

Dr. Tom McKaskill

MASTERCLASS FOR ENTREPRENEURS

on

Strategic Exits

***INSIGHTS ON HOW TO
LEVERAGE STRATEGIC
VALUE TO ACHIEVE
A VERY HIGH PRICE
WHEN SELLING A
BUSINESS***

BREAKTHROUGH PUBLICATIONS

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Insights

*Strategic value deals are different.
You need to craft the exit strategy
around the synergy to the buyer.*

*It is the strategic asset which the buyer
wants not your revenue or profit.*

*Your size, growth rate, profitability and
customer base may all be irrelevant
in creating strategic value.*

*The buyer creates strategic value by
exploiting the underlying strategic asset or
capability inside their own business, often
through a very large customer base.*

*Decreasing inherent risk, preparing for
ownership transition and making it easy
for the buyer to exploit the acquisition
is the path to high exit prices.*

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.

Tom McKaskill is a member of the Brisbane and Melbourne Angel Groups and of the Australian Association of Angel Investors.

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December 2010

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Published by:
Breakthrough Publications
RBN: B2173298N
Level 1, 75A Chapel St.,
Windsor, Melbourne, VIC 3181

www.tommckaskill.com
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National Library of Australia Cataloguing-in-Publication data:

McKaskill, Tom
Masterclass for Entrepreneurs on Strategic Exits: Insights on how to leverage strategic value to achieve a very high price when selling a business
ISBN: 978-0-9870663-8-1 (115 pages) 245H x 175W
1. Investments. 2. Investment analysis. 3. Entrepreneurship. 4. Business enterprises - Finance.

I. Title.

332.6

Cover design: T. McKaskill

Page design and production: T. McKaskill

Preface

I have a fascination with strategic exits. How is it possible to achieve 20 times revenue or 100 times EBIT on an exit? Certainly not from the profit generating power of the business being sold! There is something else we need to examine. We need to see the acquisition from the viewpoint of the buyer and understand how they perceive value and why they are able to justify such a high purchase price.

When you have looked at hundreds of cases of strategic exits as I have, you start to see underlying trends. Buyers have very similar reasons for their actions and they can readily justify the premium on purchase if they know they can exploit the acquired business to 50 or 100 times the size it is at acquisition, usually within a few years. Thus they see something they can exploit easily and they know they have the capability and capacity to do so.

My own experience of selling several businesses for significant strategic premiums put me into a position where I saw the process from the inside. I was leading the negotiation and had to create the case for the high premium. Over time I got better at doing so and finally understood that it was the buyer's power to exploit the potential which created the premium. That and of course having competition in the bid.

After selling my fourth business, I spent almost a decade as a Professor, recently as a Chair in Entrepreneurship at the Australian Graduate School of Entrepreneurship, where I had time to look into this issue in greater depth and to undertake research in the area. My fully documented process for selling a business based on its strategic value is the result. This process is now used widely by Angels and Venture Capital firms to select and exit their investments.

PART A: STRATEGIC VALUE

Very few entrepreneurs have an experience selling a business with strategic value. That doesn't mean that the business did not have such value, only that they didn't recognize it or the buyer was smart enough not to point it out during the negotiations.

Most of us have been locked into a conventional valuation model which determines our valuation based on our historical financial performance. Even to suggest that this might be entirely irrelevant to a buyer seems to fly in the face of all conventional wisdom and practice. But in fact the truth is that it is only what the buyer can exploit from our business which creates value in their eyes not what we have done with it. So a buyer who can scale our business by 50 or 100 times would see a very different value.

Our task is to understand how strategic value occurs and how to extract this from the buyer.

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 you 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.

STRATEGIC EXITS

What creates a strategic sale?

We all know of small ventures which were purchased for more than 20 times revenue or 100 times EBIT. Whenever this would come up in conversation, I would hear people stating how lucky the founders were and what a difference luck and timing makes. But if you have seen a lot of these, is it just luck and timing? My own research into this phenomena suggests that you can set out to build a company which can have these huge exit values.

Just after I started my last business in the USA in 1995, a company called Red Pepper was purchased by Peoplesoft for 25 times revenue. Peoplesoft wanted to get into the manufacturing software business and needed an icon product to launch their campaign. Red Pepper had the market reputation to do that for them. A few years later, I sold my own business to Peoplesoft for 6 times revenue, even though at the time it was running up a \$1 million loss. Since I had sold a prior business for \$1 million which had never traded and an earlier business for US\$9.6 million which was only breakeven, you might say I had a lot of ‘luck and timing’. However, these exits did happen in periods of significant growth in the computer industry and so one should question whether they were anything but luck.

So if told you that I assisted a small sport travel business to get 40 times EBIT you would no doubt wonder if there was an underlying process which any venture could follow to set up a high value exit. The fact is that any business which has the potential to enable a large corporation to exploit a large scale revenue opportunity can gain a significant premium on sale.

However, very few people understand how to set up such a deal. We have spent most of our lives believing that our businesses are worth some meager multiple of EBIT. In fact, if you talk to most professional advisors, investment bankers and business brokers, they will focus their analysis of your business on what profit you are achieving now and what your likely revenue and profit growth will be in the near term future. I will freely admit that such analysis makes good sense when you are dealing with conventional businesses. If the only value they contribute to the buyer is the generation of revenue and profits through their own resources, an EBIT multiple valuation seems reasonable. But what about those

businesses which can enable a large corporation to exploit a national or global opportunity?

Most private business are heavily constrained through lack of finance, limited capacity, poor access to large distribution channels, lack of skills and so on. The inhibitors to growth often prevent them from exploiting their underlying potential. In the hands of a better resourced and more capable buyer, the underlying potential can be aggressively exploited. Even so, most products and services can only generate limited growth due to the competitive nature of the market they are in. But what if you had a world class product or service which had a clear competitive advantage? Could you find a large corporation which could exploit this advantage on a national or global scale to achieve 50 or 100 times your revenue in a relatively short period? This is the basis of a strategic value sale.

The fuel for such an opportunity lies in the assets and capabilities which a large corporation can exploit, usually within an existing large customer base. How do you know if you have the right assets or capabilities to drive such an opportunity for a large corporation?

First you need to examine your own assets and capabilities. What do you have or do which could provide the basis for resolving a serious threat or enabling a large scale revenue opportunity for a large corporation? Often these are things which currently provide your competitive advantage but they may also be things which you are not exploiting in your own business but which some other business could. Products and services which typically drive high growth rates solve compelling needs, that is, solutions to problems which you must solve. Products or services which can be delayed, where there are many alternatives or which you can decide not to bother with, do not satisfy the compelling need test.

Next, you need to determine whether you can provide the buyer with some reasonable period within which they can exploit the asset or capability without it being copied, eroded or negated by an aggressive competitor. Something that can be easily acquired, assembled, developed or negated is of little interest to a large corporation. Thus you need a strong competitive advantage, perhaps build on intellectual property or deep expertise.

Lastly you have to have a proactive approach to the market. You can only do this when you pursue a well defined but large niche market of clearly identified and reachable customers who are willing and capable of buying your product or service.

If you can satisfy those attributes in your business you have the potential for a strategic sale. Now all you need to do is to identify which large corporations can exploit the opportunity. Your exit value is then based on what they can do with your product or service not what you are doing with it. Simply get them to compete for the chance to acquire you so that they can exploit the underlying revenue opportunity.

STRATEGIC VALUE 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.

STRATEGIC VALUE AND PROFITS

What if I have both financial value and strategic value in the business?

There is considerable difference between the sales strategies of businesses which sell to a financial buyer versus those which sell to a strategic buyer. But what if you have the possibility of selling out to either?

Many services business face this particular quandary. On the one hand they might have a thriving consultancy or support business while, on the other, they have some good intellectual property. The IP might be of value to a global software corporation but they are unlikely to want the local services component. Alternatively, the services component might be very profitable and have good potential and be able to attract a very good price from a local acquirer. Clearly it would be possible to weigh up the possible exit values of each potential buyer and concentrate on the one which has the highest exit value. However, what if you could do both, that is, sell the IP to a strategic buyer and the services activity to a local financial buyer.

Such a scenario is highly probable as long as there is a clear delineation of business resources which can go with each sale and one is not dependant on the other. For example, you might sell the IP to a US corporation and agree that your local services business could be allowed continue to support the current customer base. The local business might be able to negotiate a longer term agreement allowing them to continue to support new customers or to act as a sales and support agent for the global corporation which would significantly improve its own sale value.

Firms which have strong IP which can create the basis for a strategic sale often get confused about what the buyer really wants. They too often consider their own company as a whole entity and not a collection of income generating activities which may have greater exit value when they are split out and sold separately. The objective should be to maximize the value on exit of the whole even if it is sold in parts and even if sold off progressively over time. Thus one part could be prepared for sale while other parts continue being operated normally.

We often fail to take into account the perceptions of the buyer. If we ask ourselves ‘what is the buyer really interested in?, we can often gain insights into how the buyer will treat the business after the sale. If the buyer is likely to close down parts of the business because they are a distraction from the main objective, these parts may be split off without affecting the sale price of the part the buyer is focused on. In fact, it can often be the case that a stripped down business which only passes essential resources over to the buyer can be worth more when the buyer is not confronted with the task of cleaning up a mess or closing down the parts they don’t want.

Start with the buyer in mind. Work out what a specific buyer wants from the business and how you might best package those parts which are of interest to maximize the value to the target buyer. Now can you find a buyer for parts which the major buyer doesn’t want? This strategy may allow you to split off several parts of the business into different value components which can be prepared for different sets of buyers. The overall sales value can often be significantly greater than what any one buyer would generate.

DEFINING STRATEGIC VALUE

What is strategic value?

Just after I started my last business in the USA in 1995, a company called Red Pepper was purchased by Peoplesoft for 25 times revenue. Since then I have seen numerous examples of such deals in the internet space and in biotechnology. Every time I mention these deals to friends I get the same response ‘luck and timing’. Also, these things happen only in the internet and biotech sector.

So if told you that I assisted a small sport travel business to get 40 times EBIT you would start to question this view of the world. The fact is that any business which has the potential to enable a large corporation to exploit a large scale revenue opportunity can gain a significant premium on sale.

However, very few people understand how to set up such a deal. We have spent most of our lives believing that our businesses are worth some meager multiple of EBIT. In fact, if you talk to most professional advisors, investment bankers and business brokers they will focus their analysis of your business on what profit you are achieving now and what your likely revenue and profit growth will be in the near term future. I will freely admit that such analysis makes good sense when you are dealing with conventional businesses where the only value they contribute is the generation of revenue and profits through their own resources but what of the business which can enable a large corporation to exploit a national or global opportunity?

Most private business are heavily constrained through lack of finance, limited capacity, poor access to large distribution channels, lack of skills and so on. The inhibitors to growth often prevent them from exploiting their underlying potential. In the hands of a better resourced and more capable buyer, the underlying potential can be more quickly achieved. Even so, most companies can only generate reasonable increments of growth due to the competitive nature of the market they are in. But what if you had a world class product or service which had a clear competitive advantage? Could you find a large corporation which could exploit this advantage on a national or global scale to achieve 50 or 100 times your revenue in a relatively short period? This is the basis of a strategic value sale.

The fuel for such an opportunity lies in the assets and capabilities which a large corporation can exploit, usually within an existing large customer base. The process of setting up such a deal starts with an examination of your own assets and capabilities. What do you have or do which could provide the basis for resolving a serious threat or enabling a large scale revenue opportunity for a large corporation? Often these are things which currently provide your competitive advantage but they may also be things which you are not exploiting in your own business but which some other business could. Next, you need to determine whether you can provide the buyer with some reasonable period within which they can exploit the asset or capability without it being copied, eroded or negated by an aggressive competitor. Something that can be easily acquired, assembled, developed or negated is of little interest to a large corporation.

Next you need to identify which large corporations can exploit the opportunity. Now you have the basis for setting up a deal where you potentially could achieve a sale price of many times EBIT or revenue.

TRANSITION

How do I move my business from a financial sale to a strategic sale?

Where are the big bucks in selling a business? If you think of those businesses which managed to reap many times revenue, then what you will see is a sale based on some underlying asset or capability which a large corporation wished to exploit. The reason they are prepared to pay such a large premium is because they have worked out how to generate many times the revenue and profit of the seller. They achieve this, typically, by selling the seller's product or service through their own distribution channel which is likely to be tens, if not hundreds, of times the size of the seller's.

Financial sales, on the other hand, only represent what the seller's business can achieve on its own. Even if this has significant potential, it will fall a long way short of what a national or global corporation can achieve with the same product or service. So the business which sells to a financial buyer is lucky to get several times EBIT for its business whereas the strategic sale can often generate large multiples of EBIT or many times revenue.

The key to a strategic sale is to provide a large corporation something which can generate large incremental revenue through the buyer's existing distribution channel or to enable the buyer to open up new markets for significant revenue. The basis of such an opportunity lies in exploiting an asset or capability which the seller has. The opportunity for the large corporation is to throw significant resources at leveraging the asset or capability where short term revenue can be readily generated. Even if longer term opportunities exist, the short term revenues are the ones which will justify the premium on sale.

The task of the business owner is to identify those assets (patents, trademarks, licenses, copyrights, brands, customer base, locations, specialized plant, deep expertise, etc) or capabilities (those things which you do which you do exceptionally well) which a large corporation could exploit. The target asset or capability then needs to be protected in some way so that the buyer has some reasonable time to exploit it without it being copied or eroded by its competition.

Lastly, the asset or capability needs to be put into a form where it can be readily scaled or replicated to provide the revenue generating capability and/or capacity required for larger scale operations.

You need to imagine that you are building a launch platform and vehicle for the buyer. The buyer is going to provide the launch site, fuel, crew and landing site. Your job is to work out what it would take to generate significant revenue from your target asset or capability and then to construct a launch capability from which a new revenue strategy can begin. At the same time, you need to build protection through patents, brands, trademarks and expertise to slow down the erosion of the competitive advantage which the buyer is acquiring.

Strategic value does not depend on your profitability or growth. Even size may not matter if you can provide the right scalability capability. Many companies have achieved significant sale prices where they were not yet revenue generating or were in a loss situation.

EXPLOITATION

Exploiting Strategic Value

Many businesses are either unable to exploit the underlying strategic value in their businesses or are simply unaware that it exists. Most firms are focused on what they can do today and spend their efforts on those parts of their business that are easiest to leverage in the short to near term. Additional value that may be exploited from underlying assets or capabilities is left unrecognized or untapped. But this may be where the real capital gain on the sale of the business resides.

Acquirers are prepared to pay a premium on the purchase of a business where they can see assets or capabilities that they can leverage through their own resources. For example, they may be able to open up considerable potential for existing products where they complement the buyer's own product range. This may be because they have a large customer base, a well developed distribution channel or alliance partners that can utilize the products. Their test of strategic value is going to be quite simple "Are we able to exploit the potential of this business in a relatively short period of time". The key to strategic value lies in releasing the potential of the acquisition. They may also see how existing products could be used by them to open up new markets or where underlying technologies could be used in combination with their own capabilities to develop new products for an existing market or used to enable the buyer to enter a new market.

Most businesses are valued on the basis of the profits that they generate from their current operations. This 'fair market value' is normally defined as the value that an independent investor would pay for the business based on the expected future flow of free cash expected to be generated by the business. That is; what is the business worth if it continues operating as it is? This basically assumes that it will continue to be managed in the same manner and work in the same market that it is in currently. While this is fine for those businesses that have limited potential, it seriously undervalues those businesses that could be better exploited by a larger entity that can leverage the business into larger markets or provide better funding for growth.

Many privately owned businesses are limited by their access to internally generated funds or by the capabilities of their owners. Most are reluctant to seek

external finance as this either puts them at greater risk or dilutes their ownership where they have to give up equity. Perhaps to reach the next stage in the development of their business they need to invest in new technology, specialized staff, new plant and equipment or a professional sales force, all very scary to the owner that has a nice tidy business that is generating a good income. But the business itself may be more than capable of expansion given an injection of more experienced management talent or sufficient funds or access to a larger market.

Often there is a goldmine of intellectual property or intellectual capital in the form of patents, unique processes or specialized knowledge lying dormant in the business that is not reflected in the current balance sheet or profit statement. The business might be sold in haste due to the ill health of the owner or due to a serious downturn in revenue without these underlying assets ever being noticed. In the rush to sell the business the owners simply have not taken the time to evaluate the potential of untapped assets or capabilities. In the end the business is sold and the owners never benefit from the true value in their business.

Business brokers rarely have the opportunity to fully prepare a business for sale to a strategic buyer, a task which can only be done over an extended period of time. Stephen Harvey of Barclay's Business Services Network, a nationwide business broking service, is often confronted with this problem. "I have seen a lot of businesses over the years where significantly more value could have been achieved in the sale if more time was spent identifying the strategic value in the business and then seeking out those companies that could exploit that value. Sometimes this could have resulted in the business achieving several times more than it actually sold for, but the owners were impatient and simply wanted to get the sale done in the shortest possible time"

The key to unlocking strategic value lies in the preparation of the business for sale. Instead of rushing into selling the business, the owner needs to take 18 months to 2 years preparing the business for sale. During that time, the strategic value within the business is examined in light of how a buyer might exploit it; not how it is being used within the current business. The owner needs to answer the question 'Who can make more money out of this business than me?' Most strategic buyers work within the same industry as the seller and are often working with similar products, services or technologies. Often it is simply that the larger business can readily exploit the potential. So slow down, take a real hard look at where the strategic value lies in your business and then take the time to prepare the business for sale to a company that will pay you a premium for the opportunity to exploit it.

POTENTIAL

Move away from the balance sheet

Few businesses are capable of creating a sale price of more than four times their revenue or 40 times their net profit, but it does happen. Furthermore, if a business has the right attributes, a strategy can be developed with a high chance of achieving a premium selling price well above what the balance sheet might have suggested. The key to a high premium on a sale is to find a way by which a potential acquirer - the strategic buyer - can increase the revenue to new heights by using assets and capabilities that are already built into the business. The strategic buyer takes what already exists or is being done in the business, and puts them into a new environment where they can be exploited for higher revenue and profit. The size of the opportunity is what justifies the size of the sale premium.

Conventional valuation techniques are based on what could be called the independent investor model. That is, the amount investors make as a return on investment by buying a business and paying themselves a dividend of the free cash that it produces. If future uncommitted cashflow is discounted by the prevailing rate of return needed by an independent investor, a value can be assigned to the business. Entrepreneurs typically push up their market value by improving profitability and providing a platform for future growth. But this model fails to take into account the extra benefits that a corporation could achieve by leveraging the assets and capabilities of the acquired business in a much larger entity.

- An owner looking for a strategic buyer has to ask some key questions:
- What corporation has a large customer base that would buy my products?
- If I have a large customer base, what corporation has a set of products that could be readily sold into my customer base?
- Could my products or underlying technology be used to open up new markets for a big company with the resources to fund market development?
- Do I have products that could be easily modified or extended to create new products that could be sold to the customer base of a big corporation?
- In conjunction with the capabilities and technologies of a

large corporation, could my business provide the catalyst for a large corporation to break into a new growth market?

Most often, the seller and the strategic buyer are in the same industry. They often sell to the same customers and markets. As a result, potential buyers readily appreciate an opportunity once it is presented to them. The best acquirers will be experienced acquirers. They will have staff who frequently undertake acquisition evaluations, experienced executives who assist in the integration of new businesses, and acquisition processes that are able to readily evaluate an obvious synergistic opportunity.

But even a good opportunity will not normally get results without some preparation. A premium selling price can be justified only if the vendor's business can be rapidly integrated into the buyer's organisation and if the opportunity can be readily exploited.

That means the business must be ready for immediate sale, with no underlying problems, risks or potential litigation. Internal systems for performance management, compliance and operational efficiency have to be in place and working.

Key employees need to have incentives to prepare the business for sale as well as be willing to assist in the transition of the business to the new owner. Finally, the seller and the senior executives who are not part of the acquisition need to be able to prove to the new owner that they have built a robust succession capability.

A strategy for achieving a strategic sale needs a planning horizon of about four years. The first two years are spent reducing risks in the business, preparing a list of potential strategic buyers and building informal or trading relationships with those on the list.

The two years after the sale include the period required to integrate the two businesses as well as the early stage of opportunity exploitation. The more revenue that the buyer can produce in the early days of the acquisition, the more value the seller can extract as a premium on the sale.

Of course, there is a need to have more than one potential buyer when the time to sell arrives. This lets an auction develop among several potential acquirers where each will see a compelling reason to make the acquisition. It is also essential to obtain the best professional advice that can be afforded. Professional advisers experienced in working with large corporations on acquisitions are very

useful in the seller's corner.

Does this process work? Yes. An examination of the situations where high premiums were achieved by vendors will always show that the buyer was seeking some underlying strategic asset, and that the current revenue and profit of the acquired business had little to do with the price paid.

HOW MUCH STRATEGIC VALUE

How do I work out what the strategic value of my business is?

If you have some unique underlying assets or capabilities, you might be able to get a premium on sale if you sold to a strategic buyer. But, the key question is – what is your strategic value worth?

Strategic value is created when a buyer extracts greater value from the acquisition than can be provided by the inherent profit generating resources of the business being acquired. That is, the buyer is able to generate greater profits than those which the acquired business is able to achieve, or could achieve, in the future if it continued as a stand alone business. The stand alone value of a business can be calculated by working out the net present value of the future stream of earnings which the business in its own right could generate. Any premium paid above this by the buyer is considered to be the value of the strategic value of the business.

Strategic value is created when the buyer utilizes the assets or capabilities acquired to produce profits through the buyer's organization, which may mean cross selling to their customers or distributing the acquired products and services through their own distribution channel. Other forms of strategic value accrue when the buyer is able to take costs out of the acquired company by merging activities or by leveraging their brands or unique processes in the newly acquired business.

The problem the vendor has is to figure out if a strategic premium is possible and then to work out what size the premium might be. Sometimes this is relatively straight forward and other times it is pure guess work. For example, calculating what revenue and profit your product or service might generate in a much larger customer base or distribution channel when you have good data on take up rates might be relatively easy. But working out what contribution your incomplete technology might have is problematic. Sometimes you can look to equivalent deals to see how large corporations have valued similar contributions. This has generally proved to be useful with recent acquisitions of internet community businesses where a price can be estimated per member.

In the end, it really comes down to two factors. First, are you certain that you can generate a price for your business above the value which could reasonably be calculated from its inherent future earnings, in which case you are better off with a strategic buyer. Secondly, you need to ensure you have multiple buyers competing in the deal. Smart buyers will be able to undertake their own calculations of the strategic value of your business. Let them fight it out for the privilege of taking it to market. In several of the businesses which I sold, I was clearly generating a sales price well above the fair market value of the business based on its going concern value, all I had to do was to ensure I had a number of potential buyers who could exploit the full potential of the business and let them push the price up through the bidding process.

INCREASE STRATEGIC VALUE

How do I increase my strategic value?

If you have something which is attractive to a large corporation, then take the time to work out how you can make it more valuable before you put yourself on the auction block. Large corporations are especially interested in assets or capabilities which they can leverage quickly to create large revenue gains. To secure a premium for such an asset or capability, however, you need to be able to provide the buyer with some reasonable period of competitive advantage during which it is can be exploited. Something which can be readily copied, negated, created or purchased has little strategic value.

Once you have identified that you do have something which can leverage a strategic sale, spend some time to work out how you can make it more valuable to the buyer and thereby increase your potential premium on sale. Something would be worth more to a buyer if they could exploit it earlier and faster. Thus, if there were less issues to resolve post acquisition before the underlying asset or capability could be exploited, this would have an upwards impact on the sale price. A business which is well managed, efficient, with good governance and with few outstanding problems to resolve would clearly be more valuable. At the same time, a business which could be readily absorbed or integrated into the corporation's organization would be more attractive.

The major objective of the buyer is to exploit the opportunity. Where the underlying asset or capability has been structured so that it can be readily replicated or scaled, the opportunity can be more aggressively exploited. Where this results in higher growth revenue generation and earlier profits, the buyer generates an earlier payback on the acquisition investment. This in turn means that the investment has a higher present value and thus the seller has the opportunity of securing a higher premium on sale in a competitive bid.

When you have a specific buyer in your sights, you might spend some time working out how you can increase the strategic value of the assets and capabilities for that buyer. If the sales value to their customer has a certain price, what can you do to increase the price? If your product has a number of features or components, can you add more to increase its revenue generating capability?

If there is an after market for services, spare parts or complementary products, can you find additional services or products to add to the list? If the product has an implementation or consulting requirement, can you increase the value of the revenue associated with that part of the sale? Your objective is to increase the revenue per unit and thus increase the revenue generating power of your offering.

The key to maximizing the premium on sale with a strategic buyer is to confront them with a compelling opportunity to generate high levels of revenue and profits as soon as possible after the acquisition. The premium is, however, normally only secured by having multiple bidders after that opportunity. This is especially effective if the revenue is either new revenue to all the bidders and provides them with a growth advantage or is a competitive weapon which will take market share away from the losing bidders.

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.

DOES SIZE MATTER

Small is sufficient

How often have you been told that you need to grow your revenue and profit to make your company more valuable. Increasing size and a higher stream of future profits drives conventional valuation models and yet sometimes higher valuations can be derived from being smarter rather than being larger.

Conventional valuation makes an assumption that the existing business will continue to do business the same way and with the same product/market interface and will continue to be managed in the same manner as it been in the past. With such an assumption, it can only result in one approach to valuation – whatever is there now will continue to be there in the future and nothing has changed. Thus historical performance is probably as good as you will get in terms of predicting the future performance of the business. Whatever risk profile the business had before, all other things being equal, will exist in the future. But what if you could change the future?

With a conventional business, that is one which derives its value purely from its own generated profits, you can set out to change the future by changing the capability and capacity of the owner. Thus a new owner who can exploit untapped potential in the business will generate a much higher level of future profits. If, at the same time, you can create an environment where the future risk of the business is decreased, you can also increase the current valuation. Thus a business which puts its efforts into reducing risk and creating greater future potential for a more capable buyer can readily be worth more than the same business which solely concentrates on getting bigger and generating more current profits.

The case for ‘small is beautiful’ applies even more with businesses which have underlying strategic assets or capabilities which can be exploited on a large scale by a national or global buyer. The essence of value in such a business lies not its own revenue and profit generation but in the extent to which the buyer can generate rapid profits through exploiting the strategic value. Thus a biotechnology firm which develops new drugs may never have any revenue but is still worth a considerable amount if it makes a breakthrough discovery. The revenue is generated by, say, a large pharmaceutical acquirer which takes the approved

drug to market through its extensive distribution channels.

In the case of strategic value based businesses, value is not increased by getting bigger and generating more revenue and profit but by further developing the asset or capability which is the basis of the strategic value. If structured correctly and sold to the right buyer, the small development firm can be worth a lot of money. Valuations in the multiples of tens are readily achieved in such situations.

The key to higher valuation is to understand what creates value for the buyer. Conventional valuation models are not creative nor proactive when it comes to strategically matching the untapped potential in a business with the right buyer. Small can be worth a lot more if the selling process is done right.

BUYER SETS PRICE

Getting the Strategic buyer to set a value

If you are a conventional business, you should be able to estimate what you can get for your business by using an EBIT multiple valuation. But what if you are seeking a strategic sale and the value that is placed on your business is what the buyer can achieve in terms of new incremental revenue and profits rather than the profits you have been generating in your own business. In order to decide whether the time is right to put your business up for sale, you really want to have some idea of what value the prospective buyer will put on the business. How do you extract from them some idea of what they think you are worth?

The key to a premium on sale is to have several prospective buyers bid for the opportunity of buying your business. What you really want in that activity is a group of prospective buyers who have a very clear idea of how they can exploit your business to generate new revenue. If you approach them with no prior relationship and offer to sell your business but they have little time in the bidding process to ascertain exactly how they would exploit your assets or capabilities, you will certainly not get the best price you can. Prospective buyers need to have time to work out how to best exploit the opportunity and this may take them some time to work through the process of scaling up the business, developing new internal capabilities, opening up new sales channels or interfacing the new products with their existing offerings. What you want them to do before they come to the bargaining table is to work out just how much new revenue and profit they could gain if they were the successful bidder. If the numbers are very attractive, they may be willing to bid up the price to ensure they are the successful buyer and, of course, they would rather that their competitors were denied the opportunity.

Your challenge is to work out how you can extract from the potential buyers what they think your business could be worth so you can decide whether to put it on the market. Since they will be reluctant to divulge this information, you need to go about this by approaching them from a different perspective.

Most large corporations are always on the look out for ways to increase their revenue and improve their competitive advantage. If you have something which could do this, you might approach their business development group rather than their M&A group. Your approach to them will be to discuss how you might work together in a strategic partnership to pursue new revenue where you provide the intellectual capital, asset or capability which is to be marketed and they contribute their marketing and distribution capability to make it happen. Your approach is, however, conditioned on the fact that, because of your limited capacity to support such a venture, you can only support one partner although you are interested in exploring this opportunity with a number of large corporations. You request each one to undertake an internal assessment of the opportunity and then provide you with a convincing argument as to why they should be the selected partner.

This process provides time for each potential partner to work though how they would best exploit the opportunity and to work out just how much additional revenue they could generate through the relationship. Soon they will discover that they can make significant market gains but that they will be limited by your capacity to support an aggressive rollout. When they try to convince you of their worthiness to be your partner, they will also have to show their hand. What you hope is that this will stimulate them to move the discussion to an acquisition conversation. You now have an idea of what you are worth to them but you also have several well informed potential buyers in the frame.

PART B: STRATEGY

Most business owners think that selling a business is simply handing over responsibility to a business broker. They see their role as cleaning up the business for sale and then interviewing the prospective buyers dragged through the door by the commissioned broker. It would be hard to think of a strategy which would be worse.

Extracting value on sale is not simply cleaning up the business it is putting yourself into the shoes of the best possible buyer and solving three problems. How can I reduce risks delays and obstacles to the buyer which are inherent in my business? How do I smooth the path to a change of ownership and lastly, how do I ensure the buyer can fully exploit the potential in the business. All this takes time and should not be undertaken in haste. It takes time to identify and connect with the best buyers. It takes time to prepare the business for due diligence and it takes time to set the business up so that it can contribute the maximum value to the new owner.

What is needed is a systematic process not a hand off to a stranger. Professional advice is worth having but the founder needs to direct the activities.

FOCUS

We are asking the wrong questions!

I recently reviewed a set of investment ready criteria published by a respected Angel Group. All the usual factors were there; what problem was being sold, the extent of competitive advantage, the experience of the management team, size of market and so on. You could quickly infer from the questions that the objective was to find a high growth potential venture to invest in. No doubt the intention was to fund the investee firm to establish a market position, growth market share and then somehow harvest the venture. What I found remarkable was that the question of possible exit path was not on the list.

Perhaps I shouldn't be that surprised. I recall undertaking a research study some 5 years ago when I and a US colleague reviewed several hundred VC websites to ascertain the extent to which exit strategies were discussed or requested in investment proposals. Even then I was surprised to discover that over half the sites had no mention of exits and not one had an explanation of the various forms of exit and an indication of the what information the Venture Capital (VC) firm would like to see on the proposed exit strategy. Five years on and I had hoped that we would have gained a much better appreciation of the importance of the exit strategy to the investment evaluation. It seems I was wrong.

What I find distressing is that Angel Investors still seem to be locked into a business concept from the 70's and 80's where the dominant VC model was to grow a business to a point where it could be taken to an Initial Public Offering (IPO). The pent up demand for computer hardware and software applications meant that any reasonable product could fuel significant growth so an IPO was a real possibility. Then along came the internet boom followed by the biotech boom and that simply reinforced the conventional wisdom. However, it is very clear now that the days of easy IPOs are gone and so is the conventional VC model.

The harvest options for Angles are now very limited, basically the best path is a trade sale. If that is the case, then why are they still fixated on building out the business. Surely the question they need to ask is – what form of trade sale is the best harvest option for this venture? Only then can they deal with the other criteria. Is it not the case that the exit method drives the development of the business?

The same question should be put to the entrepreneur. Before we get tied up in legal and financial due diligence we should be working out the exit. We should be ascertaining how the venture will create value and what type of acquirer wants what they have? Since there is a fundamental difference between a trade sale based on inherent revenue and profit generation from one based on exploiting an underlying patent or other form of IP, these are critical to an evaluation of whether the venture can be prepared for sale.

Asking about the impact on value of market share, distribution channels, management experience, R&D pipeline and so on, before ascertaining the exit path is clearly asking the wrong questions.

SCALABILITY

Why is scalability important

The value to the buyer in a strategic sale is created through the exploitation of some asset or capability acquired in the purchase. To release that value, the buyer needs to deploy the product or service throughout their organization or through their distribution channels. The faster that can be done, the quicker the buyer releases the potential profits from the acquisition.

What does this mean for the seller? Basically, the more easily and quicker the buyer can exploit the inherent potential of the acquisition, the more it is worth to the buyer – if you look at the investment in terms of the present value of a stream of future earnings. The basic premise is that larger and earlier profits generated from the acquisition are more valuable than smaller and later profits. If you translate this into the value of the acquisition, it is obvious that the acquisition is worth more to the buyer at the point of acquisition if the benefits can be released earlier. The opposite side of this argument is clearly that the business is therefore more valuable and therefore can be sold for a higher price.

Following this logic, the seller can best prepare the business for sale by recognizing the need of the buyer to quickly integrate the new acquisition and then rapidly deploy the acquired asset or capability. Thus the more easily the products or services can be scaled, the more able the buyer is to exploit the acquisition potential. The seller should thus examine the business to ascertain what it would take to dramatically scale up the appropriate strategic value asset or capability. So, given unlimited resources, what should the product or service look like at the point of acquisition. How should the business itself be structured to provide the best launch platform for integration and then scalability of the strategic asset or capability?

Scalability might involve many aspects of the business. For example, documentation, monitoring systems, specialized equipment, training aids for salespersons, demonstrators, installers, available capacity, lining up suppliers and distribution channels. Ask yourself - what would need to be done to scale the activity by 50 to 100 times?

Part of the task of the business owner is to work out which corporation can best exploit the acquisition. In doing so, the entrepreneur is identifying which corporations have the capability, capacity and experience to best exploit the opportunity presented through the acquisition. The entrepreneur should then proactively set about presenting this opportunity to the prospective buyers so that they can evaluate it. In bringing the opportunity to their attention, the entrepreneur should articulate what steps he or she has taken to ensure that the acquisition is well prepared for scaling the acquired asset or capability. In this way the entrepreneur is also showing the buyer that he understands the potential of the acquisition and also how much it is worth.

The final part of the puzzle in ensuring that the entrepreneur gets full value for that potential is to ensure that he has several potential buyers lined up for the time when he wishes to trigger a sale.

INTELLECTUAL PROPERTY

How important is it to have intellectual property?

Intellectual property (IP) can form the basis of a competitive advantage in a conventional business which would be sold on its revenue and profit generating ability or the basis of strategic value for business sold to a large corporation. By intellectual property I mean those forms of rights embodied in patents, trademarks, copyrights and brands or those which stem from deep expertise. The business advantage which accrues from IP is the ability to exploit it for commercial advantage where competitors cannot readily match your products or services in your target market. Thus, IP typically allows a business to charge a premium for its products or services because customers are not able to find close substitutes.

When we calculate the value of a business we look to two different approaches to assessing value; the future stream of potential profits or the strategic value. In the case of a conventional business, the IP generally provides a greater level of stability and certainty to future profit streams. This has the effect of reducing the risk associated with the business as well as providing more certainty around future income projections. These two factors combine to reduce the valuation discount rate and generate positive present value for more distant earnings, both of which substantially improve current sales value for the business.

In the case of a strategic sale, IP is almost always at the heart of significant premiums on sale. The nature of the strategic sale is that the business being sold has some asset or capability which a very large corporation can exploit throughout their organization or their customer base. To have value, however, those assets or capabilities must provide a reasonable time for the acquirer to exploit them without being eroded or negated by competition. Also, to have value, the buyer must not be able to easily acquire, build, assemble or develop a similar asset or capability within a reasonable time period, say, two years. At the same time, the strategic asset or capability, in the hands of the buyer, must be able to be scaled or replicated quickly to generate significant revenue. All these characteristics are present in good IP.

Most business can improve their profitability and growth potential by developing IP to enhance their competitive position. In doing so, they will almost

certainly improve their current valuation in a conventional financial sale. Those who are able to develop IP which would be of interest to a large corporation are especially fortunate because a strategic sale price would almost certainly be several times greater than that of a financial sale.

Entrepreneurs interested in selling their business would be well advised to examine their business to see what knowledge could be developed into registered IP. Alternatively, unique expertise may be able to be documented and prepared so that it can form the basis of a strategic sale. By taking the time to uncover and package such IP, they may be able to position their business to better advantage and thus gain a premium on sale of their business.

PART SALE

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.

EXTERNAL INVESTMENT

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.

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.

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.

VENTURE CAPITAL

What role for Venture Capital?

If you sell out to a private equity firm, it is they who will extract the premium on sale not you! An unfair statement? Perhaps. But it is often the case that a private equity firm has purchased well, refinanced the business with significant debt and, with some minor improvements in management, systems and positioning, turned the investment into a healthy return. They are able to do this because many business owners fail to prepare their business properly for sale and fail to extract full value from them during the sale process. Why not do this yourself rather than give it away? More particularly, why not partner with a venture capital or private equity firm and do it together.

Quite often the entrepreneur has the potential to extract a higher price on sale but not the resources to properly prepare the business for the best outcome. Once you start to focus on the end game and especially on whom the best buyers are, you often see that your business is not best positioned to extract the highest price. Premium prices are achieved when a business is structured in a way which reduces risks and maximizes growth potential for the buyer. The business you have today may need to be restructured and repositioned to achieve the best outcome. Imagine that you need to introduce new systems, update equipment and build out some growth capability to reposition the firm. Such activities may be expensive and beyond your capability or your ability to fund the changes. This is a good time to bring in an external investor who can assist with the process.

The strategy would be to find a venture capital or private equity firm who can help you make the transition with advice, connections and funding. Whether you take this on as an additional investment or take the opportunity of selling out part of the equity alongside the additional investment, the objective is to take the opportunity to bring in a partner to help restructure the firm to extract the best sale outcome. It is not unusual for this process to involve the introduction of some new management, an improvement in internal performance setting and evaluation systems, the creation of a formal board and a restructuring of debt. The focus is on reducing risks, improving profitability and creating greater growth potential.

Venture capital and private equity firms are generally experienced in trade sales and IPOs and can help connect the firm to experienced professional service providers and M&A advisors. They also know to start the sales process early and will be seeking out the best potential buyers well in advance of the sale. Attention will be given to ensuring that the pool of potential buyers are well informed about the value of the business and are well positioned to bid when it comes on the market. In most cases, the additional knowledge and skills brought by the external investor results in a considerable lift in value thus providing the original shareholders with a much greater return than what they could have achieved on their own.

CONSOLIDATIONS

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.

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 they 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 through an unwillingness to admit that they were not the ideal person to undertake the entire sale activity.

PART C: SALE PREPARATION

Imagine that at the time of the sale you were fully prepared for the discussions with the potential buyers - what would you have available and what decisions would you already have made to assist in the negotiations?

It may seem like a tall request but in fact this is the ideal position to be in. If you can go into the discussions with the confidence that you are fully prepared and you know what you want and what you are willing to concede, the chances are that the deal negotiations will go smoothly. In fact, it is even easier than you might think. What you have to do is put yourself into the shoes of the buyer and think through the deal issues. Providing you can deal with all the issues, there is no reason for the deal not proceeding. It is when we have surprises or are unprepared that things go wrong.

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.

RISK REDUCTION

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.

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.

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 a 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.

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 senior 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 managers 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.

SENIOR MANAGEMENT

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.

PROFESSIONAL ADVISORS

Should I be using a business broker, professional advisor or 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.

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 among 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 is 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.

NEGOTIATION

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.

MANAGEMENT TEAM

Do we have the right management team?

I know we all want the ‘A’ team managing our investee firm but we rarely expect to find one. What we tend to do is supplement the existing team with people with experience so that we have a reasonable chance of growing the business and avoiding the basic mistakes. We want to see a team with good leadership, strong marketing and operations experience and good networking skills. But aren’t we simply assuming that there is one size fits all and that building revenue and profit is the only game in town.

I have been in number of investee review meetings recently where the intention was to build up the team to create a business which had a reasonable chance of meeting higher revenue targets. However, when the discussion has come around to positioning the business for an exit, a completely new set of requirements have been identified with dramatically different timescales. The question of who should undertake the exit strategy activities is a very different one from who could grow the business.

Once you focus on the exit, the set of tasks to be undertaken to prepare the business for, say, a trade sale are often very obvious and some will be of a specialist nature such as IP, legal and deal negotiation. Also you may find that instead of building up a sales and marketing force and establishing a customer base, you only need a couple of good customer sties as proof of concept. Instead of growing the business to 10, 20 or 100 people, you might just need a small team to complete a limited set of development and proof of concept tasks.

While your entrepreneur might not have the leadership skills to grow the business, he or she might be just right for building relationships to the prospective buyers. Alternatively, you might task the entrepreneur with getting the trial sites working and employ an experienced M&A corporate executive to set up relationships with prospective buyers and negotiate the final deal.

What is obvious from the many investee reviews which I have attended is that they have failed to work back from the exit to establish what needs to be done and who should do it. If the only business model you have in your head is revenue

growth, you will always end up with a growth oriented team. If, however, you have a strategic exit in mind, the nature of the tasks to be undertaken are likely to be very different and it will call for a different mix of people. What you will also find is that the 'B' team you have is more than capable of participating in the exit strategy.

Strategic exits are much less demanding on resources, tend to have shorter execution times, lower operational risks and higher investment returns. What is also obvious is that it needs a different set of skills from a conventional growth oriented business strategy. Before you commit to hiring anyone, take the time to set out your exit strategy and then see how you would use the existing staff and what additional skills you will need to execute the exit deal.

MANAGING COMPETITORS

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 in 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 armour 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.

PART D: STRATEGIC BUYERS

Strategic buyers look at deals differently. They don't focus on what has been achieved or simply project current operations forward, they envisage a major exploitation of the underlying strategic asset or competency. Thus you would expect them to be different and behave differently when confronted with a major opportunity.

Your task as the seller is to get into their shoes, see the deal the way they would and package your business so that it meets their acquisition criteria. You need to have a very clear idea of what type of corporation has the capability and capacity to fully exploit the opportunity and the manner in which they would undertake that. Your job is to select and engage a small number of potential buyers - not wave the deal in front of large numbers of buyers. In this case, small is better.

STRATEGIC BUYERS

What does a strategic buyer look like?

Few businesses are capable of generating a sale price of more than four times their revenue or forty times their net profit and yet it does happen. Furthermore, if your business has the right attributes, you can develop a strategy that has a high probability of achieving that size of a premium at the time you sell your business.

The key to a high premium on sale is to identify how a potential acquirer, the “strategic buyer”, could leverage assets and capabilities that you have in your business to generate significant revenue. Basically the strategic buyer can take what you have or do in your business and place it into an environment where it can be exploited to generate significant revenue and profit, perhaps tens or hundreds of times what you could have achieved yourself. It is the size of that opportunity that justifies the size of the premium on sale.

Conventional valuation techniques are based on what could be called the independent investor model. That is, what could an investor generate as a return on their investment by buying your business and paying themselves a dividend of the free cash generated by the business. If the future uncommitted cash flow is discounted by the prevailing rate of return required by independent investor, a value can be assigned to the business. Entrepreneurs typically push up their market value by improving profitability and providing a platform for future growth. However this model fails to take into account the additional benefits that a corporation could achieve by leveraging the assets and capabilities of the acquired business into a much larger entity.

To find the strategic buyer you need to ask some key questions.

- What corporation has a large customer base that would buy my products?
- If I have a large customer base, what corporation has a set of products that could be readily sold into my customer base?
- Could my products or underlying technology be used to open up new markets for a large corporation that has the resources to fund the market development?
- Do I have products that could be easily modified or

extended to create new products that could be sold into an existing customer base of a large corporation?

- In conjunction with the capabilities and technologies of a large corporation, can my business provide the catalyst for a large corporation to break into a new growth market?

Most often the strategic buyer occupies a place in your industry. They are often competitors, alliance partners, customers or suppliers. They often sell to the same or similar customers and thus understand your market and can readily appreciate the opportunity if presented to them. The best acquirers will be experienced acquirers, have staff who undertake acquisition evaluations frequently, experienced executives that assist with the integration of new businesses and have acquisition processes that can readily evaluate an obvious synergistic opportunity.

However, significant premiums don't normally happen without some preparation. The premium can only be justified if the vendor's business can be rapidly integrated into the buyer's organization and the opportunity readily exploited. That also means that the business must be ready for sale. Underlying problems, risks and potential litigation need to be resolved in advance of putting the business up for sale. Internal systems for performance management, compliance and operational efficiency have to be in place and working. Key employees need to have incentives to prepare the business for sale as well as be willing to assist in the transition of the business to the new owner. Finally, the entrepreneur and the senior executives who are unlikely to go with the acquisition, need to be able to prove to the new owner that they have built a robust succession capability.

A proactive strategy for achieving a strategic sale needs to consider a planning horizon of about four years. The first two years are spent reducing risks in the business, identifying potential strategic buyers and building informal or trading relationships with those that have the highest potential. The two years after the sale include the period required to integrate the two businesses as well as the early stage of opportunity exploitation. The more revenue that the buyer can generate in the early days of the acquisition, the more value the seller can extract as a premium on the sale.

Of course, you do need to have more than one potential buyer at the time you come to sell. You need to create an auction among several potential acquirers where each sees a compelling reason to undertake the acquisition. You should

also have the best professional advice you can afford. Professional advisors that have experience working with large corporations on acquisitions are very useful when they are in your corner.

Does this process work? Certainly! If you examine situations where high premiums were achieved by the vendors, you will always find that the buyer was after some underlying strategic asset and that the current revenue and profit of the acquired business had little relevance to the price paid.

THE RIGHT BUYER

How do I identify the right strategic buyer?

A strategic buyer is a corporation which can best leverage your underlying assets and capabilities to resolve a threat or impediment in their own business or generate a large revenue by exploiting your strategic value through their own distribution channels. The key to a strategic sale of a business is to identify a buyer which has the capability, capacity, willingness and the internal culture which can quickly exploit the asset or capability you have. However, your key assets or capability must provide some exclusive period of exploitation. Thus they must be protected by rights, licenses or regulations or be hard to copy, difficult to acquire or expensive to buy, assemble or create.

Ask yourself the following questions:

- Who can exploit my business capability better than I can?
- Who can ramp up my revenue rapidly to 10, 50 or 100 times what I am capable of?
- Who can release the constraints on my business so that it can grow rapidly?
- Who has complimentary products, similar customers and the ability to sell my products alongside theirs to a very large customer base?
- How can my technology or knowledge be best exploited to create a large revenue opportunity and who has the capability to most easily do that?

What you are seeking is a very large corporation which can bring your products to market quickly, has the customer base and/or distribution channels already in place and has the resources to do the job efficiently and quickly. If you can structure your company so that your strategic asset or capability can be rapidly scaled or replicated, which corporation has the best chance of taking it to market and generating the most revenue from it?

You are almost certainly looking for a large corporation within your own industry because they are likely to understand your product or capability best

and are probably best placed to appreciate its potential. The highest premium will come from finding a corporation who can readily achieve the exploitation of your potential. But don't just chase after anyone, focus on those corporations who have a good performance track record of successful acquisitions and who have the right culture in order to ensure that your best employees are willing to stay long enough for the acquisition targets to be achieved. The last thing you want to happen is for a buyer to pay you a high premium on sale and then fail to achieve the result. Failure is a fast track to litigation, regardless of how well you prepared the business for sale.

Major corporations are always searching for good acquisitions. You need to get on their radar. So once you have identified your set of target buyers, spend some time to let them know about your business and ensure they understand the potential you can deliver to them. Remember that they have an objective of acquisitions and so you are simply making their task easier. As you get to know them, check out their record of successful acquisitions. Talk to former business owners who have sold out to them and find out how the deal was done, how well the former staff were treated and whether the former owners were satisfied with their deals.

When it comes to selling out, your potential strategic buyers should already be in place.

CONNECTING

What is the best way of getting a strategic buyer interested?

If you have some underlying asset or capability which can leverage a very large revenue opportunity for a large corporation, it should not be difficult to get their attention. The uncertainty which most entrepreneurs experience with this objective is that they don't know who are the best buyers and are not sure about how to get them interested.

The end game is to get acquired by a large corporation who can exploit your strategic value. Clearly, the highest price will be paid by those corporations who have the capability and capacity and product/market space which can best exploit your asset or capability. They will be even more interested in acquiring your business if you can structure your business to reduce risks in the acquisition, speed up the integration process and then provide a structure which can rapidly deploy your product or service. Almost without exception, the best buyers will come from within your industry and will have similar customers and competing or complementary products or services – thus they aren't that difficult to identify.

The next step is to get in front of them. You should always keep in mind that the best acquirers are also frequent acquires and will have a unit within their organization whose task it is to identify, evaluate and acquire firms which can contribute to their corporate strategy. Therefore, there are people inside the prospective buyers who are likely to want to talk to you. Your job is to make contact and encourage them to give you a meeting.

You can achieve this through a variety of channels. You could of course just contact them directly and ask for a meeting explaining that you have a firm which might be of interest to them at some time in the future and you simply want to understand their acquisition criteria and process. You can always approach their local subsidiary managers and explain what you want to do and get them to recommend you. You might also find out the names of their Directors and approach one of those either directly or through a contact. An approach might also be made through your professional service provider.

Most companies within your industry will attend a variety of trade events, exhibitions, conferences and industry charity functions. You can use these to make contact with a senior manager of a potential buyer and use that opportunity to find out how to approach the M&A group, CFO or CEO. If you find that the right person is always too busy, ask to meet them when they are attending one of the industry functions. If you are making a lot of effort to go to meet them, they will normally respect that and set some time aside for a meeting.

The purpose of the initial meetings is to simply get on their future acquisition radar. Once you have their interest, it will be easier to set up subsequent visits where you can spend more time explaining what you have which would interest them and how you are able to facilitate them making significant revenue out of an acquisition of your business.

ENGAGEMENT

How can I get closer to a strategic buyer?

Strategic buyers acquire businesses in order to take advantage of some underlying asset or capability which the vendor has. Generally the buyer recognizes that they can achieve a higher return on the investment in acquiring than they could in seeking to develop the asset or capability themselves. Often it is a case of time to market where the delay in building their own capability is significantly outweighed by gaining instant access to a capability or asset which they can exploit immediately.

The nature of a strategic acquisition means that the buyer will embrace the acquired strategic asset or capability within their own business. That is, they will use their larger size to more rapidly exploit the asset or capability, often by replicating it within their own organization or by selling it through their own distribution channels. Given that most strategic acquisitions are used to enhance the revenue generating capability of the acquirer it suggests that most strategic acquisitions occur within an industry. It is very normal for large corporations to acquire emerging firms with their own industry in order to secure new innovations or specialized processes or knowledge. This being the case, the vendor who wants to identify a strategic buyer need look no further than the large corporations within their own industry.

The ideal strategic buyer will normally have complimentary or similar products, sell into the same or similar customers, use similar marketing and sales processes and have a track record of undertaking acquisitions. To be a good strategic target they should also have a similar culture and have a good track record of meeting their investment objectives from prior acquisitions. With this set of criteria, the entrepreneur can readily develop a list of preferred prospective buyers. Given that a large portion of acquisitions occur where there is a formal or informal relationship between the parties, the next task of the entrepreneur is to develop closer links to the prospective acquirers.

This objective is much easier than most entrepreneurs think. We need to remember that large corporations desire to undertake acquisitions and that they will have executives tasked with identifying targets and developing knowledge

and perhaps relationships with those firms. The job of the entrepreneur is to become one of those targets. This can be often achieved simply by making contact with the M&A group and opening up a dialogue. Alternatively a first approach can be made to a local subsidiary CEO, a business development executive or a member of the Board. Introductions can be made through the firm's professional services firm, a local venture capital fund or a local investment bank.

If the prospective acquirer is reluctant to enter into discussions, the entrepreneur might try setting up an appointment at a trade fair, industry exhibition or through the industry association. The aim of the entrepreneur should be to educate the prospective buyer on the future potential of the firm as well as to suggest ways in which the prospective acquirer might exploit the underlying assets or capabilities in the firm in a manner which is well beyond the firm's ability to do so. Once the relationship is established, the major task of securing a future potential buyer has been achieved.

COMPETITIVE TENSION

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.

MAKING CONTACT

How do I make contact with a global corporation who I think would be a good buyer?

If you have some really smart, well protected technology, a highly innovative process or hard to find deep expertise, you probably have the basis for a strategic sale to a global corporation. However, as a small business you may find it somewhat daunting to tackle the task of putting yourself in front of a giant corporation. If you are like a lot of entrepreneurs who desire to sell their business, you would probably settle for a sale to a local national firm and take whatever EBIT multiple they offer. In doing so you are almost certainly walking away from a sale price which could be five to twenty times what a local corporation would be willing to offer. But how do you get in front of the big buyers?

First, you need to understand that large corporations often grow through acquisitions and they have very large M&A departments set up to do exactly that – buy businesses, often just like yours. Next, think of the impact your strategic assets or capabilities might have on the right buyer. If you select your potential buyers well, you should be choosing companies who can make 50 to 100 times the purchase price over a 5 year period. Even if they pay you 10 times the conventional financial value of your firm, they still come out well in front. If you seriously have something to offer, you owe it to yourself to find a way of putting your proposition to the best of the potential buyers.

How do you make contact? Remember that they are always on the look out for strategic acquisitions. Your job is to let them know you are up for the discussion. You can start with the head of their M&A department. After all, that is their job so they should expect to be approached. You might also set up a meeting with the head of their local subsidiary since part of their task is to identify future acquisitions for the parent company. Another strategy is to work through your local service provider, investment bank or business advisor. If you have venture capital, then ask them to set up the connection.

Perhaps you don't want to be so obvious. That is, you don't want to declare that you are for sale but you still would like to set up an informal discussion with

potential buyers. You could use an independent third party such as a professional service provider to make contact for you. Alternatively, you might contact the potential buyers through their business development director with the objective of setting up a strategic relationship. If they are interested, they will soon work out that it would make more sense to buy you and exploit the opportunity quicker rather than to have to scale back their efforts to match your resource level.

This is a time to be bold, pick up the phone and just make the calls. You will be surprised how open large corporations are to an initial discussion. Once the door is open, you can take your time in building the relationship, finding an internal champion and getting ready for the deal of a lifetime.

PART E: DEAL CONSIDERATIONS

The sale of any business is complex. Not only do you have to consider your own personal and tax considerations, you may need to deal with similar issues involving managers, employees and other shareholders. At the same time, the buyer needs to position the purchase to be most effective for their own financial and tax issues. If this was not enough, there are numerous legal considerations to do with entitlements and so on to take into account. Thus good professional advice and help is essential, especially given the likely size of the deal relative to the size of the business being sold.

Within the boundaries of the deal, there are numerous ways in which the deal can be improved for both buyer and seller and often where both parties gain. It is worth spending the time to consider the issues and the options to see if the deal can be improved. At the same time, think through what will happen to the firm and its employees after the sale. Some will go and some will stay - a difficult transition for all concerned.

CONSIDERATION

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 shares.

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,

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 meeting 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 may 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 willing 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.

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 be 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.

EMPLOYEE CONSIDERATION

There can be an 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.

CONTINUED 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.

EXIT PLANS

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!

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