lawyers undertake a vendor due diligence. This will examine your business through the eyes of a buyer and point out to you where changes are required. Once you have implemented those changes, keep your due diligence files up to date and your performance and governance systems working properly so you will be ready for the buyer due diligence.

Also think about how your business might be integrated with that of the buyer and what you can do to ease that path. Using standard industry contracts, documenting processes, ensuring the key employees are retained and putting in a succession plan are some of the activities you might undertake.

Next, think about how the buyer will operate your business after the sale and put in place systems and processes which will make managing the business easier for the new owner.

Really smart buyers purchase companies which are efficiently operated and are prepared for a new owner. The new owner can then concentrate on generating profits instead of fixing problems.

LEVERAGING POTENTIAL

Why would the buyer pay me for the potential which only they can achieve with the business?

Any premium paid above conventional value for a business is being paid for the unrealized potential in the business. The reason why this is not already built into the value of the business is that it will require the buyer to exploit this potential. That is, the potential will only be realized by the buyer and not by the current owner. The essence of this argument is that the buyer will need to bring something new to the business, such as new funds, energy, knowledge and/or synergistic relationships and so on, in order for the potential to be realized. If this is the case, why would the buyer pay for something which only they can realize?

Almost without exception, professional advisors will tell you that buyers will not pay for what they bring to the enterprise. At best, they are only willing to pay a fair value for what the business as a going concern can produce. Look at this from the buyer's viewpoint. Let us imagine that I am smarter than you and that I have worked out how to increase the growth rate of your business to double what you, the vendor, are currently achieving. I should be able to buy your business on the basis of your growth rate, make the changes and then benefit from the increased rate of growth which I can achieve. Any subsequent increase in value surely must be mine since you, the vendor, were not able to do this previously. Without a doubt, this latter position will be heavily supported by knowledgeable buyers.

If I as the vendor were unaware of how to extract future potential out of the business, I would certainly not expect any buyer to pay above the conventional going rate. But what if I knew exactly how the business could be exploited and therefore knew that the business would be worth a lot more in the hands of the right buyer. My challenge would be to try to extract part of that future value for myself. The critical point here is that, if they don't buy, the buyer does not get the opportunity to extract the additional value. Thus what I need to do is to hold off selling until the offer price goes up or get the business into a competitive bid so that the buyers are forced to bid up the price is order to be the successful acquirer.

The smart vendor works out how the business could best be exploited and lays the foundation for that prior to sale. They then identify those potential buyers who can best exploit the potential in the business and bring to their notice the possibilities which might accrue to the successful buyer. Finally, they put the business into a competitive bid to ensure that the buyers have to compete for the opportunity to gain the additional value. While it is unrealistic to expect that all the potential will be passed back to the vendor, sufficient will to result in a premium on sale.

ERODING VALUE

Buyer delays eroding value

I know of many entrepreneurs who have lost value on the sale of their business when the buyer has strung them out through the negotiation and due diligence process. The disruption to the business due to due diligence activities and the distraction of focus caused by the tension in negotiations often leads to a fall in revenue and a lowering of profits. Where the sale price is based on a multiple of earnings, this downturn can seriously hurt the final sale price. Only by recognizing this impact, whether deliberate on the part of the buyer or not, can the entrepreneur mitigate the damage.

Not all buyers are honest and scrupulous and not all are well prepared for the buying process. Thus it is not uncommon for the sale process to be drawn out with a subsequent loss of focus on the business. This rarely works to the advantage of the seller. In fact, it is not unknown for potential buyers to use such tactics to wear down the vendor in order to get the firm at a lower price.

While some delays are unavoidable and tension and distraction are a normal part of the process, the smart entrepreneur prepares in advance for this eventuality. There is no question that it is hard to go through the sale process without significantly using up senior executive time as there will be some elements of the negotiation and due diligence process which simply cannot be delegated. Knowing this in advance, however, the vendor should put in place a succession plan so that essential operations can be undertaken by other than the senior management team.

Preparation for due diligence is an obvious step in selling a business. The last thing you want to be doing is hunting through storage cabinets looking for old documents or compiling essential employment or financial data which is standard in a due diligence checklist. The vast bulk of due diligence information can be assembled in advance and kept up to date for when a deal is on the table. While the buyer is busy doing the analysis, you can be back running your business.

By far the best way, however, to keep a deal in play and progressing is to ensure that you have multiple potential buyers. If you are well prepared, have good advisors and have done your homework to identify those potential buyers who would have the most to gain through an acquisition, you have much greater control over the timeline of a sale process. Those buyers who are not prepared themselves or not willing to meet the deadlines will simply drop out of the process, but you do need to have a number of potential buyers to play that hand.

If you can clearly see that a buyer is deliberately using delaying tactics to wear you down and reduce the price, you are almost certainly going to be better off by pulling out of the negotiation. That tactic alone may well bring them up to the mark. The greatest danger in any sale process is to be in a position where you have to sell, you are unprepared and you have only one potential buyer. Planning the sale well in advance, being prepared and having several potential buyers is the only way that you can really ensure you get the maximum value on sale.

THE RIGHT BUYER

It pays to find the right buyer

When you are selling your business it pays to look at your business through the eyes of the acquirer. While it might look attractive to squeeze the last drop out of your buyer, you should try to avoid the naive buyer. There are some very good reasons why you might want to limit your selection of potential buyers to those companies that have a good track record of successful acquisition.

There is now considerable research available on acquisitions and their impact on the acquiring corporation. A 1999 study by KPMG found that 83% of mergers failed to unlock value. A 2004 study by Bain & Company of 790 deals made by US based companies from 1995 to 2001 confirmed prior research that '70% of all deals fail to create meaningful shareholder value". It would seem that the likelihood of success in a merger or acquisition is against the acquirer. However a more recent Bain & Company study of seventeen hundred large public companies in six industrialized nations spanning the time period of 1986 to 2001 did uncover corporations that were consistently successful in their M&A activities.

Bain found that corporations that were successful had several characteristics in common:

- They were frequent acquirers. That is; they had a M&A program that undertook regular acquisitions
- They typically started with small deals and gradually became more expert at acquisitions and then progressed to larger deals
- The size of the deals was generally small – often less than 15% of the parent company's capitalized worth
- A clear return on investment case was made for the acquisition and they were prepared to walk away if their criteria were not met.
- A comprehensive due diligence was undertaken of the potential target with a strong emphasis on the integration effort. This included a serious consideration of the culture match between the two businesses.
- Frequent acquirers set up benchmarks so that they know that the integration effort is on track and have

processes to deal with under-achievement.

- Successful acquirers have an acquisition strategy that targets potential firms that offer value to their core business and build relationships with them prior to formal discussions.

Clearly successful acquirers rarely overpay for their acquisitions and so it would appear that your chance of generating a premium on the sale of your business would be minimal. However it is clear that successful acquirers also look for strategic value. They are interested in acquiring firms that can clearly add to their core business through extending the scope of their offerings or their ability to scale the size of their business through distribution capacity or customer base. The firm that can show how their products, processes or capabilities can be leveraged by the acquirer should thus be a good acquisition target.

Your proposition to a potential acquirer should show the buyer how they can exploit the potential of your business. Most private firms are constrained by limited resources, lack of funding, an inability to recruit the best people due to their size, a limited distribution channel or small customer base. Often these elements are exactly what the larger corporations have in abundance. This present a great opportunity for the acquirer to release unrealized revenue from the underlying products, processes or capabilities of the smaller firm. The key is to find the right buyer that can do that. If you can show how significant revenue can be generated then it is certainly possible to extract a premium on sale of the business.

There are some other good reason why you might want to look for competent and successful acquirers. Generally they understand what to look for, thus their due diligence will be thorough. If they find a serious problem they will request it be fixed, make an allowance to fix it or walk away. That means that there are unlikely to be hidden rocks which can catch you out later on. The last thing you want is for the buyer to sue you over something that could have been discovered during the due diligence process. You also want a successful integration for your business into the buyer's and you want them to achieve the benefits of the acquisition. A buyer that is making lots of money from an acquisition is less likely to worry about a few problems that they uncover. However a deal that goes sour will find the buyer going over every inch of the business trying to find how they can litigate to get their money back.

The successful acquirer that pays a premium on the deal is also less likely to get rid of your employees. They acquired the business because they saw potential in it. It is most likely that the potential needs to be supported by your previous employees, thus you are potentially also taking care of your loyal employees by find the right buyer. Successful acquirers also understand how to go about the integration effort and are also less likely to lose good people through a lack of understanding of the degree of change they are being put through.

The message is compelling for the potential seller. Identify those corporations in your industry or adjacent to it that can leverage your assets and capabilities to create significant value, set up a relationship with them to allow dialog and then build a case to show them how the acquisition can work for them. Then you wait for the offer or decide when to make the approach to them.

OTHER CONSIDERATION

Vendor objectives beyond price

Most entrepreneurs will compromise the opportunity to get the maximum price on sale if other non-financial objectives can be met. At the end of the day, a generous sale price will gain the entrepreneur much more wealth than he needs to live comfortably for the rest of his life. Any excess funds received above what is needed to live well are simply stuff to invest or worry about. When it comes to trading excessive wealth off against other personal objective, few hesitate to do so. Thus the corporation offering the highest price is not necessarily the successful buyer.

Almost every entrepreneur will acknowledge that they only have the opportunity to gain wealth through the efforts of the employees, customers, suppliers and service providers who assisted them on their journey. In many cases, those closest to the action are acknowledged with bonuses and option schemes and thus do share in the rewards, but often this does not go far enough to satisfy the entrepreneur. What will happen to loyal employees after the sale is often of considerable importance to the selling entrepreneur. They fully acknowledge that they cannot control events after the deal is done but they can certainly influence it though their choice of buyer.

Most employees are stressed during a sale process. They are concerned not only for their future continued employment, but they may well have concerns over their terms and conditions, relationships with new managers, entitlements to health and vacation benefits, flexible working, education funding, child care and so on. Some will worry about the future of the business itself and whether it will be relocated, fully or partially closed down or taken in a new direction. They worry also that employee's accumulated knowledge of products and services or of customer or supplier relationships wont be as useful if the business changes its focus.

An entrepreneur concerned about the future welfare of employees may spend time with each prospective buyer ascertaining their future intentions, reviewing their employment practices and assessing their internal culture. While they cannot give guarantees of the future of their products and services, picking the right buyer where those are valued and intend to be further developed, might give greater comfort to employees transitioning to new ownership.

Such considerations are not necessarily suboptimal. A buyer who wishes to fully utilize acquired personnel and who can see future growth potential in the acquired products and services, should be high on the list of desirable buyers anyway. If the buyer ends up paying a premium for the business, then ensuring that key employees stay is critical to gaining a positive return on the investment. The selling shareholders would want to be assured that the buyer had the capacity and capability to exploit the potential so that the premium paid could readily be validated by the results. The last thing selling shareholders need is for the acquisition to fail and for the buyer to send in the lawyers demanding their money back.

As the selling entrepreneur, I would want to know that the people who helped me gain wealth were looked after. I don't think this is an unusual position for entrepreneurs to take and, if this means taking a little less for the business, I don't think too many entrepreneurs would hesitate to do so.

WHAT TO SELL

Assets or shares – which should I sell?

When you come to sell your business, you may have a choice between selling shares in the business or some or all of the assets of the business. There are of course situations where you will have no choice as the outcome can be determined by local legislation, foreign currency remittance rules or the legal structure of the buyer. You may also be limited by the retention of a minority interest who chooses not to sell or a buyer who decides to keep them involved. However there are other considerations.

Often a buyer wishes to avoid taking on selective obligations or potential liabilities of the seller. As these are normally attached to the legal entity, it might be judicious of the buyer to take over some of the assets and liabilities but leave behind those which are problematic. Alternatively, the buyer could buy the whole business but have an agreement with the prior shareholders that they will meet any liability arising out of particular situations.

Employee obligations, entitlements and legal rights may compel the deal to go one way or the other. Where a firm changes ownership, the rights or the employees transfer to the new owner, however, there may be legal obstacles where that ownership is foreign or where there is an intention to close down the business.

Another common scenario is where only part of the business is being sold. This could be done as a spin out where that part of the business to be sold is setup in a newly formed company, or alternatively, the part being retained is spun out to a new entity. Companies which have a number of parts of the business which have untapped potential may be much better off selling off parts of the business over time as value is created.

Unless the decision is clear cut and meets the desires of both the buyer and seller, the issue can be problematic. Most times the seller wants to shed any future obligations to the business, even those which are yet to surface. The sellers wants to be able to walk off into the sunset knowing that they can get on with the next phase of their lives. The buyer, on the other hand, is somewhat sensitive to what they don’t know which could come out of the woodwork some way down the track and bite them. Generally a sale price reflects both positions and the risk rate used to arrive at a sale price takes the unknown future risks into account. However, clearly there are going to be situations where the buyer discount is going to be higher than the risks anticipated by the seller and an asset sale rather than an equity deal will be the only way to get the deal done. The seller then has to live with whatever surfaces.

This is one of those situations where getting good legal advice is essential.

THE OFFER

How can I get the maximum price when I get an offer to sell out?

Many entrepreneurs are quite surprised when a prospective buyer turns up at the door with an offer to buy. Even when they anticipate it might happen one day, the actual event is still surprising. Then of course, the entrepreneur must consider whether to entertain the offer or reject it without consideration. Few of us can resist at least finding out what is on the table and so it is more than likely that some discussion will be entered into. Sometimes this is 'just in case', that is, just is case it is a crazy high offer and you might want to seriously consider it.

If you are a conventional business and if you understand the normal valuation models for your industry, which are usually based on some multiple of EBIT, then it is not hard to work out what a premium offer might be. If you are a high growth potential business at an early stage of proving your business model and you are hoping for a strategic buyer, you might have some difficulty working out what a reasonable offer might be. Even so, there will clearly be a price where you will move forward with the negotiation. But how do you know you have the highest price you could achieve at that moment in time?

Most acquirers are not in the business of being generous and they will pitch their price at a point which will just get your interest and secure the deal. If they don't need to offer more to secure the deal, why should they? Even if you thought your business had greater potential, you still might be willing to settle for a bird in the hand. Once you have decided that the offer price is at a point where you will sell the business, the only way you can be sure of getting the best price is to put your business into a competitive bid.

When you have an offer, it is unlikely that the prospective buyer will hang around while you start the process of working out who else might be interested and go through the exercise of making contact and educating other prospective buyers. Most offers have relatively short offer periods – basically take it or leave it. However, if you like the price, then the only way you can move it to a competitive bid is to have the other prospective buyers waiting in the wings. That is, you will have set out sometime in the past to proactively identify and make contact with a group of prospective buyers with the intention of setting up a future competitive bid. Whether you trigger off such a bid or it is activated by an offer, you need to be prepared for such an event.

An offer often comes with a condition of exclusive dealing, however, this is normally done so that the prospective buyer doesn't waste their due diligence time and costs. If the business is already prepared for due diligence and the prospective buyers already understand the potential in the business, the vendor can hold off on due diligence until more prospective buyers are in the frame. Then only the highest bidders will be invited to undertake a limited due diligence to arrive at a preferred buyer.

POST-SALE ROLE

Should I plan to go with the deal?

Few entrepreneurs are willing to admit that they may be more of a liability than an asset to a future buyer of their business. Because they often see themselves as being a critical part of the enterprise, they wrongly believe that they will get a better price for their business if they commit to working for the buyer. In fact, because they are often a critical part of the business, this is exactly what worries a buyer.

You need to see this from the buyer's viewpoint. On the one hand, you have a talented individual who can bring essential knowledge and is willing to commit to the future of the business. An alternative view, however, is that this critical individual is unlikely to stay and thus all that essential knowledge will walk out the door. Even if the entrepreneur is enthusiastic about his or her new role and contribution, the truth of the matter is that few last the distance. Buyer's understand this and are very wary of taking on ventures where a major shareholder is essential to its success.

This is not an unreasonable attitude on the part of the buyer if you look at the circumstances. Basically, you have a cashed up entrepreneur who is used to being in charge, making quick decisions without being accountable and is the person who has determined the strategy of the business. To expect them to suddenly resign to being an employee, taking directions and having their actions reviewed is a little bit unrealistic. Couple this with the fact that they now have enough money to do what they want in life and probably don't need to work and you can see the problem facing the potential buyer.

However, there are a number of ways that this can be approached by the entrepreneur which can create positive value for the potential buyer without creating undue risk. Firstly, the entrepreneur has to ensure that the business is able to be managed without their active involvement. They might achieve this by putting in a competent COO, establishing a Board of Directors and then concentrating their efforts on longer range business development. Some founders stay active by taking on the position of Chairman of Directors and/or export development. Secondly, the entrepreneur might suggest that they join the buyer in a different area away from their prior business but be available for consultation. They might also suggest a role with considerable challenge and future rewards tied to performance to show their degree of commitment.

Smart acquirers anticipate that founders won't fit into a large bureaucratic organization and assume that they will leave. Thus they look for businesses which can be managed without the founder's involvement beyond a short handover period. While there are numerous examples of founders who have made successful transitions into large corporations, the normal experience is the opposite. Given this trend, the smart entrepreneur anticipates this and plans the sale of their business so that the buyer does not see the founder's role as a potential risk. In the majority of cases, it is usually better for the continuing business and for the founder that they move on and devote their energies to the next venture.

MINORITY INVESTMENT

They want to take a minority stake in my business – should I?

Large corporations will often suggest that they take a minority stake in an emerging business. They might be seeking an insider's view of a developing technology and want to be able to preempt competitors by making an offer for the remaining shares before the business is up for sale. They may want the business to invest in additional capacity and capabilities to support an alliance relationship. Alternatively, they may wish to invest in the business as a corporate venturing opportunity to gain a higher than average return on funds employed.

The entrepreneur may be interested in selling part of the business in order to cash up part of his or her investment. If the shares are invested in the business it might be a cheap source of capital or a way to gain greater attention from a strategic partner. Alternatively, it might be used as a hook for a possible future sale.

Minority investments do not come without their problems. Few knowledgeable investors make minority investment without conditions. These might include veto power over executive remuneration, raising new equity or debt, capital expenditure, dividends and so on. They will normally include a position on a Board of Directors and the right to replace the executive team if agreed performance targets are not met. An emerging business which has little formal reporting and no Board of Directors will suddenly find themselves with a major change in their performance evaluation and governance environment.

However, for the entrepreneur this can be a way of accessing equity funds and it could be linked to access to resources, technologies, networks and knowledge. It is sometimes undertaken to secure a strategic customer or strategic partner who can advance the progress of the business. It often forms the basis of an acquisition where the parties have a chance to get to know each other and the investor has time to fully evaluate the benefits and risks of an outright purchase.

There are, however, traps and the entrepreneur needs to weigh up the benefits with the restrictions and loss of flexibility. The agreement may come with a first right of refusal on the issue of further equity or on the sale of the business. Such a restriction might scare off potential investors and buyers. There is also the risk that the investor will not step up to putting in the resources to assist the business leaving the entrepreneur with an ineffective, if not hostile, minority shareholder.

What the entrepreneur needs to assess are the benefits of having the corporate investor over the alternative of an angel or venture capital investor, or even if it would be better going it alone without the interference of an external investor. If, however, significant progress can be expected by bringing the corporate investor on board, then the risks may be outweighed by the benefits. Certainly, the likelihood of an outright sale to the corporate investor would be greatly enhanced with a minority investment. The difficulty then would be to ensure that a reasonable market price for the business could be achieved in the absence of a competitive bid.

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