



MidMarketCapital, Inc.

SELLING YOUR BUSINESS TEN STEPS TO MAXIMIZE VALUE

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You started your company 20 years ago “in your garage”, worked many 80 hour weeks, bootstrapped your growth, view your company with the pride of an entrepreneur, and are now considering your exit. The purpose of this article is to help you evaluate your company as a strategic acquirer might. From that perspective we will ask you to focus on ten critical areas of value creation. The benefit to you is that the better your performance in these areas, the greater the selling price of your business. The most likely result is that you will sell at the high range of the multiples normally associated with your industry. For example, during the last 18 months similar companies have sold at an EBITDA multiple of between 4.8 and 5.7 times. Moving your company from the low end to the high end of that range can result in a significant swing in transaction value. If your EBITDA were \$2 million, the low price is \$9.6 million and the high price is \$11.4 million. The Holy Grail in selling your company is when an acquirer throws out the traditional multiples and acquires your company based on strategic post acquisition performance. Below is our list of STRATEGIC VALUE DRIVERS:

1. **CUSTOMER DIVERSITY** – If too much of your current business is concentrated in too few customers that is perceived as a negative in the acquisition market. The concern is that if the owner exits and the major customers leave, the business could be negatively impacted. On the plus side, if none of your customers accounts for more than 5% of total sales, that is viewed as a real plus. If you find yourself with a customer concentration issue and are planning an exit, start focusing on a program to diversify. A quick fix would be to make an acquisition of a competitor with customer diversity, integrate them and then take your company to market.
2. **MANAGEMENT DEPTH** – A common thread in privately held businesses is a concentration of responsibility with the owner operator. The buck stops here may be a good slogan for a presidential candidate, but it will not help create value for a business owner. An acquirer will look at the quality of the management staff and employees as a major determinant in acquisition price. A key in preparing for exit is to develop your people so they could run the business after you are gone. You should make the move of assigning your successor a year in advance of your scheduled departure date. If you have no one that you feel has the ability then go hire someone that can do the job. If you have a strong management team in place and you are anticipating an exit, you should try to implement employment contracts, non-competes, and some form of phantom stock or equity participation plan to keep these stars involved through the transition. A strong management team is a valuable asset in the middle market. If you have one, take steps to keep it in place and the market will reward you. If you are weak in that area, the acquisition market will punish you if fail to take the corrective action.
3. **CONTRACTUALLY RECURRING REVENUE** – All revenue dollars are **not** created equal. Revenue dollars that are the result of a contract for annual maintenance, annual licensing fees, a recurring retainer fee, technology license, etc. are much more powerful value drivers than new sales revenue, time and materials revenue, or other non-recurring revenue streams. It’s all about risk. The higher the risk (future sales) the lower the return. The lower the risk (contracted revenue stream) the higher the return. The most extreme case of this occurs in the software industry where companies



are typically sold at a multiple of recurring maintenance revenue. New license sales, historical levels of project work and projected install revenue are virtually eliminated from the valuation formula. The lesson here is that if you can turn a T&M situation into an annual contract, you will be greatly rewarded when it comes time to sell your business.

4. **PROPRIETARY PRODUCTS/TECHNOLOGY** – This is the area where the valuation rules do not necessarily apply. Strategic acquirers buy other companies to grow. If they believe that a new technology can be acquired and integrated with their superior distribution channel, they may value your company on a post acquisition performance basis. The marketplace rewards effective innovation. On the flip side, however, the market yawns at “me too” commodity type products or services. That business is vulnerable to competition, especially after the owner leaves. Continue to look for ways to innovate in what ever industry you are in. Your innovation should not be limited to product improvements. The marketplace values innovations in distribution systems, collaborative product design process, customer service and other functional areas that can provide a competitive advantage. If you create a technology advantage in your company, think what that could mean to a much larger company.
5. **PENETRATION OF BARRIERS TO ENTRY** – A wise buyer told me once, “I want to own companies where I have an edge.” He happened to be a buyer of Waste Facilities. All the regulations and approvals required tend to limit competition. In its simplest form, a large restaurant chain buys a small family owned restaurant to acquire a grand fathered liquor license. Owning hard to get permits, zoning, licenses, or regulatory approvals can be worth a great deal to the right buyer. Your company may be able to secure approvals on the local level that a national player may have difficulty obtaining. Selling your product or service to the government can be quite lucrative, but the government market is extremely difficult to penetrate. If your product or service applies and you can break through the barriers, you become a more attractive acquisition candidate. The same holds true of a local marquee account that would be desirable for a larger supplier to crack. One strategy for penetrating these accounts is to ask the buyer to identify the best salesman that calls on him. Go hire that salesman to sell your product to that account.
6. **EFFECTIVE USE OF PROFESSIONALS** – Reviewed or audited financials by a reputable CPA firm are quite valuable in the eyes of a buyer. Professional financials cast a positive halo on your approach to controlling your business while at the same time reduce the buyer’s perception of risk. Bring a good outside attorney into the mix, and the risk drops even more. The thought process is that this attorney has been giving his client good advice for years on protecting the company from litigation. A strong professional team is a great asset in growing your business and in helping you obtain maximum value when you exit.
7. **PRODUCT/SALES PIPELINE** – Large pharmaceutical companies are well known for buying smaller pharmaceutical companies that have a robust product pipeline for very generous prices. Smaller companies often are more agile and have better R&D efficiency than their high overhead big brothers. In technology, time to market is critical and big companies are constantly evaluating the build versus buy question. Small companies that develop a hot new technology are faced with the decision of developing distribution internally or selling to a larger company with developed channels. A win/win scenario is to sell out at a price, in cash and stock at closing, that rewards the smaller company for what they have today, plus an earn out component tied to product revenues with the new company. The same earn out philosophy can be employed for a selling company that



has a large sales pipeline. The acquirer is not anxious to pay for that pipeline at closing and the seller wants to delay his company's sale until the next big deal. An intelligently structured sales contract with a contingent payment based on closing accounts in the pipeline is a great solution.

8. **PRODUCT DIVERSITY** – A smaller company that has a quality portfolio of products but may lack distribution can become a valuable asset in the hands of the strategic buyer. A narrow product set, however, increases risk and drives down value. If you are planning to exit, review your product portfolio. Are there obvious gaps that could be filled quickly? How about buying a small company with a few complementary products? What about buying a product line from a company? Can you lock up distribution rights for North America for the best product from a Finnish manufacturer? Have your customers been asking you to develop a new product? Spread out your product risk as a value enhancing strategy.
9. **INDUSTRY EXPERTISE AND EXPOSURE** – This activity is often overlooked because it is difficult to measure its direct returns. We find that it is a value driver when it is time to sell the business. To the extent possible, encourage your staff to publish articles in industry magazines and newsletters. Get exposure as a presenter at industry events. Encourage local and industry reporters to use you as the voice of authority with industry issues. Your company is viewed in a more positive light, you may get more business referrals, and a buyer from your industry will remember you favorably and is more likely to consider you as an acquisition candidate.
10. **WRITTEN GROWTH PLAN** – If I could get you to do one thing that will cost you nothing but brain power and your time it would be to capture the opportunities available to your company in a two to five page written growth plan. Even if you are putting your company on the market tomorrow, it is not too late to identify all the opportunities your company has created. For any company, in any stage, this is a valuable living document to guide you strategically. Small companies with limited staff are forced to put out fires and live tactically. A growth plan helps create a process that will allow you to break big strategic plans into executable tactical activities. What additional markets could we pursue? What additional products could we deliver to our same customers? What segments of my current market offer the most growth potential? Where are the best margins in our customer set and product set? Can we expand in those areas? Can we repurpose our products for different markets? Are we getting the best return on our intellectual property? Can we license our technology? Do strategic alliances or cross marketing agreements make sense? Capturing this on paper as part of your exit plan will increase the likelihood that an acquiring company will view you more as a strategic acquisition. It demonstrates that you have identified a path for growth and it may identify opportunities that the buyer had not considered. Those opportunities can add to the purchase price.

The bottom line when it comes to unlocking the market value of your privately held company is not limited to the bottom line. Profitability is hugely important, but the factors above can result in significant premiums over traditional valuation approaches. When one buys or sells Microsoft stock, there is no room for interpretation about the market price. The market for privately held businesses is imprecise and illiquid. There is plenty of room for interpretation and the result for the best interpretation by the marketplace is a big pay off when you decide to sell.

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MidMarketCapital, Inc.

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