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Taking the practical exit

A business owner needs to answer two essential questions when thinking about selling: What are you really selling? And to whom are you selling?

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by Kenneth H. Marks

Many small- and middle-market business owners pour their lives into their businesses. They hatch ideas against great odds. They persuade investors to join their cause. And they build teams of loyal employees. They imagine a time when they can monetize their investment and cash out. Having by then made countless personal sacrifices, owners can have a hard time getting their minds around an appropriate valuation range for their company.

Business owners who go to market without a realistic idea about the value of their company run the risk of wasting their time and energy and, perhaps more importantly, wasting the time and energy of their management team. A protracted merger-and-acquisition process can be a wholesale distraction that keeps the team from focusing on the growth and relevance of the current operations. Beware: A less-than-well-orchestrated sale process can have a negative impact on a company's value.

A business owner must consider competing priorities when he or she decides to sell. Price is always important, and many argue that the right value for a middle-market business is the result of complex calculus. But creating the ideal sale transaction is, in reality, a careful balance of personal and financial interests. A seller may have goals that are as important as or more important than monetary value. He or she may want to create a legacy, preserve the business's deliberately built culture, create a social impact, or demonstrate loyalty to employees and customers. Further complicating the issue are the terms of the transaction. How much is cash at closing versus earnout? What is included with the sale? What are the imputed values of employment contracts? What is the present value of the cash to the seller? A company's value is much more complicated than a formula.

The web of soft-factor decisions must then be laid on top of another complex web: the company's evolving position in its industry and the industry's evolving position in the larger economy. These are just a few of the factors in establishing a healthy perspective and realistic expectations about company value.

Of the numerous factors that drive a company's value, these three have the most significant impact:

- The seller's chosen transfer channel or transition path.
- The company's financial performance.
- The company's strategic position relative to its industry.

The transfer channel is the channel by which the business will change hands. Business owners must be clear about whom they consider to be potential buyers. If an owner hopes to sell the business to the management team, an employee stock ownership plan, or to a family member, he or she will need to get comfortable with the idea that the value of the business will generally be lower than if he or she sells to a strategic buyer or private equity group. Many middle-market business owners decide they'd rather sell to their son or daughter than to another company, and, though this may be a worthy decision and the right one for many people, the market value in this context will almost always be lower.

Understanding the market and a company's position in that market will influence how valuable the business is to a financial or strategic buyer, and can greatly impact the EBITDA multiple or revenue it is willing to pay. Below are key questions that may help an owner frame the likely value:

- What does the company really have to sell? Is a seller selling a strong customer base, a solid team of

employees, a reputable brand, or a sought-after technology? In other words, what is a buyer really getting for the money?

- How is the company positioned to compete in the future? A strong competitive position can reduce a company's risk of achieving the expected cash flow and, therefore, increase its implied value. Such a position has other benefits, such as attracting high-quality talent, which pays off over time.
- What is happening in the company's industry? A growing market with increasing demand may provide more predictable pricing and margins over a contracting or consolidating market with price pressure and eroding margins. Each scenario will affect the future cash flow and attractiveness of a business differently.

Because of the nature of what they do or how their industry operates, certain businesses trade at low multiples in the market. The market worth of construction companies, commercial real estate brokerages, job shops, and other project-oriented businesses resides in a team of professionals or in large, one-off projects. The value of these businesses is relatively low compared to their size or to other types of companies. When a business's value is tied to its owner or a principal actor, it tends to trade at lower multiples. Companies that are often called Main Street businesses sometimes have more value in the real estate and fixed assets than in the operating entity itself. If a business does not have a strong competitive position or operates in a commodity market where players are consolidating, a buyer may base its value largely on potential cost savings.

On the other end of the spectrum, a company with a unique technology or capability that may be considered a game-changer can be valued as an option on, or bet in a segment. In this scenario, the buyer finds much of the business's value in its ability to accelerate time-to-market, expand capabilities, or gain access to technology for rapid deployment in a market space. When a larger company views a smaller company as a strategic deal that offers the opportunity to expand products or access to new customers, it may be willing to pay for the opportunity to grow by taking advantage of revenue or other synergies. These kinds of sale transactions are among the most lucrative for middle-market companies, and the significance of historical financial performance is reduced in the overall value equation.

Business owners come to the decision to sell their company for any number of reasons. Optimizing the sale first depends on what a particular business owner defines as important. Coupling these objectives with a realistic view of what a company has to offer the market and how buyers assess the value of similar companies should guide the seller toward a practical value range.

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