What business owners need to know about value before selling

What's the value of my company? This is an age-old question that all business owners ponder as they consider whether to sell their most important investment. However, the questions they should ask first are: how will buyers go about determining the value of my company? And, what can I do to enhance what someone is willing to pay in order to acquire what I have worked so hard to create?

Mitch Gorochow, senior advisor with RSM's Center for Business Transition and Ken Sanginario, founder of Corporate Value Metrics and creator of the Value Opportunity Profile®, recently discussed how business owners can view value through the eyes of buyers and then what they can do today to plan for a successful event down the road. Excerpts of their conversation follow below:

Q: When most business owners talk about what their company is worth, they immediately go to some multiple of earnings they have been told is standard in their industry. Is that the way sophisticated buyers really determine what they are willing to pay?

A: Owners should understand that value is not derived from multiples but, rather, multiples are derived from value, and value is very significantly affected by the underlying quality of the subject company.

Unfortunately, business owners are often misled into thinking about the value of their businesses in terms of standard industry multiples. In reality, nearly every industry exhibits a wide range of transaction multiples based on the relative quality of the underlying companies. In any given year, within any given industry and size parameters, there is often a range of three to four turns between the low and high multiples in transactions. That amounts to a 70 to 80 percent spread between the low and high transaction values.

Sophisticated buyers use discounted cash flow (DCF) analyses, in addition to looking at market multiples, to determine value. They go to great lengths to assess the underlying quality of prospective target companies, and their assessments determine the discount rate to be used in their DCF models. The discount rate reflects the riskiness of the company and helps them determine whether they will make any offer to purchase and, if so, at what value and on what terms.

More often than not, deals either fall apart entirely, or offers get traded again because of qualitative issues that are identified in due diligence. Some refer to this as the due diligence slaughterhouse, where very few companies come out unscathed.

Q: As a business owner who thinks about selling a company in the future, why not just focus on growing my revenue to drive the value and ultimate sale price of the business? Wouldn't that focus be the best strategy to try to maximize my ultimate selling price?

A: Revenue growth is obviously a factor in determining value, but the quality of revenue growth can mean the difference between creating value and eroding value. Too often, companies chase revenue in an attempt to be able to show growth, and they wind up with revenue that is not a good fit, strategically, with their core business. Examples include achieving revenue that is nonrecurring or outside of the company's core competency; gaining a larger contract than the company can reasonably fulfill; or reducing prices to drive more volume which hurts margins in the process. When companies employ such tactics, there are often unintended consequences that actually erode value rather than create value. Any growth adds business risk, but nonstrategic growth can strain the organization, consume capital, damage customer relationships, and hurt the company's reputation. We've seen it many times where companies end up in a distressed situation because they were chasing revenue as a strategy to drive value. Alternatively, strategic revenue growth, supported by an overall balanced organization that can effectively support the growth, can certainly drive value creation. However, that's a much more holistic approach than just chasing revenue.

Q: What do (financial) buyers evaluate beyond a company's financial results and maybe the financial projections when determining what they are willing to pay?

A: Financial buyers perhaps conduct even more due diligence than strategic buyers because, if the acquisition starts to underperform, they don't necessarily have the backup resources from a parent operating company to solve the problems. As a result, financial buyers put a heavy emphasis on the management teams of the target companies. If they are not totally convinced that the management team can grow the company, the deal is dead at the start.

Beyond assessing management, they do a deep dive into due diligence across the entire enterprise in order to understand every aspect of the company's strategy, customer base, product lines, competition, organization, operations, and sales and marketing.

Over the last 10 years or so, due diligence has evolved to be a broader and deeper exercise than it ever was previously. There are a number of reasons for that, including competition among private equity firms regarding their own portfolio performance, so they can raise new funds, and the relative ease of getting information from companies because of all the technology available to use in the process.

Q: How much stock do sophisticated buyers put in a company's three- to five-year financial projections?

A: Since value is a prophesy of the future performance of the company, sophisticated buyers put a lot of stock in the company's projections. However, through the due diligence process, they will understand, challenge and test every assumption that underpins the projections, and will do a lot of sensitivity analysis on the projected results for changes in the assumptions. They will also assess whether, and what it would take, for the entire organization to be able to execute the assumptions in the projections, from people, to systems, to physical capacity, to capital requirements, among others. Based on the buyer's testing of the projections, they will typically create their own range of results and value the company accordingly.

Q: What do you mean by the quality of a company's earnings? Aren't earnings fungible from one company to the next?

A: A quality of earnings report answers two main questions: First, do the reported earnings accurately reflect the market-based results that an independent owner would report? Second, are the reported earnings sustainable in the future?

Earnings can be calculated very differently from one company to another, without any company doing anything incorrectly or inappropriately. An example would be key executives in one company being paid below market salaries but having equity incentives, while another company pays its executives market salaries but no equity. Do the higher earnings of the first company make it more valuable?

Another example might be a company owner who separately owns the real estate in which the company operates, and charges the company either above or below market rents because of their personal tax planning initiatives.

Another example might be a big revenue increase that's attributable to a one-time contract that is not sustainable. That kind of revenue, and profitability, may not add much value unless it is expected to be replicated in the future.

There are many more examples, but a quality of earnings report will normalize such factors so that company earnings reflect sustainable, market-based results.

Q: A company has been in business for 20 years. Why would a buyer be concerned about risk? Should a business owner really be concerned about that as a factor in how a sophisticated buyer would look at their company?

A: The value of a company is all about the future results. The past, no matter how many years it includes, is only used as a starting point proxy for the future, which will then be adjusted for new information and developments. The risk in any company is that the company will not be able to achieve the future that it is presenting to an investor or buyer, and that risk is affected by hundreds of factors. The reason that due diligence is so broad and deep these days is to be able to properly assess the risk factors and their impact on the subject company's future performance. Ultimately, the risk factors are incorporated into the sophisticated buyer's sensitivity models of future cash flow and will affect the discount rate being applied to such cash flows in order to develop a range of values for the company.

Q: Does the cost of capital affect the multiplier of earnings that a sophisticated buyer is willing to pay for a company?

A: The multiplier of earnings is merely the inverse of the cost of capital. So, a multiple of five times implies a cost of capital of 20 percent, four times implies 25 percent, etc. Cost of capital can range from 10 percent to more than 50 percent, implying a multiple range of two to 10 times for companies that can even be sold. Many companies can't be sold at any multiple and just get liquidated at auction value.

The cost of capital is comprised of several factors, each of which is affected by the overall quality or riskiness of the subject company, what we refer to as company-specific risk. More than half of the overall cost of capital could be represented by the company-specific risk factors.

The three components of cost of capital include the cost of equity, the cost of debt, and the mix of equity and debt in the capital structure. Each component is viewed from the perspective of an outside investor coming into the deal. That's important because, for example, a company might have more debt in its capital structure (lower cost of capital than equity) than what is optimal, but a lender might allow it because an owner personally guarantees the debt and maybe even collateralizes it with personal assets. An outside investor coming in, however, might not be able to put as much debt on the company without a personal guarantee, which would mean more equity, a higher cost of capital and a lower value.

Generally speaking, the higher the risk profile of the company, the more expensive the equity and debt become, and the more equity (higher cost than debt) is needed in the capital structure, thereby increasing the discount rate and reducing the implied multiple.

Q: Isn't the premium in the cost of capital that you talk about for a small/non-public company truly a subjective factor? How does a sophisticated buyer attach a specific rate to that?

A: The three big factors that cause a higher discount rate for non-public companies include liquidity, size premium and company-specific risk premium.

In an order of magnitude, liquidity and size premium comprise about a third to maybe as much as half of the differential in value between a public and a private company. Neither of those two factors is within the control of the private company business owner. Company-specific risk, however, comprises the remaining half to two-thirds of the value differential and is largely within the control of the private company owners, if they choose to proactively mitigate such risks.

Liquidity is easy to understand; investors will pay a premium for public companies because they can sell their stock instantly if they so choose. Paying a premium is the same as requiring a lower return, resulting in a lower discount rate (higher value).

Size premium is a little more subjective. The premise with a size premium is that smaller companies are less able to withstand shocks to their companies, or to their industries, or to the general economy. However, some small companies are far better structured, and have better strategies and execution, than others. In other words, some of the risks of being small are controllable and, therefore, some of the size-premium is linked to the company-specific risk premium. We've all seen companies that behave like larger, more sophisticated companies because of the way they run. Those companies would certainly be more resilient in the face of business shocks. Although they cannot totally eliminate all risks of being small, they can certainly reduce the risks by operating at a higher level.

Q: So, what overall advice do you have for business owners that are seeking to position their companies for future transactions and want to focus their efforts on enhancing the value of their companies?

A: There are a number of things that business owners looking to position their companies for a future transaction should do. First, they should evaluate all of their key business systems—operations, sales, marketing, human resources, finance, etc. Then, execute on making improvements to areas where there are weaknesses and lack of structure. They should also make certain there is a robust planning process in place that helps bring to life the company's strategy. Finally, it should go without saying that a focus on profitable, sustainable growth is the final piece of the puzzle. All of this will take time and energy. However, if business owners and management focus their efforts accordingly, potential buyers will recognize that business as a sustainable, low risk, quality and attractive potential acquisition.

For more insights on how to position your company for a future transaction, visit **rsmus.com/cbt**.

+1 800 274 3978
rsmus.com

This document contains general information, may be based on authorities that are subject to change, and is not a substitute for professional advice or services. This document does not constitute audit, tax, consulting, business, financial, investment, legal or other professional advice, and you should consult a qualified professional advisor before taking any action based on the information herein. RSM US LLP, its affiliates and related entities are not responsible for any loss resulting from or relating to reliance on this document by any person. Internal Revenue Service rules require us to inform you that this communication may be deemed a solicitation to provide tax services. This communication is being sent to individuals who have subscribed to receive it or who we believe would have an interest in the topics discussed.

RSM US LLP is a limited liability partnership and the U.S. member firm of RSM International, a global network of independent audit, tax and consulting firms. The member firms of RSM International collaborate to provide services to global clients, but are separate and distinct legal entities that cannot obligate each other. Each member firm is responsible only for its own acts and omissions, and not those of any other party. Visit rsmus.com/aboutus for more information regarding RSM US LLP and RSM International.

RSM® and the RSM logo are registered trademarks of RSM International Association. *The power of being understood®* is a registered trademark of RSM US LLP.

© 2017 RSM US LLP. All Rights Reserved.

wp-nt-con-all-0617