Preparing Your Business For Sale

Summary Notes

Session 3 of 6

Monteck Carter mc²
energise your business

chartered accountants

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Why we decided to have these seminars.

We know a lot of our clients will be looking for funds for retirement from business sale - this may not happen if the business is not in a good condition for sale. 80% of businesses put up for sale do not sell - you want to be part of the 20% that do sell.

Any client over 50 years old should be starting to think about your future plan. Our goal is to help business owners find the options and choose the one most suitable.

Article: "Why Baby Boomer business owners may retire with nothing".

The baby boomer owners will be retiring in the next 6 years. 458,000 businesses in NZ are SMEs (97% of NZ business) and employ 31% of all employees. Most businesses are owned by men aged 35-59 years. There will be many of these businesses coming up for sale.

The business lifecycle has 7 stages - Expansion, Mature or Exit are the last 3.

Expansion – the business needs to continue to grow to ensure it's saleable.

Mature - complacency can set in but are ripe for new entrants becoming a threat. If you can't prove future growth is possible the price of sale can fall.

Exit - profits can reduce close to sale as owners are older and don't start new initiatives. They need to move back into growth and do something different.

The 4 Learnings of Business

1. Learn how to be in business
2. Learning your business
3. Learning how to lead your business
4. Learning to let go

Part of planning to sell your business is to ensure you have other activities that will interest you after your business is sold.

Paul Ayers and Myles Cooper

Challenge Partners work with investment customers wanting to syndicate [ownership in] a business without the day to day running responsibility.

Two years ago we made an investment in agricultural machinery which was our first firm. LEP engineering plastics was offered to us - it didn't fit inside its Malaysian owner's plan. They were commodity brokers and didn't understand plastics and engineering. When we arrived they had an absenteeism problem and now they do not - sick days accumulate and we now have a sizeable liability to pay for them. That's a good thing.

November last year we bought Massport foundry - around half the business. It was a business that was neglected and the owners focused on cost reduction not growth but we found the worldwide market for cast iron is growing by 3% a year and the firm exports 80% of its production.

Over the past 2 years we've bought 5 businesses.

What is important when a professional buyer takes a look at your business?

In property it is location, location, location - for a business it's certainty, certainty, certainty. I want to know every customer will stay around for ever even when prices rise.

Comprehensive information is the level below certainty. We looked at over 30-40 businesses which were offered for sale - if anything looks uncertain we pass onto the next business.

When you need to be reassured that someone has thought everything through - you need written planning, comprehensive information, written reporting all helping the buyer understand what's happened. **Written records are like warranties** - they demonstrate all causal issues with warranty claims. How you address a problem shows us how you look at every problem - we assume the same attitude works elsewhere.

We want **systems not personalities** in the business (unless you sell personality) and even representing yourself like this is good even though it may not be the whole truth at the time of sale.

Accuracy not approximation - know the detail of your margins. It shows us that you know your stuff - and we make a judgement. Ultimately it's about proof not belief.

Image - your company external image (electronic media - Facebook, website) update it regularly. If it's old you are thoughtless of by a potential buyer. Internal image - covers your staff, their attitude, your print material in the office. What you have needs to look good and be in the right place e.g. painted yellow lines on the factory floor. If a buyer looks and you have that in place it shows you're proud of what you do and you are working on a system.

What is the right price?

The hardest question you'll ever be asked is how much are you prepared to pay - there's a dynamic - everyone wants to buy a bargain but the vendor wants to say he got a good price.

A lot is said about multiples - various sizes of business are sold based on existing prices of comparable firms also for sale in the marketplace. This works for small firms - but larger firms are usually priced based on earnings multiples. What is the multiple based on? The more people you talk to the more answers you get - you have to decide how you measure profitability or the cashflow that'll come out of the business.

We look at the predictability of earnings - EBIT works in our industrial sector.

We ask questions like

- Is Earnings EBIT or EBITDA or does it include owner's earnings?
- Is it based on next year's income?
- Does it exclude leases e.g. the owners' wife's car?
- Normalisation is now commonplace - they take out items like the boat costs "repairs and maintenance", the kid's school fees and petrol for the family cars.

What you can realise from a business - don't believe quotes you're told by friends because the figures can be manipulated.

You won't believe you got the right price unless you're really lucky - five years after selling you my have a more accurate perspective.

Because it's pivotal, important and emotional you may never be fully satisfied. Unless you can understand the purchaser's fear, worry and the fact that they don't know what you know - unless you can do that you'll always think your firm is worth more than they do.

A trucking company we appraised had an owner who got most of his contracts by drinking, golfing or hanging out with mine owners - we won't pay for that.

How to get the right price

Start 3 years before you really want to sell. Most of the things that are good practice in running a business will turn out to be very valuable when you get to sell. If you don't have an independent director and the skill to produce reports and documentation - this could cost you $20,000 plus $5,000 in extra accounting fees for 3 years = $75k. Will we pay for this? Yes we will possibly 3 times more if it gives us certainty.

1. Sell when you're at the top of your game

If you wait until you are too old you won't get the returns you deserve.

"Zombie companies" is what we call firms where the owner is too old - nothing has been refreshed, margins are decayed, the owner accepts how he did it 15 years ago…. and you won't get a lot of money for that.

If my concern is to get the most value for it - now is the right time. Zombie companies muck up markets too because they provide lousy service and so don't sell their products at the right price. They compete on price only and destroy markets.

We look for **trends in a business** - sophisticated ones give us 5 years of annual results - the board reporting and monthly results should also be there (few are). If you can see progress over 5 years and demonstrate you are winning in your market - can we understand why you are growing and how.

Concentration of customer base is also important from a risk perspective if 70% of your sales are from one customer and they cancel the contract it's a high risk. The buyer will say they cannot risk money on that business.

Good marketing will help you get the right price - how well laid out is the business, measure the staff enthusiasm - what's the culture? The marketing is how a firm projects itself out into the wider market.

As a vendor, get a group of people to listen to - professionals and folks who know you well - they may point out how you will respond to buyers (well or not so well) They'll say how you understand a buyer too. Take the same approach you would as if you were a new parent. Read books - don't internalise.

From day 1 you have to define and say why a stranger would risk their life savings to buy what you've got.

2. We also need to be able to sell the upside

We can pitch a buyer about new opportunities in the future - what's the new market? How can you get 5% more a year from the key customers? That involves systems, sales reporting, and the ability to pull out current leads. But without that paperwork to reinforce proof that your system works you won't get buyers.

3. Governance

An independent director has to add value to the parts of the firm where you don't add value. Look for good administration (a plan, P&L and budget), salesmanship (get out and talk the talk), Technical ability (if you're selling you have to know what you're talking about). These three (administration, technical and salesmanship are what every business needs.

Having external advice is essential because we all suffer from not knowing what we don't know. We don't have the consumer sophistication for a business - ask others who know the industry what they'd look for.

Usually we get two of those three - Challenge Partners provide the third leg, typically the administration skills. Know what your skills are and get an advisor to come in and provide the third leg on the stool.

Who's likely to buy your company?

Start thinking 3 years before - if I was them what I would be looking for? What would be in it for me? Do engage a broker when you do decide to sell they can remove emotion and engage with you better and negotiate for you.

- **Trade sale** - competitors, customers and suppliers are your first targets. There's often an advantage for them which is greater than an outsider.
- **Other value chain participants** - people in complementary firms, a shared interest. You can be broad about this.
- **Peripheral companies** - distant from your operation due to geography or market characteristics - they may be looking for a foothold in a new market. Building up relationships over 3 years can lead to opportunities.
- **Investment companies** - few have an industrial approach like us - many want to focus on high tech and fast turn arounds. Ring them up and ask them what they think.
- **Wealthy families** may have funds in trust - they may be worth an approach.
- **Private individuals** - may also want to buy into your success.

Remember adverts go up when you sell but screening respondents is the hard bit. A broker has to present the first 2-3 who pass the first screening. You don't want to do anything that makes them want to shy away. If a website that hasn't been updated since 2009 I think they're lazy and I see a weakness, they will also have lost sales. Everything you do comes back to haunt you down the track.

If you use an advisor as an external Director - keep good writer records so we can see if it adds to your credibility.

Preparation

Stamp out risk as you prepare your business for sale. Look at yourself from the buyer's perspective at how you're seen.

The 80:20 rule

Every business has dusty stock in the corner - the value of the stock is secondary if you buy on earnings multiple - if you as the owner can take stock which hasn't sold for 18 months and can sell it for whatever money you can get. Put the cash in your pocket and when you sell, it will be normalised and won't affect the business value.

Levels of secrecy - we have been intimately involved in the sale of a business which went for half it should have because the owner was so paranoid about secrecy - that's just stupid.

There are 2 ways of going about this:

Word will get around however hard you try. You don't have stupid staff - unless you have all the information you will have to get it from your staff and they'll jump to conclusions.

Or

Accept that this is one of the challenges and you prepare the staff. A buyer will be impressed by the mission not the man. Staff may smile as we walk round the factory. If they feel excluded they may be insecure. They won't run off for a job at a competitor if you involve them early and explain what it will mean. But they may quit if they find out 6 weeks before from another source. What will they take home to their families to explain it?

They've trusted most of the decisions you made as their boss, chances are they'll trust your next one.....And with suppliers they really want to continue selling to the new owners - you don't want them putting off your buyers during the sale process.

There may be opportunities you don't know about - third parties may say "I wish I'd known you were for sale".

There's one thing for all of you to take away - no-one knows it all. Professional advisors are there for a reason - they are here to stay and are worth investing in. Find one who understands you and your goals. **Use someone else to negotiate - they'll get a better deal.**

What we do in due diligence

We audit GST and see if that matches turnover. We follow an order through the system - where does it come in, written up, processed through the stock or hours system, invoice issued, statement and deposit in the bank.

Then we do a sales analysis so we understand which key customers there are - we will want to talk to them and get Bruce Montgomery (of Monteck Carter) to go and dig deep to see sales are real and not reversed credits from another period.

We have a 17 page checklist though not all apply to every company. The period is 2-4 weeks - we use advisors to identify the risks e.g. environmental risks - and employ someone to see if the consents are relevant etc. Then we send auditors like Monteck Carter in to go and check the numbers. At that point it's become a very stressful thing. We are spending $20-80,000 and its very stressful and sometimes a bank also needs to be looked after. And transitions for stuff, suppliers etc also need to be planned.

What are we looking for?

A multiple of 4 means a 25% return on capitalisation of earnings but there's' a lot of risk to match this return. We start at 4. **EBIT** of $1m we'd start with a price of $4m look at quality of information, people, market and decide if the price goes up or down. If your business is jobbing work that may drop down to a multiple of 3 because the order books aren't long term.

We look at **customers** - how healthy are they financially, how much do they need you for their business.

Suppliers - how strong are relationships, how much power do you have in the relationship, are new products coming through?

Staff - how much technical and commercial skill is needed

You can pay for a business in several ways

- 100% on the day is good
- Most people ask for a handover which can be paid or unpaid - I'd use that as a negotiating tip.
- Delayed settlement
- Vendor finance

All these add to the risk to you as a seller. From a buyer point of view if the vendor is willing to leave money in the business it makes us believe they believe in the business.

- We'd lock in the GMs in a long term virtual share scheme.
- We make the staff believe in us and so they won't leave.

An announcement to staff on the first day of a new owner could be "There's no bad news today, nothing is going to change, we're here to stay and grow the business - opening line to a newly acquired business."

People get fearful when there's no control. Trust and predictability are valued!

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