THINK LIKE A BUYER

To maximize both today's results and tomorrow's exit value, examine your business through the eyes of your future buyer.

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By: **Michael Rosenbaum**
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This year, like last year and the year before that, most business owners who pursue the sale of their companies will blow their opportunity to capitalize fully on decades of investment and sweat. Roughly 40% of the deals that reach the Letter of Intent stage will fail to close, while a substantial percentage won't even get to an LOI in the first place. Even those deals that do close will often be delayed and devalued by major concessions that diminish returns to the seller. In many cases, companies will fail to draw any buying interest at all.

And, no, we aren't referring to somebody else's company. <u>We're talking about you.</u>

While it takes very little effort to multiply the selling price of a company, most owners fail to follow a few simple and inexpensive steps that practically guarantee success. And each year, as a direct result of that failure, acquirers will gain $billions or tens of $billions in returns that woulda/coulda/shoulda gone to the sellers.

For the seller, the lost opportunity is referred to as *money left on the table.* For the buyer, it's return on investment. Logically, it would make sense that the person who knows the company best would also be best equipped to capture its full value. Logic fails, however, when sellers and buyers have dramatically different perspectives on the company and its value—and the buyers' perspectives are generally superior.

For many owners, the sale of a business is somewhere on the horizon, but not close enough to command much attention. The day-to-day intervenes and draws management's energy, which seems to leave little or no time to focus on *someday.* By the time the owner decides to pull the trigger, the window for maximized returns has closed. The result, for many owners, is an inadequate price and unfavorable terms for the most influential transaction of their lives.

Fortunately, there is a cure for this malaise and the cure offers two vitally important benefits:

1. Performance improvement in advance of any sales process
2. A stronger negotiating position and exit price for the sale

It takes very little effort to achieve these goals. Briefly, all owners need to do, at least one or two years before the official sales process begins, is to gain an understanding of the people who would buy the company and, then, work backwards to address the buyer's hot-button issues.

In short, think like a buyer.

The Most Valuable Product You'll Ever Sell

Business owners are usually at a disadvantage when it comes time to sell their companies or take on new investors. Excluding some *professional owners,* such as private equity firms, most owners spend their time running the company and selling products/services. Unlike the people who might buy their companies, owners do not focus on the company itself as a product to be marketed.

That is exactly what the company is, though: a product. And it's a product whose value is determined at least partially by different metrics than the ones applied to the company's operations. As with any sale, it's critical to get into the buyers' heads and address the issues that are most important to them. Let's examine a few of those issues.

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- **Rate of Return**

It goes without saying that every buyer is seeking a profit from the businesses they acquire. No reader is going to be shocked by this statement, but many sellers will fail to recognize the risks and opportunities that this simple truth creates for them.

While each buyer wants a profit, different buyers will have different standards for minimum profitability levels and the certainty of returns. Just as individual stock market investors or funds will have different risk/reward profiles for their investments, acquirers will vary in terms of their taste for risk, returns and timing.

This is a critical issue for sellers, because the quality of earnings and relative level of risk can vary substantially from one company to another and from one acquirer to another. As a general rule, buyers will pay more for consistent performance than for cyclical variations, even if long-term totals tend to accumulate to the same level. Similarly, buyers will discount offers based on their perception of risks related to future performance.

One of the most important factors to consider in the risk calculation is that risk, like discounted cash flows, is a projection, a belief about how things are likely to turn out in the future. Most of the time, when people speak of risk, they are not referring to a known number, but a future possibility. Even when a risk is calculated as a reserve on a company's income statement, the number is a best guess, not a reality.

That means the correct reference language should be *perception of risk,* which is subject to many types of interpretation and adjustment. In turn, differences in the *perception of risk* can translate into dramatic variations in the price of each dollar of expected earnings. If a company might sell at a 3-6 multiple of EBITDA, for example, the seller can double the sales price simply by selling at the top of the range.

Often, significant differences in pricing multiples reflect variations in the *risk discount* assigned to a company. If one buyer believes a company is 90% likely to hit its targets and another buyer believes the likelihood to be closer to 40%, those differences in *risk perception* are likely to yield sharply varying offers.

Similarly, one buyer might seek a 30% annualized rate of return on investments while another is willing to accept 20%. All else being equal, one of these buyers might offer 50% more than the other to acquire a specific company.

Timing is an important factor, as well. Different buyers will anticipate holding periods that might range from three years to forever. For a company operating in an industry with long cycles, the buyer with less time pressures might be willing to offer a higher valuation, simply because there is less risk of needing to resell the company in a future cyclical trough.

- **Financial versus Strategic Buyers**

For specific companies, the highest exit value might depend on whether the buyer is a strategic or financial investor. As a general rule, strategic buyers are in the same industry or an industry related to the seller. A bookbinder might want to buy another bookbinding company to expand market penetration, broaden geographic reach or achieve economies of scale. A bricks-and-mortar retailer might decide to buy an online competitor to strengthen its e-marketing channels.

Two factors that might differentiate strategic buyers from financial buyers are emphasis on management and holding periods. As a rule, financial buyers will be more likely to emphasize management retention, since many of them do not bring industry experience to the table, while strategic buyers might believe they already possess the management depth to operate the acquired company. That doesn't mean a strategic buyer will plan to eliminate all managers after the purchase, but it often indicates more shuffling will take place than with a financial buyer.

Financial buyers are more likely to have a holding period in mind for the company that's acquired. Often, a private-equity fund will be financed by investors who expect to receive their investment, plus returns, within a five-year or seven-year period. That doesn't mean every company bought by a financial buyer will be sold in five years, but the presence of a timeline can influence a financial buyer's price elasticity in different ways than is the case for a strategic buyer.

Which type of buyer is likely to pay a higher price for a specific firm? That will depend on both the sources of the selling company's value and the needs of the buyer. A strategic buyer looking to expand geographically might be willing to pay extra to gain immediate access to facilities in its targeted regions. The same buyer might discount the value of those facilities, though, if they duplicate existing resources.

A financial buyer might be willing to pay up for a cohesive management team that will stay and run the business after the transaction closes. If that management team is nearing retirement, though, this "asset" might not command a premium.

This brings us back to rate of return. If an acquirer is buying an asset-rich company, but plans to trim those assets to achieve higher returns, the buyer will tend to discount the value of the assets more than a seller who relies on those assets each day. A financial buyer who needs an in-place management team might be willing to pay more for a company than a strategic buyer who anticipates the disruptions and expense that will flow from staff consolidations after the close.

Check the Baggage

Quite frequently, business owners will have a strong emotional connection to their companies. The company might be a product to the buyer, but it's core to the seller's sense of self, of value and legacy. The company is the *favorite child* for many owners, which is not surprising when one considers the number of hours and degree of focus most owners devote to their work.

This emotional attachment often puts the seller at a disadvantage when negotiating a transaction. It might be a great source of pride that dad founded the company immediately after disembarking at Ellis Island, but it is rare for this pride to translate into valuation at sale. A corporate culture that encourages multiple generations of employees from the same family could be a core value to the present ownership group, but it might be seen as a negative by an acquirer.

It's critical for sellers to understand which aspects of the company create value for a buyer. Too often, owners will focus more than is healthy on aspects that are important to the owner personally, but not likely to draw additional compensation from a buyer. It's great, for example, that *this is a family-run business,* but that value disappears when the company is sold to a non-family member.

Similarly, an ownership team might work hard to obtain status as a minority-owned or female-owned business, gaining access to additional sales opportunities in the process. This status can limit the number of acquirers willing to purchase such a firm, knowing that a portion of sales might be lost if minority/female-owned status disappears at the close.

In the M&A industry, it's estimated that roughly 40% of all deals that reach letter of intent in any given year will fail to close—and another large percentage will fail to clear the LOI hurdle in the first place. One oft-cited reason for this astonishing failure rate is unrealistic expectations of sellers regarding the value of their companies. Far too often, sellers and buyers see value very differently, which leads to a major gap in the number of offers that match expectations.

Find Your Most Likely Buyer

While it's impossible to anticipate all the details that will affect the pricing and terms of a specific transaction, it is possible to anticipate the type of acquirer that would be most interested in an owner's company. Recognizing that a wide array of potential buyers might be targeted, the owner can begin considering the best targets for his or her specific company.

A company with a Midwestern footprint might be most valuable to an acquirer seeking to enter the Midwest. A company that has recently updated its manufacturing facilities might draw a premium bid from a competitor with “legacy operations.” Real estate, intellectual property, reputation, contracts….any and all of these can be important drivers of buyer interest for a specific company.

With so many potential drivers for valuation, there is no single answer to the question: *What is this company worth?* Identifying the various sources of likely value is a relatively straightforward process, however. This exercise can be conducted within the context of a strategic planning program or annual corporate retreat, and many advisors can offer valuable insights for value creation.

In the Quadrant Five methodology, for example, we begin with a single question: *What do we do better than our competitors?* Then we ask if the company’s *A-List* customers both believe this to be an advantage and, if so, whether/how they will deliver returns on that strength. After all, there’s no point to focusing on a perceived advantage if it turns out that one’s best customers either reject the reality of that edge or refuse to pay for it.

Most businesses spend a great deal of time and dollars replicating the offerings of their competitors. It’s often necessary to do so, of course, but matching the market is a form of table stakes. It gets you in the game, but it doesn’t make you a winner. Companies that want to obtain the highest value for their competitive edge must determine, first, the nature of that edge.

It takes a bit of discipline to identify the competitive edge that should—not necessarily *does*—create the greatest value for a company. Each member of the management team will have his or her filters, anecdotes, points of pride and feedback loops. Owners must recognize that their perceptions of value, based on internal engagement and personal experience, will not likely be seen the same way by potential buyers. The ownership team must step outside its skin to view the company the same way an acquirer would, and respond accordingly.

The core strengths that are valued most by A-List customers are just the starting point in value identification and enhancement. While the management team will want to focus more bandwidth on promoting/cultivating those strengths and de-emphasizing the also-rans, it’s important to examine additional factors that will help/hinder marketability.

While customer assessment processes like Quadrant Five can bring customer perspectives into the value-maximization process, a wide array of advisors can help the management team enhance value through stronger financial controls, operating efficiencies, management development, etc. By improving performance and predictability of results, each of these improvements can reduce a buyer’s perception of risk and increase the ultimate exit value of a company.

Bridge the Gap

Once the team has identified the company's core competitive edge and the type of buyer who would be most interested in paying a premium for that strength, among others, it's time to switch gears and think like a seller. If the ownership team was in the business brokerage business and this company was the product being offered, what steps would be needed to maximize returns?

At this point, the ownership team has figured out, to the extent possible….

- What gives the company a competitive edge in its markets.
- What assets or operations add to value, either by increasing returns or reducing risk.
- Which specific acquirers or acquirer types would be likely to pay a premium price.

Now, the ownership team can look at the gaps to be closed in order to increase its likelihood of success. If the company's strengths are tied to A and B, what weaknesses could reduce the premium a buyer would pay for those strengths? What product, service, operating system, financial structure or asset allocation undermines the fundamental value of the business? Can the company repair or eliminate the issue and reduce ongoing costs, while also increasing transaction value?

If, for example, the ownership team determines that its highest-premium buyer would close redundant facilities, the critical question is whether to do that in advance of an exit process. If a buyer would pay less for the company, anticipating the cost of spinning off a legacy product line, the ownership team could consider making this change without prompting.

The key is to make these decisions with eyes wide open. A business owner can decide to keep the legacy product line that generates essentially zero return on assets, recognizing the sentimental attachment that product has for the founding family. It's important to make that decision intentionally, though, fully aware that the company's continued investment in that product line is diminishing both current profitability and exit value.

When value gaps arise in negotiations, they are often a result of work left undone by the seller—and value the seller could have created before the sale. Many of these changes could be classified as low-hanging fruit, requiring minimal expense and no change to culture or staffing.

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Often, the seller could have benefited from years of improved performance while also expanding transaction value, simply by implementing minor changes to operations. Refocusing a product marketing program or adjusting commission structures can drive stronger performance. Small changes to training programs or website pages can change the course of growth, as well.

In any case, the process should involve shifting of existing resources (dollars, time, staff, assets) more than the investment of new funds. Performance enhancement will flow from increased focus in the areas that drive value and the improved results that result from that focus.

That's the kind of performance an acquirer would want to see and, not coincidentally, an improvement that would be appreciated by the existing ownership group. There's no need to leave excessive amounts of money on the table when it's time to sell the company. All the ownership team needs to do is think like a buyer and many of the answers will become apparent quickly.

Michael Rosenbaum is founder and president of Quadrant Five, a unique methodology for customer-driven performance improvement. Through more than a quarter century as an advisor to C-Suite executives, and as president of a $35-million consulting firm, Rosenbaum identified the patterns that lead to success and failure at hundreds of companies. The result of his experience is Quadrant Five, a methodology that is both conceptually simple and sophisticated in its implementation. Beginning as a newspaper reporter, Rosenbaum developed a specialization in business journalism and earned an MBA on his way to a 25-year consulting career. Rosenbaum's most recent book, *Six Tires, No Plan,* examines the career path of a self-made billionaire whose approach to business is a strong match to the Quadrant Five process. In addition, Rosenbaum has authored four other books and is an active member of YPO/WPO, AM&AA, MMA and MBBI.

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