

Marketing Instincts

When it is time to go...

... and the factors that influence the value of your company.

Over the last ten years, my young management consulting practice has successfully completed over 150 consulting assignments for clients; working mainly for mid-sized privately owned Canadian companies that were seeking help in either creating growth or managing growth. These assignments covered a wide range of subjects such as re-igniting sales growth, improving profitability, charting a new strategic road map, restructuring and re-organizing the business to be more competitive and so on. Many of these assignments also involved succession planning in one way or another.

In many assignments, I helped the owners/shareholders pass on the baton to their children or other members of their families. In other situations I assisted them in selling the business altogether or divest a unit or division of the business to better focus on the core activity.

You can read more about succession planning in *Marketing Instincts* number 8 of summer 2002. In this issue of *Marketing Instincts* however, I would like to provide some practical advice to owners and shareholders as to how to position their business for sale and the factors that can help increase the value of their company.

My experience comes directly from what I call the "business battle field". I am sharing this experience in the hope that you find some nuggets of wisdom in the next four pages.

Who is a prospective buyer?

If you want to sell your business or plan a succession, a number of options can be considered: You can sell the business to family members (sons and daughters, brothers and sisters or other family members). You can also sell to employees, usually members of the senior management team. If these two options though are not practical, the most common sale is usually made to an external party; most probably a competitor or a company that would like to enter your line of business. This last alternative comes usually in the form of a VC (venture capital) or fund company. This short list of "potential buyers" should get you started in thinking, which option is realistic and which is not, and who are the potential buyers.

Evaluating your company's worth

Regardless of who can purchase your company, you need to evaluate your company's worth and determine a realistic price range for it. A common evaluation method used by financial experts is the Free Cash Flow method (FCF). This evaluation is based upon the cash that the company is expected to generate in future years. Cash flow is usually the sum of profits and depreciation. You should ask your accountant to help you evaluate the company or alternatively you may want to engage the service of a specialized firm. It is important however that you "do your homework" coming with the right price range to minimize an emotional estimation that may either scare a genuine and motivated buyer or run the risk of

under-pricing your company. You can also arrive at some indicative prices by doing some relatively easy research. I will explain the two most common methods of evaluation I use:

Market to book value ratio: Review the market value of public companies that are in the same line of business as your company. The market value is the on-going price of a share. Compare this price per share to the book value per share. For example, if a share of a certain company is quoted in the market at \$15 while the book value of the share is \$5, the market is paying a premium of 3 times the book value. If for example your company's book equity was \$500'000, applying the same premium (3 times) would give your company a value of \$1.5 millions ($\$500K \times 3$). While many factors influence this ratio, now you have a relative point of reference.

Earnings per share ratio: Another simple "back of the envelope research" consists of finding out what is the price-earning ratio for public companies with the same activity as your company. Therefore, if the price earnings ratio of comparable companies is in the range of 8 to 12 times and your net profit at the last fiscal was \$180'000, then applying the same ratio would give your company an evaluation in the range of \$1'440'000 ($\$180K \times 8$) to \$2'160'000 ($\$180K \times 12$). Here again, you now have a price range based on a "semi-objective" method. You can also take the mid-point of the range as a price point. In our example it is \$ 1'800'000. ($\$1'440'000 + \$2'160'000 / 2$).

You may also combine different evaluation methods by adding them up and dividing them by the number of methods used. Using the same examples, I arrive at a price point of \$1'650'000. This is done by adding the price point of the first method of evaluation (\$1.5M) to the price point of the second method of evaluation (\$1.650K) and dividing by two.

Please note however, that investing in a small or mid-sized private company is usually considered more risky than buying shares in a publicly quoted company. To compensate for this, the valuing of a private company may be adjusted by an appropriate amount, let's call it the risk premium. If a 30% risk premium may be considered applicable, you can adjust the price point we calculated by 30%. Using our previous example, the new price point would be \$1'155'000 ($\$1'650'000 - 30\%$ or $\$1'650'000 \times 0.70$).

As you would have noticed, this is not "rocket science". My experience tells me, however, that these simple and straightforward methods are not that far from the more elaborate methods used by professional financial experts. At the end of the day, evaluation methods are more subjective than objective. So take my two methods not as a substitute for professionally done evaluations but rather as a starting point that can give you a good guideline about how much the business is worth.

What to look for?

Now let's get to the core issue of this article: what are the factors that can increase the evaluation of your company? Or simply put: What are the factors that can positively influence the market value of your firm?

Goodwill and brand name

Goodwill is defined as the premium a buyer pays over the book value of the company. Does your company have a separate goodwill from you personally? Or are YOU the goodwill of the company? What would happen to the company's evaluation if you were no longer associated with the company? A company with a separate goodwill from its owner commands a higher evaluation. Similarly a strong and recognized brand name would obviously add some extra points to the company evaluation.

Concentration of customers

A revenue base derived from a large customer base will command a higher valuation than a revenue base that is built around a handful of customers. If company A and company B have similar annual sales volume and similar number of customers, but company A has 80% of the revenues coming from the top

3 customers while company B has its revenues evenly distributed among all its' customer base, most certainly company B's evaluation will be much higher than company A. This is due to the vulnerability of company A to its three key customers. Loosing one of them takes away over a quarter of the revenues while loosing a customer in company B would be immaterial.

High repeat business

A high repeat business from existing customers will usually command a higher evaluation. If company A and company B have the same sales volume and the same number of customers but company A has a business mix of 80/20 repeat customer vs. new customer and company B has a ratio of 50/50; company A would probably have a higher evaluation than company B. This is because the customers of company A tend to come back again and again while company B has to look every year for 50% of its revenues from new customers. Long-term contracts with customers also indicate steady and stable revenues and thus influence a higher evaluation.

Strong management team and low employee turn-over

A strong management team in place with high seniority and a stable employment level with low turnover are also good contributors to a higher business evaluation. A strong management team with a stable workforce is a good recipe in today's volatile and competitive marketplace where companies compete for qualified human resources and talented managers.

Trademarks and Patents

Businesses that have registered trademarks and/or patented products are usually more favorably evaluated over firms that do not hold such trademarks and patents. Trademarks and patents are considered a barrier to entry, providing a competitive edge in today's marketplace.

Well established relationships with key suppliers

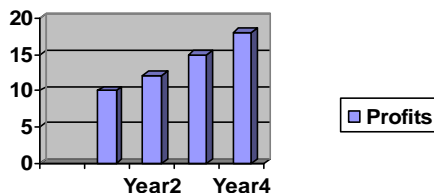
Strong relationships with key suppliers indicate a more stable and durable source of materials. A sturdy and solid supply chain would also be construed as a favorable ingredient in today's marketplace and would add few points to the business evaluation.

Diversification

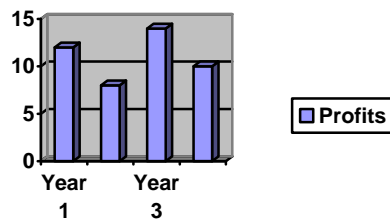
This is a double edge sword factor. In some instances a company with a diversified product/service offering is perceived as a lower risk proposition and thus commands a higher evaluation while in other circumstances, a more specialized and non-diversified product/service company is perceived as a "cleaner, simpler and more focused" business. Which of these two opposing factors apply to your company?

Smooth earnings and upward trend

There is usually an understandable tendency among buyers to prefer a steady and smooth profit growth to a number of years rather than a series of volatile shifts.



Company A



Company B

In the above example, profits made by company A and company B for the four year period are equal, but company A would probably score a higher evaluation because of its consistent upward trend. The same argument can be said about the trend for sales, gross profit and equity. Most buyers prefer a consistent upward trend to an inconsistent business trend.

Exclusivity and market share

As is commonly known, a high market share position allows for a leading role over a certain industry, product, service or geographical area. Along with leadership comes better control over pricing which in turn leads to higher profitability. Exclusivity goes usually also hand-in-hand with high market share. In most instances, these two factors usually drive a higher evaluation.

Favorable media coverage and a professional website

A track record of favorable media coverage and awards, a leading role within an industry, positive public relations and an attractive website are all positive factors adding to a higher evaluation. The contrary is also true; on-going and/or unsettled litigations, negative media coverage and a mediocre website portray a company with “issues” on its hand and would influence a lower overall evaluation.

Finally, before you embark on a sale select a team of professionals that could give you good counsel and help you avoid potential pitfalls. Your team should include an accountant, a lawyer, a business broker and of course an experienced management consultant. After spending a lifetime building a family business, deciding to sell is a most difficult decision with many fears and anxieties linked to the succession process and the outcome. Conducting good research, planning ahead and surrounding yourself with experienced professionals can turn an emotional decision into a business decision and help you achieve your goals.

Hugh Latif & Associates
Management Consultants and Corporate Governance
135 Park Home Avenue,
Toronto, Ontario, M2N 1W7 Canada
Tel. 416.229.0520 Fax. 416.223 8849

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