Merger & Acquisition Focus

August/September 2004

It's 2004 – Do you know your company's market value?

Selling your business to a strategic — vs. a financial — buyer

Giving creditors their due: A bankruptcy war story

Ask the Advisor

Roll-ups can present integration challenges

It's 2004 – Do you know your company's market value?

Placing a value on a company — how hard can it be? Business owners do it all the time. Some use an old figure and perhaps increase it a bit to account for inflation. Others do a little asset-adding here, take a few numbers off a spreadsheet there, and voilà.

These homegrown appraisals may seem innocuous at first; after all, nothing's wrong with using a ballpark figure. But while that may be true in some arenas, it's decidedly *untrue* on the M&A playing field.

What's it worth to you?

Nothing is as simple as it initially appears, and that applies double to valuation. Although some owners take a more casual approach to valuing their businesses, homegrown valuations can come back to haunt you. This is true whether you're suddenly embroiled in litigation and must defend your value judgment, you're ready to sell your business, or you want to know a target company's value.

Businesses seek valuations for myriad purposes, including estate valuations, divorce proceedings, partnership breakups or buyouts, insurance purposes and determining the business's market value. Because valuation is such a broad and complex area, let's focus on a business's market value — and how the seller and his or her agents can enhance it.

Most people and institutions define market value as the price a willing buyer will pay a willing seller, meaning there can be no undue pressure to buy or sell on either side of the transaction.

Increasing value

As a business owner, you want to do everything you can to increase the perceived value of your business before you put it on the market. As when selling a home, you'll want to "tidy up" before putting it up for sale.

So streamline your business practices by eliminating extraneous, unjustified expenses. If the building or equipment you use needs maintenance or a little touch-up, now is the time to do it. Get your books and legal papers in order.

Even if you're on the seller's side of the table, think like a buyer: What information would you expect as a buyer? If you were to buy this business, what would you look at when making a physical inspection? And what would you want to know about the company's marketplace?

To get the most bang for your buck, understand what motivates a buyer. Most are purchasing future cash flows, so they'll want to know how secure those cash flows are. The most important items comprising cash flow are operations (actions that directly affect the net income line) and the company's use of capital.

The use and makeup of capital can seriously affect a company's return on investment, which will be reflected in the company's balance sheet. The presence of debt on the balance sheet — and possible expectations that the buyer is to assume that debt — will affect the value a potential buyer puts on the business.

The more efficient a company is in the use of its capital, the greater the potential return on investment. In other words, inventory, receivables, payables and the condition of capital equipment must be continually monitored and corrective actions taken when necessary.

It's a team effort

Whether you're thinking about selling your business or considering buying one, assemble a team of experts in the field. Those professionals can include:

1. A business broker or other intermediary,

2. An independent accountant who is accustomed to the activities involved in the buying and selling of businesses, and

3. An attorney whose practice has involved numerous transactions similar in size and complexity to yours.

This team of experts can help get your company ready to go to market, protect your firm's interests when purchasing another business and facilitate the transactions.

While no two businesses are exactly the same, potential buyers want to compare prices paid for similar companies. These figures, while useful, should be cautiously viewed. They can be misleading for reasons that include market share differentials, timing and circumstances surrounding the sale, and lack of available information about transactions involving private companies.

The sale of your business is time consuming and costly. The way in which you undertake its sale can have a significant impact on the perceived value of the business and, ultimately, the amount of capital you receive.

Rushing the sale of your business can detrimentally affect its value. An anxious seller is a potential buyer's best friend. In addition, don't insist on 100% cash at the close of the transaction, as some do. It can decrease the value you receive for the business. Conversely, being somewhat flexible on the terms can enhance the amount you receive when you sell your business.

When setting the asking price for your business, ground your expectations in reality. Your asking price needs to be defensible and justifiable to the buyer. Therefore, it's useful to step back and study the numbers presented to you. What would you be willing to pay for your business's expected cash flow?

Silence is golden

How your business is presented to the marketplace can substantially affect its value. A degree of confidentiality and discretion should be maintained. Always err on the side of caution when it comes to confidentiality.

It would be unfortunate, for example, if your key selling accounts became aware of the impending sale early in the transaction process. Equally as detrimental to your operations would be leaking information to your employees. Their productivity and accuracy are bound to suffer if they're concerned about the company's future and their place in it. Key managers may even leave — at a most inopportune time in the transaction process.

It's worth knowing value

Few people would consider selling their homes without getting a professional appraisal first. In fact, the savviest individuals get an expert appraisal whether they intend to sell soon or not. After all, opportunities do arise unexpectedly. Being prepared — particularly in an uncertain economy during turbulent times — is wise.

Selling your business to a strategic—vs. a financial—buyer

In tight-money days, reports of companies sold for seemingly extravagant sums to strategic buyers may inspire entrepreneurs. Similarly, those seeking investment believe that strategic investors will recognize higher valuations than financially oriented venture capitalists. Also, strategic investors can provide validation for financial investors and influence them to recognize a higher valuation.

What are strategic buyers? How do they differ from their financially focused counterparts? And how can you locate someone who will have a strategic interest in your business?

The hidden value of data

An example of an often unconsidered synergy is the value of data. In the course of operating your business, you're likely capturing data about your customers that someone else may deem valuable.

Let's say a national real estate company is in serious discussions with a potential strategic investor. The investor is enthusiastic about the prospect of selling information gathered by the real estate company to companies willing to pay well for data about people who are contemplating a move.

While data may not be the first thing that pops into your mind when you think "value," don't discount it.

Strategic vs. financial buyers

Simply put, strategic buyers believe that your business will help make their business perform better, while financial buyers are interested in the economic value that your business will create on its own.

Because a strategic buyer will likely have a larger business than yours, the leverage that your business can create may be much greater than the value of the business to you.

Generally, strategic buyers will pay more and sometimes will buy when no one else will. And, if you can interest more than one strategic buyer, you may find yourself in the best possible situation: a bidding war.

Where to find one

It's unlikely that a strategic buyer will unexpectedly knock at your door. Rather than relying on serendipity, consult with M&A professionals to find strategic buyers and learn how to reach out to them, directly or indirectly.

A CEO searching for strategic buyers can devise criteria to find potential strategic value. It's easier to look for viable buyers once you've identified possible synergies. Integration options include:

Vertical. Integrating vertically allows the buyer to bring its solution to industries in which the seller currently focuses. An example is a larger executive-recruiting company that acquires a business specializing in executive recruiting for the health care industry.

Horizontal. Integrating horizontally allows the buyer to bring its solution to the market in which it currently focuses. A marketing company, for example, might acquire a Web developer so it can provide Internet-based solutions to its established clients and prospects.

Channel. The strategic buyer has a sales channel that can easily adopt the acquired company's products. As a result, the buyer will have more to sell to existing customers.

Capacity. The acquiring company has unused capacity that can be filled with the target company's product. For example, a manufacturer can make the acquired company's products in its existing factories without adding new real estate or additional equipment.

Geographic. The seller gives the buyer access to its strongest geographic markets. For example, an office-furniture distributor headquartered in Chicago acquires a similar business based in Detroit.

Operational efficiency. The buyer may be able to operate the combined businesses at a higher margin by eliminating redundancies. For example, a bank may acquire a competitor and eliminate 15% of back-office costs by combining staffs.

Time to market. The buyer quickly needs what the seller has to fill a strategic gap in its product line. A great example was Microsoft's purchase of software pioneer Vermeer Technologies for almost $200 million. Vermeer's sales at the time were less than $10 million, but the resultant product, the Web page creation software

now known as Microsoft FrontPage®, was critical to Microsoft's Internet strategy.

Explore your options

Even if you're not currently interested in selling your business, understanding how it might create strategic value for larger companies can be a productive exercise. That analysis may allow you to create new strategic relationships and increase sales.

Your ability to identify these and more subtle synergies — and demonstrate them to the potential buyer — can be worth millions in exit value (that is, the value at the time the company is sold). Every executive team can create value and realize benefit by examining the potential strategic synergies their business can create and initiating discussions with potential strategic partners, acquirers or investors.

Giving creditors their due: A bankruptcy war story

When a business seeks protection from creditors through the courts, everything changes. While that's pretty straightforward in theory, it's foggier in practice. It certainly was for Dan.

Dan was newly appointed to the board of directors of a publicly held company just emerging from bankruptcy. Having served on other public company boards, Dan presumed he was well prepared to serve on this one. He was wrong.

Dan was shocked, for example, that his fiduciary responsibility as a board member lay first with the secured creditors, then the unsecured creditors, and only *then* to the business's stockholders and employees. As he soon learned, when a company is under court supervision, its best interests sometimes conflict with those of its creditors.

Under their thumbs

Both secured and unsecured creditors' primary interest was reaping as much cash as possible from the company. The creditors didn't particularly care about the company's prospects if they potentially interfered with quickly generating substantial cash. To top it off, the court had to approve any significant company actions, and the creditors' committees could approve — or disapprove — most of the company's activities.

Briefly, the court appoints creditor committees. At a minimum, there are usually two: a secured creditors' committee and an unsecured creditors' committee. Among other things, these committees are charged with safeguarding — to the best of their ability and under the court's supervision — all of the claims of the class of creditors they represent.

To appease its unsecured creditors, the company's board began to consider selling some of its assets to generate cash. Among these assets were several operating units that generated considerable cash flow.

Common sense would seem to dictate that the business should retain those operating units to benefit from the positive cash flow. Unfortunately, retaining the units would not be in the best interests of the creditors, who had "first dibs." The creditors went to court and the bankruptcy judge decided in favor of the plaintiff; the operating units had to be sold and the proceeds given to the creditors.

Because Dan and the rest of the company's board didn't consult with divestiture professionals before going to court, the company lost — perhaps unnecessarily — substantial, continual cash flow. Eventually, the company emerged from bankruptcy minus its money-making operating units and with its creditors owning a large share of what was left.

Ask the Advisor

Q. I've heard that the market for selling small to midsize businesses like mine has improved substantially this year. If so, why, and how much better is it?

A. The market for selling small to midsize companies has definitely improved this year. Three primary factors help account for the recovery:

1. **Equity capital availability.** Private equity investors are pursuing acquisitions more aggressively than they did in the previous two years. This buyer competition is exerting significant upward influence on the earnings before interest, taxes, depreciation and amortization (EBITDA) multiple used to calculate purchase price.

2. **Improving economy.** Overall economic stability spurs better financial results for many companies. And higher multiples combined with greater EBITDA increase sales prices. In most industries, healthy companies are selling for one multiple of EBITDA more than they were a year ago.

3. **Debt-financing availability.** Banks and other senior lenders have started loosening debt-financing standards. In addition, more mezzanine financing, with better terms, is also increasing the chance of getting deals done.

These combined factors help raise purchase offers enough to entice previously wary investors to enter the game.

Q. Does it make good business sense to merge my private company into a public shell?

A. The term "public shell" refers to a publicly held company that is no longer doing business but has kept current on its public company filings. When a private company that is operating merges with that public shell, the private company has automatically become public.

Businesses consider this strategy when they want to generate liquidity and help raise capital for acquisitions. Unfortunately, it rarely achieves its desired objectives and its negatives outweigh its potential positives.

Banks and other senior lenders have started loosening debt-financing standards.

The strategy assumes that another company would be willing to be sold in exchange for stock of the now public entity. Because sellers seek the advice of capable advisors, it's unlikely that would happen. In fact, most sellers would be put off by the fact that the public company stock is not being traded in any public market.

Furthermore, every public company, no matter how small or thinly traded, must adhere to the same regulations and reporting rules as large, heavily traded public companies. And, regardless of company size or stock-trading volume, complying with regulations is costly and time consuming.

Roll-ups can present integration challenges

There really can be strength in numbers. Because of synergies and economies of scale, combining smaller companies within an industry may create a stronger entity that can operate with higher margins. This combination is known as a roll-up.

Recent examples of roll-ups include consolidation in the telemarketing and the credit services industries.

So what makes a roll-up work? Successfully combining entities requires planning and careful execution. Integration challenges include people, facilities, IT systems and sales channels. Too often, an acquirer focuses more on getting the deal done than he or she does on post-integration challenges. And that inattention can lead to disaster.

Determining details

The fact is that the majority of roll-ups don't work. A single acquisition can be challenging; a string of successive acquisitions raises the degree of difficulty exponentially.

So companies that execute roll-ups successfully leave little to chance. A carefully developed plan for every aspect of integration is essential.

Contributing heavily to a roll-up's success or failure will be determining which of the acquired companies' CEOs will be part of the new entity and the ongoing role of each of them. If these former CEOs, for example, will lead divisions of the larger entity, clearly define measurements and incentives. Also, will the divisions continue to operate as largely autonomous entities or will control be centralized?

During the bubble years, several companies tried to execute what was then described as a "poof roll-up." A poof roll-up occurred when several different companies in one or similar industries were combined to create the appearance of size, with no real integration strategy in mind. Typically, the goal was to make a windfall through an initial public offering (IPO) before the whole thing potentially collapsed under its own weight.

Almost invariably, these transactions failed because either the IPO would tank or the management teams that attempted the roll-up were unprepared.

Proceeding wisely

To successfully execute a roll-up, a company will need professional management that is experienced in integrating multiple companies. A carefully scripted roll-up integration plan with clearly documented time lines and accountability is a must. Systems to measure the achievement of the various milestones are also essential.

For more information about the synergies involved in strategic acquisitions, see "Selling your business to a strategic — vs. a financial — buyer" on page 3.