PRIVATELY HELD COMPANY

The Oil & Gas Advisor™

For more than three decades, we've been advising buyers and sellers in successful business transactions in the oil & gas industry. Our goal is to deliver the best possible deal for you.

Call today for a free, confidential consultation

844-749-6016
info@oilgasadvisor.com
www.oilgasadvisor.com

IN THIS ISSUE

Valuing a Business from a Buyer's Perspective

Often times, public company data is used when attempting to value a privately-held firm. This comparison usually requires substantial adjustments to offset the risks inherent in the privately-held or closely-held company. These potential risk characteristics are usually elements that are overlooked by sellers, but not by potential buyers.

Sellers obviously look at their companies much differently than do prospective acquirers. Owners and company officers tend to place value on different factors than does a buyer. However, when it comes time to sell, it's important that the seller consider those factors that are important to a buyer.

Interviews with buyer prospects reveal that they are concerned with, and influenced by, the factors outlined below. They are often the basic considerations that determine whether they actually purchase the business, as well as the price they are willing to pay. It is the buyer's evaluation of these factors that can make or break a possible sale.

Buyers tend to look at these elements as risk factors. They also look at the expectation of future earnings. The following characteristics affect, both positively and negatively, the future earnings potential of and the risks involved in a target business.

Historical Earnings

The history of a company's earnings is very important to a prospective buyer. A long history of stable, and hopefully increasing, earnings is a positive factor in whether the buyer will pursue the acquisition. Conversely, a brief history or inconsistent earnings will certainly be a negative factor. A short time frame (for example, a company that has been in business for a a couple of years or less) and erratic earnings present obvious risk factors.

Entrepreneurs often underestimate the costs (and time) necessary to get the company to a profitable level. Start-ups are difficult to sell under the best of circumstances. The next time period in the life of a business is after three years,

Continued on next page

Valuing a Business from a Buyer's Perspective (continued from front page)

at which point there is some history, and a track record is beginning. The third period is usually after the company has been in business for a minimum of five years. Now the company has a track record and a reasonable history of performance.

Growth Prospects for Both the Business and Industry

If the buyer is from the same industry, then he or she should already have the answers to these questions. If the buyer is from a different industry or business type, then these are very important issues. Certainly, no one can predict the future, so these issues are subjective at best. Thanks to the Internet, however, information is much easier to obtain than ever before. If the buyer perceives the target business to be in a growth industry, then the valuation can be considerably higher than one that is not.

Employee Stability

Well-trained and skilled employees are a big asset. National studies indicate that over 50 percent of employees are unhappy with their jobs. Having a skilled and happy workforce in place is especially important for new owners without industry experience. Prospective purchasers are equally concerned with the high-cost of finding, hiring and training new employees. For these reasons, companies with a well-trained, skilled and contented workforce will command a premium value. Companies that utilize low-skilled employees and have high employee turnover will bring a much lower price.

Depth of Management

Just as a skilled and well-trained workforce commands a higher value, so does strength and depth of management. Generally speaking the smaller the company, the less depth of management. A business that is primarily dependent on the owner or a manager will bring substantially less in the marketplace than one that has key management in place. Many prospective purchasers also want more than one layer of experienced management in place.

Some Buyer Concerns About Management

- Will top management stay beyond any contractual periods?
- Is the current management motivated and what incentives do they need?
- Are current management values, etc., consistent with the buyers?
- Does current management have the leadership skills to move the company forward?
- Is the depth of current management sufficient to fulfill projected growth plans?
- Is current management able to handle change?

Terms of Sale

Is the company solid enough to support debt financing as opposed to equity capital? Are the company owners, if

privately owned, willing to help finance the acquisition? The answers to these questions impact value. The availability of capital can be a significant factor in increasing the value to an acquirer.

Diversification

Diversification has two elements. The first is the diversification of products or services. Can they be readily expanded? Do the products or services just fill a niche and therefore limit expansion? What limitations does the company have, such as customer or supplier restrictions? The second element is geographic. Providing the product or service on a national level certainly increases value and decreases the risk to the buyer. Conversely, only local or regional distribution reduces value and increases risk.

Competition

Companies in very competitive industries may have less value than ones with little or moderate competition. Heavy competition can lead to lower prices creating lower volume and profits. However, concentrated competition, for some businesses, such as auto dealers clustering in auto malls, can actually increase sales.

Business Type

This element is most likely to be in the "eyes of the beholder." The buyer's perception of risk may focus almost entirely on the type of business or industry. Businesses that are easily started obviously have less value than those that are equipment/capital intensive or require very skilled workers or specialized knowledge. Industry trends can play an important role in the value of a business.

Some industries seem to be simply more "popular" than others. Manufacturing represents less than 10 percent of all businesses, but the demand for this type is very high. The demand for retail businesses that must compete with the large "box" stores is very low.

Location and Facilities

A well-located office and/or facility will, at least psychologically, increase value. Well-maintained fixtures and equipment will definitely increase value. Everything else being equal, an attractive plant with well-maintained equipment located on the "right side of the tracks" will have a higher value than one without these advantages.

Industry Characteristics that Increase Value

- Industries with strong trade or professional associations
- Industries with low failure rates
- Industries with any type of regulation, licensing, patents – anything that might restrict the amount of competition
- Industries with established products or services coupled with stable pricing

Summary

The business characteristics described above outline some of the pitfalls or risks in using public company data when looking at the privately-held or closely-held company. Buyers obviously–and sellers certainly–should be aware of the factors or characteristics described above as they heavily influence the ultimate value of a company, the time it takes to sell, and sometimes whether it will sell at all.

Note: Much of the above information is based on an article contained in the Mergers and Acquisitions Handbook of Small & Midsized Companies, published by John Wiley & Sons.

What a Buyer May Really Be Looking At

Buyers as part of their due diligence usually employ accountants to check the numbers, 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. However, 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. Your business intermediary professional is a good person to help a seller look at these issues. They are very familiar with what buyers are looking for when considering a company to purchase. Here are some things that a buyer will be checking:

Finance

- Is the target company taking all of the trade discounts available or is it late in paying its bills. This could indicate poor cash management policies.
- Checking the gross margins for the past several years might indicate 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?
- 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 that 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?
- A good benchmark is 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.

When a business owner is considering selling, it will pay big dividends to consider the areas listed above and make whatever changes are appropriate to deal with them. Since many prudent buyers will look at these areas, doesn't it make sense to review them; plus it also makes good business sense to resolve as many of the issues outlined as possible.