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Doing the deal on your terms

Owners need to think about strategic position, not just current value, when entertaining buyers.

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by Kenneth H. Marks

For many Baby Boomers who are considering selling their companies in the coming years, a disappointing reality awaits: Their business is not worth what they thought. Even in today's hot merger and acquisition market, a significant valuation gap exists between what many owners believe their business is worth and what potential buyers are likely to pay.

This gap has widened in recent years for a number of reasons.

- First, low interest rates and moderate expected returns from stocks and bonds have led owners to need greater proceeds from a sale, driving their value ambitions higher.
- Second, at a time when smart companies are investing in growth and renewal, many owners have tightened their operational belts and extracted cash. While this business strategy has short-term benefits, owners who restrict their growth and pay themselves at the expense of losing competitive ground can diminish the future value and opportunity of the enterprise.
- Third, some businesses fail to generate economic returns in excess of their true cost of capital. While this concept can seem academic, it is the basic concept of value creation. While gaps have always existed between what sellers want and what buyers are willing to pay, the current gap for middle-market companies is wider than ever. Let's focus on how to bridge it.

Back to basics

No matter how strategic the buyer, all valuations eventually boil down to expected future cash flow. The value of that cash flow is determined by its absolute level, the risk of achieving the projected amount, and its growth rate coupled with the future investment required to sustain it. In the traditional sales process, buyers start by analyzing historical EBITDA as a proxy for cash flow.

Bridging the gap

To bridge the valuation gap, a company must shift the conversation from historical financials to strategic value. It must demonstrate that it is acting on a credible, forward-looking growth plan that can be leveraged by the buyer. A company that can articulate and defend its potential, forecast its performance into the future, and support that forecast with facts, trends, and action steps can create a strong position from which to lead negotiations.

To establish a sound, strategic approach for a sale, consider these two principles:

- **Know thyself.** Analyzing and executing a successful exit strategy requires a hard look in the mirror. A company must examine its business model and its relevance to the future. A deep understanding of a company's value to the market—including both customers and investors—allows the business owner to put into place value-creating strategies that offer potential buyers a vision and a plan for their investment. Remember, a buyer is an investor. Being able to articulate and defend a growth strategy to a buyer means you must do your homework and create well defined initiatives that serve as a road map for continued growth in cash flow and relevance in the marketplace. Demonstrate your company's ability to forecast and manage its growth with empirical data from existing customers and projects. Buyers often interpret predictability as less risk and, therefore, higher value. The more accurately you can forecast your business in revenues, margins, and EBITDA and the more clearly you can understand and control the earnings drivers, the more successfully you can position your business for a sale on your terms.

- **Know thy place.** Business owners who want to get more for their company spend time developing solutions that add value to the market segment in which they operate. They establish a deep sense of the market space and understand who their competitors are, how their business models work, where they make money, and where they don't. They scrutinize data from market research and understand the competitive landscape and trends. A clear read on how your business fits into the marketplace and how your growth and strategy will transpire can also widen the pool of possible "right" buyers. As opposed to a shotgun approach in a broad auction, studying the defined industry segments that surround your business helps to identify outlying candidates who may, in the end, see the most value.

  In one example, a niche grading and landscaping firm took time to understand how each of its competitors engaged with the market and to explore companies in tangential market segments. By doing so, it found a strategic buyer that wanted to enter its market segment; a direct competitor would not have perceived near the value or paid as much. In today's environment, a company is wise to optimize its strategic position by exploring partnerships and alliances that validate its significance to the market, increase its growth prospects, block competitors, or secure access to certain customers, supply, or geographies.

Historical financials validate a business's ability to be profitable and management's ability to operate. By making a strong case for the company's strategic value, you give a potential buyer the basis to formulate and pay additional consideration. By shifting the perspective and discussion from historical numbers to future cash flow and growth opportunities, you create a productive way to structure a transaction and monetize the intrinsic value of your business. More important, you build potential value that a buyer can leverage to realize gains beyond the near-term numbers.

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