

PRIVATELY HELD

C O M P A N Y

the report on transaction issues

CK BUSINESS CONSULTANTS, INC.

is your Merger and Acquisition Specialist! We represent clients in their search to sell or acquire companies, divisions, or product lines. We handle all phases of the project including valuations, marketing strategies, and execution of the transaction in a confidential and professional manner.

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What a Buyer May Really Be Looking At

Buyers, as part of their due diligence, usually employ accountants to check the numbers, and attorneys to look at legal issues and draft or review documents. Buyers may also employ other professionals and advisors to look at the target company's operations and many other facets of the business. The prudent buyer is also looking behind the scenes to make sure there aren't any "skeletons in the closet."

It makes sense for a seller to be just as prudent, and knowing what the prudent buyer may be checking can be a big help. A business intermediary professional is a good person to help a seller look at these issues. Business intermediaries are very familiar with what buyers are looking for when considering a company to purchase.

Here are just a few things that a buyer will be checking:

Finance

- ◆ Is the target company taking advantage of all of the trade discounts available? Is the company late in paying its bills? This could indicate poor cash management policies.
- ◆ Checking the gross margins for the past several years might reveal a lack of control, price erosion or several other deficiencies.
- ◆ Has the company used all of its bank credit lines? Does the bank have the company on any kind of credit watch?

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What a Buyer May Really Be Looking At (continued from cover)

- ◆ Does the company have monthly financial statements? Are the annual financials prepared on a timely basis?

Management

- ◆ Is the owner or president constantly interrupted by telephone calls or demands that require immediate attention? This may indicate a business in crisis.
- ◆ Has the business experienced a lot of management turnover over the past few years?
- ◆ Do the people who work in the business take pride in what they do and in their company?

Manufacturing

- ◆ What is the inventory turnover? Does the company have too many suppliers?
- ◆ What is the revenue per employee? A good benchmark is that a fully integrated manufacturer should have sales of at least \$100,000 per employee – and a distributor should have at least \$250,000 per employee.
- ◆ Is the company in a stagnant or dying market, and can it shift gears rapidly to make changes or enter new markets?
- ◆ How is the quality control? Are products being rejected or returned for replacement or repair?

Marketing

- ◆ Is the target company introducing new products or services? A company's R&D is a critical part of the operation – and its success.
- ◆ Does the company participate in trade shows? Is the interest level high or are the attendees over at the competitor's booth?
- ◆ Is the firm experiencing loss of market share, especially when comparing it to the competition? Price increases may increase dollar sales, but the real measure is unit sales.

Since many prudent buyers will look at these areas, doesn't it make sense for a business owner to review them as well? If a business owner is considering selling, it will pay big dividends to consider the areas listed above and make whatever changes are appropriate to resolve any revealed "issues."

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A Different Look at Valuing Your Company

Before beginning an assignment, business appraisers like to know the purpose of the appraisal. Usually the assignment demands “bullet-proof” documentation which requires comparables, EBITDA multiples, projections, discount rates, etc.

Unfortunately, in situations where the purpose of the valuation is to establish a selling price, the business appraiser may ignore, or fail to really understand, certain business elements. Since these business elements don't figure into the numbers, they are largely ignored. However, they do have value, and in some cases, they may have significant value for a buyer.

Valuing these business elements requires that computers, adding machines and calculators be put aside. The business should be looked at from three key business elements: the Market, the Operations, and Post-Acquisition. These elements are certainly subjective, but critically important to a prospective buyer. A buyer's opinion of the business elements can drive the actual offering price significantly higher...or lower. In fact, these business elements can impact price as much as the financials.

Here are some important questions to consider for each of these three key business elements:

Market:

- ◆ Are there significant competitive threats?
- ◆ Is there large market potential?
- ◆ Does the company have reasonable market position?
- ◆ Are there broad-based distribution channels?
- ◆ Is there a wide customer base?
- ◆ What's the company's competitive advantage?

Operations:

- ◆ Are there significant alternative technologies?
- ◆ Is there sound management that will remain?
- ◆ Is there product/service diversity?
- ◆ Are there multiple suppliers?
- ◆ Is there pricing elasticity?
- ◆ What's proprietary?
- ◆ What is the status of employment agreements and non-competes?

Post-Acquisition:

- ◆ Are there cost savings after purchase?
- ◆ Are there significant capital expenditures pending?

- ◆ Is there synergy between the buyer and the seller?
- ◆ Is it perceived that the integration will go smoothly?
- ◆ Are there substantial cross-selling possibilities?
- ◆ Will the cultures blend?

So how do these business elements figure into value? Following is how value is broken down by one industry expert.

◆ **The Financials – 50 percent**

By training and education, many business appraisers emphasize the numbers. They will look at the past, current and future numbers. They will consider all the basic financial figures such as:

- Growth rate
- Return on investment
- Gross profit percentage
- EBITDA percentage
- Industry metrics
- Debt to net worth
- Book value

◆ **Fundamentals – 25 percent**

Business appraisers should also consider the company's history, its management, products, distribution, etc. The following should also be seriously considered:

- Multi-products
- Different markets
- Wide distribution
- Quality of management.

◆ **Value Drivers – 25 percent**

These are important business elements that are most often ignored or completely overlooked by business appraisers. However, they are very important to a potential buyer.

- Product differentiation
- Defensible position
- Technology
- Dominant market share
- Well-known brand(s)
- Cost advantage
- Proprietary customers

To fully appreciate a company's value, one has to go way beyond just the financial figures.

For buyers, their valuation has to be a range based on the dynamics of the deal. On the other hand, business valuation experts too often are expected to deliver a specific number. Even private equity groups may be competing with other buyers.

The Three Ways to Negotiate

Basically, there are three major negotiation methods.

- 1. Take it or leave it.** A buyer makes an offer or a seller makes a counter-offer and both sides can let the “chips fall where they may.”
- 2. Split the difference.** The buyer, seller, or both, decide to split the difference between what the buyer is willing to offer and what the seller is willing to accept. A real oversimplification, but this is often used.
- 3. This for that.** Both buyer and seller have to find out what is important to both parties. So many of these important areas are non-monetary and involve personal things such as allowing the owner's son to continue employment with the firm.

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of negotiating
against
anyone.”
~Bob Woolf

There is an old adage: “Never negotiate your own deal!” The first thing both sides have to decide on is who will represent them. Will they have their attorney or their intermediary represent them or will they “go it alone”? Intermediaries are a good choice for a seller. They have done it before, are good advocates for their side, and they understand the company and the seller.

How do the parties get together in a win-win negotiation? The first step is for both sides to work with their advisors to settle on the price and deal structure positions. Both sides should be able to present their side of these issues. Which is more important? Price or terms, or non-monetary items?

Information is vital to a buyer. Buyers should keep in mind that the seller knows more about the business than he or she does. Both buyer and seller need to anticipate what is important to the other and keep that in mind when discussing the deal. Buyer and seller should do due diligence on each other. Both buyer and seller must be able to walk away from a deal that is just not going to work.

Bob Woolf, the famous sports agent said in his book, *Friendly Persuasion: My Life as a Negotiator*, “I never think of negotiating against anyone. I work with people to come to an agreement. Deals are put together.”

Do You Know Your Customers?

It's always nice when eating at a nice restaurant to have the owner come up and ask how everything was. That personal contact goes a long way in keeping customers happy – and returning. It seems that customer service is now handled by waiting on a telephone for what seems forever and having a recording tell you that your call will be handled in 10 minutes. Small businesses are usually built around personal customer service. When is the last time you “worked the floor” or handled the phone, or had lunch with a good customer?

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