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Valuing Privately-Held Companies

Introduction

Valuing companies may be more of an art than a science, but there are three basic factors that acquirers evaluate when trying to establish a price for a business.

- ◆ *Quality of Earnings* – Acquirers will look at the earnings to see if the numbers include a lot of “add-backs” or one-time events (like a sale of real estate which does not reflect on the true earning power of the company's operations). It is not unusual for companies to have “some” non-recurring expenses every year, whether it is a new roof on the building, a hefty lawsuit, write-down of inventory, etc. An acquirer will be wary of financials that restructure the earnings without “any” allowances for extraordinary items.
- ◆ *Sustainability of Earnings Following Acquisition* – The key question acquirers often ask is whether they are acquiring a company at the apex of its business cycle or whether the earnings will continue to grow at the previous rate.
- ◆ *Verification of Information* – The concern for the acquirer is whether the information is accurate, timely and relatively unbiased. Has the company allowed for possible product returns or allowed for uncollectable receivables? Is the seller above-board or are there skeletons in the closet?

The multiple of earnings varies according to many aspects including the company's history, the industry, the market, management, potential, proprietary products or services, niche, growth rate and size. The multiple also depends on the buyer's desired rate of return; e.g., a 5 multiple represents a 20% ROI while a 4 multiple represents a 25% ROI. The higher the perceived risk, the higher the desired ROI. For companies over \$50 million in sales, the multiples averaged 6.5 times EBIT while companies with less than \$10 million in sales averaged a 4.5 multiple. Based on using the same EBIT of \$1 million for one company with \$50 million in sales versus another company with \$10 million in sales, the difference in price is equivalent to 44% more for the larger company.

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Measuring Earnings

When a seller talks about earnings, one has to really define earnings; e.g., EBIT or EBITDA; 2014 earnings or 2015 projected earnings; EBITDA - CAP X; reinstated without prerequisites but with add-backs, etc. Sometimes intermediaries will submit a selling memorandum and the earnings will be recast including all the owner's (CEO) salary and compensation – Wow!

When an acquirer is analyzing earnings, he or she will want to know, is it for one year, three years, interim earnings annualized, combination of reporting periods, projections, etc.? What is the time frame for measuring earnings and what is the trend of earnings?

Another concern in measuring earnings in the future is what changes might affect earnings such as an increase in rent, family members off the payroll, loss of key customers and/or vendors, etc? Beware of companies that are locked into long-term contracts in which they are unable to raise prices or companies in a commodity- type business in which there is unrealistic market pricing.

Key Considerations

The following questions are useful in understanding a business and valuing a company more prudently:

- ◆ What's for sale? What's not for sale? Does it include real estate? Is some of the equipment leased instead of owned?
- ◆ What assets are not earning money? Perhaps these assets should be sold off.
- ◆ What is proprietary? Consider formulations, patents, software, etc.
- ◆ What is the company's competitive advantage? Is it a certain niche, superior marketing or better manufacturing?
- ◆ What is the barrier of entry? Is it capital, low labor, tight relationships?
- ◆ What about employment agreements/non-competes? Has the seller failed to secure these agreements from key employees?
- ◆ How does one grow the business? Maybe it can't be grown.
- ◆ How much working capital does one need to run the business?
- ◆ What is the depth of management and how dependent is the business on the owner/manager?
- ◆ How is the financial reporting undertaken and recorded and how does management adjust the business accordingly?

Check List for Valuation

1. Start with the Business

- ◆ Value Drivers:
 - Size, growth rate, management, niche, history
- ◆ Value Detractors:
 - Customer concentration
 - Poor financials
 - Outdated M&E
 - Few assets
 - Lack of agreements with employees, customers, suppliers
 - Poor exit possibilities
 - Small market
 - Potential technology changes
 - Product or service very price sensitive

2. Financial Analysis:

- ◆ Market Value - comparables
- ◆ Multiple of Earnings - based on rate of return desired

3. Structure and Terms:

- ◆ 100% cash at closing could reduce price 20%

4. Second Opinion:

- ◆ Even professionals need a sounding board

5. Indications of High Value:

- ◆ High sustainable cash flow
- ◆ Expected industry growth
- ◆ Good market share
- ◆ Competitive advantage - location/exclusive product line
- ◆ Undervalued assets - land/equipment
- ◆ Healthy working capital
- ◆ Low failure rate in industry
- ◆ Modern well-kept plant

6. Indications of Low Value:

- ◆ Poor outlook for industry
 - foreign competition
 - price cutting
 - regulations
 - taxes
 - material costs
- ◆ Distressed circumstances
- ◆ History of problems
 - employees, customers, suppliers, litigation
- ◆ Heavy debt load

Conclusion

The above information is helpful in determining what multiple of earnings or what discounted cash flow rate to incorporate; however, it doesn't determine the actual number. Much of the information above will influence the person's perception of value. Valuation is often in the eyes of the beholder, regardless of whether the price is rational.

Ten Tips on Selling

1. The decision to sell is not irreversible, but it should be firm. In the sale of a family business, it is important that it is not just the majority owner who is involved, but that all the family members who have some ownership, or who work in the business, are brought into the selling process. Hopefully they are in concert with the decision to sell. For non-family private businesses, all stockholders should be apprised of the situation.
2. Decide up front who is going to be the ultimate manager of the selling process so there is no ambiguity later on. Decide whether it should be the majority owner, the CEO, the intermediary or some other logical person.
3. Set time frames on the selling process in order to have milestones. For example, set time frames for completion of selling memorandum, contact of potential buyers, receipt of Letter of Intent, timeline for closing, etc.
4. Partner with real professionals. Improper advice could cost you tenfold later on. In retaining an attorney, be sure he or she is a “transaction” attorney, not a divorce attorney. Make sure the intermediary properly screens and qualifies potential buyers.
5. Communicate with your banker about what you are doing. Bankers not only hate surprises, but if they are surprised, they may not be as cooperative when you need them most.
6. Target buyers who would consider your company to be the most valuable.
7. Openly recognize certain “on and off” balance sheet items such as customer pre-payments, work-in process billing, contract obligations, lease obligations, legal threats, etc.
8. Negotiate “stay agreements” with the owners or managers so they will not jump ship before the business is sold. Depending on the situation and the importance and number of people involved, a stay agreement could be equivalent to anywhere from two to six months salary.
9. Set up a complete file in one place of all relevant information the buyer and/or his due diligence team will ultimately request; e.g., contracts, distribution and purchase agreements, leases, licenses, intellectual property documents, etc.
10. If a buyer indicates he or she will be submitting an offer or Letter of Intent, tell them right up front what items you want to be included in the document:
 - ◆ Price and Terms
 - ◆ If asset purchase, what assets and liabilities are to be assumed
 - ◆ What contracts and warranties are to be assumed
 - ◆ Lease or purchase of real estate
 - ◆ Responsible for what employee contracts or severance agreements
 - ◆ Time schedule of due diligence and closing

Understand the Buyer's Concerns

The buyer is usually aware that the founder, owner, and CEO is principally responsible for running the business. If the company has no depth of management or is perceived to be a “one man band,” the price for the business will be discounted. It is not wise for the CEO to overly brag about himself or let the seller know he has not taken a vacation in three years and works twelve hour days.

The buyer is particularly concerned whether the earnings are really there or if last year was a spike in earnings. Will the earnings continue? Is the seller justified in all those add-backs? Almost all businesses have “some” travel and entertainment (T&E) expenses.

As a seller, be prepared to answer these questions:

- ◆ How do you grow the company?
- ◆ What is the Company's competitive advantage?
- ◆ If you had a million dollar windfall in the Company's checking account, what would you do with it?

Selling the Business

Why is the company for sale? How long has the business been for sale? Are there other owners or stockholders, and if so, what is the ownership breakdown? Does the owner have the authority to sell or is it the decision of a family, partners or Board of Directors? Are there other offers on the business? Who will be doing the negotiations? What is the rationale or methodology in determining the price of the business? Are there any add backs or reconstructed earnings? What is the owner's total compensation? Is there any pending litigation or prior litigation? Are there any contractual obligations such as employees, vendors, customers, landlords, intermediaries, non-competes, or buy/sell agreements? Are there any "soft assets" like uncollectable receivables? Would the owner stay on for a transition period? Would the seller take a note as partial payment, subordinated to the bank or unsecured? Is there anything in the offer that is "not" negotiable; e.g. asset versus a stock sale? Are there any violations with OSHA, EPA, Unions (if any), etc.?

Go over the financials line by line to be sure you understand each item and also to see if there is some possible restructuring of the balance sheet which will help you make a more realistic offer. Other areas to consider:

- ◆ Consider removing the real estate if included.
- ◆ Remove shareholders' receivables or payables.
- ◆ Remove owners' assets; e.g., automobiles.
- ◆ Disclose owners' perks.
- ◆ Review reserves and accruals.

Final Questions

- ◆ If you miraculously received \$100,000 in the company, how would you use it?
- ◆ How do you grow the business?
- ◆ What differentiates this company from competitors?
- ◆ What is the culture of the company?
- ◆ What is the company's most important resource?



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