Positioning Your Company for Sale

By David N. Fuller, CFA

Introduction

The single most important event in the life of a company is usually a sale transaction. Most business owners think of the sale of the company as their most likely exit strategy, and many expect a sale within a relatively short time period. However, few begin planning and positioning for the transaction early enough to realize maximum benefit.

Although there are several techniques used to determine the value of a company in a deal, value and price are most often discussed in terms of multiples of earnings. For instance, a business might sell for $16 million based on a multiple of 8x its EBIT (Earnings before Interest and Taxes) of $2 million. Steps can be taken in terms of positioning to maximize both the multiple a buyer is willing to pay and the EBIT the company generates. By working on both sides of the equation, you can be sure you've maximized the value of the deal.

The purpose of this article is to lay the framework for properly positioning a company for a sale transaction. The areas to be addressed are selecting the timing and nature of the transaction, and things to be done before the process begins.

Timing the Transaction

In my experience, the timing of a sale is usually driven by non-scientific factors. Oftentimes it is simply the owner's age and lack of desire to continue in the business or a high level of deal activity in a particular industry. Ideally, the timing of the transaction should be based on the future return on investment the company offers compared to its risk and the owner's investment alternatives.

The fundamental issues that should be addressed from a timing perspective are 1) whether the company has exploited all of the opportunities within its reach, 2) whether its recent investments have matured, and 3) whether there are any business or economic reasons that make selling urgent.

The first issue may be the most difficult from a measurement perspective. The best way to approach the issue is to analyze the business at a granular level from functional, product/service, and customer base perspectives and try to identify gaps that could be filled or opportunities to exploit. Examples might be extension of product/service lines, expansion into new markets, or adding new clients. You should also consider whether joint ventures or alliances might be possible which would add to the company's value in a transaction or even make a transaction unnecessary. The sale should be planned for a point in time after all of the visible opportunities within the company's resources have been exploited.

Other opportunities may exist that are beyond the company's resources. These opportunities may be the motivation for a sale to someone else who can exploit them and should be remembered and highlighted in pricing discussions. For instance, expansion to a different market may be outside the capital resources of the company but may be an attractive move for a better-capitalized buyer.

The company should also evaluate its recent investments to determine whether they have borne fruit. The transaction should be deferred until returns on these investments show up in the company's financial statements. An example here might be a manufacturer investing in tooling to produce a new product line. The expenses of creating the tooling are flowing through the income statement and depressing profits but will disappear as soon as all necessary tooling is produced causing profits and margins to rise. Whether by deferring the transaction or by requiring adjustments to give value to these investments, you should avoid selling a company without getting full credit for recent investments.

The third issue is the existence of any business or economic reasons that make a sale urgent. If you have reason to believe that the company's future performance will be impaired, it may indicate immediacy in timing the transaction.

Nature of the Transaction

The most obvious exit strategy for most companies is a sale but several other types of transactions are possible which may satisfy the desires of owners without giving up their entire ownership interest. For instance, the company may elect to pursue a leveraged recapitalization in which it takes on debt to fund repurchases of some of its stock, or an ESOP in which a portion of the company's stock is sold to its employees. Owners should evaluate each of these transaction types to make sure a sale is the course of action which best accomplishes their goals and objectives.

Maximizing the Multiple

As stated above, companies are often priced on a multiple of earnings. The exact multiple applied varies depending on the general pricing of companies in the industry, the characteristics of the particular company, how many potential buyers there are, and the desire and negotiating ability of the parties. That said, steps can be taken to maximize the multiple.

Not much can be done to influence the general pricing of companies in the industry, buy its not uncommon to see an average multiple of 8x EBIT and a range of 5x to 10x EBIT. The key is to understand what drives the differences in those multiples. In certain segments of the healthcare market, a key differentiator is the proportion of their business dealing with Medicare. Other examples might be whether a company has ISO9000 or Six Sigma quality programs in place that open doors to larger clients. You should not only find out all you can about transactions where similar companies have been sold but also determine what changes you can make to elevate the multiple for your company.

The strength and depth of your management team is also a critical driver of multiples. Management quality is implicitly shown in the recent growth and profitability of the company, but also plays into expectations for future growth and profits which drive multiples higher. Depending on the buyer's need to retain management, this may be the most critical factor in driving interest and price.

Another driver of multiples is competition. A buyer will pay no more than necessary to buy an asset. Its no surprise that the highest multiples are paid in situations where an auction is held among several motivated buyers. As you look at deals in your industry, note who the buyers are and build a comprehensive list of potential buyers for your firm. Look for changes you can make in your firm to expand the number of buyers who will be attracted to your firm when you begin to market it for sale.

As a final comment on maximizing the multiple, develop the most professional and highest-quality image possible throughout your organization. A courteous and professional staff, well-organized and complete business records, and high-quality marketing materials are to a business what "drive up appeal" is to a home. These factors increase multiples and decrease time to market.

Maximizing Profits

The other variable in the pricing equation is the level of earnings the company generates. If you are aiming toward a sale, you should manage the company with the goal of maximizing profits in the period before the sale. This allows the owners to reap maximum benefit during the holding period and also maximizes the price of the transaction.

Management should start with an analysis of each process that occurs within the business to determine where expenses could be reduced and make appropriate changes to increase profits. Management should also determine where assets are poorly utilized and address those issues as well. This kind of a review can be done any time but is especially important prior to a sale because each $100 of expense saved increases the purchase price by $800, assuming an 8x multiple. Effectively, the deal amplifies the payback on the exercise and turns it into cash.

Closely held companies often face the challenge of changing their mindset in terms of the way they operate the business. Instead of seeking to minimize tax liability by taking excessive compensation and running as many perks as possible through the company, they have to learn to maximize reported profits in order to maximize deal price. Again, the multiple changes the economics of decisions. If a $100 item is not expensed but is purchased by the owner, the company reports more profit and pays more tax and the owner pays with after-tax dollars. Assuming a 40% tax rate, the business has to generate operating profit of $278, calculated as $\$100/(1\text{-tax rate})^2$, to buy the item instead of $100. The cost of not expensing the item is therefore $178 of pre-tax income. Assuming an 8x multiple, the benefit from not expensing the item in the sale of the company is $800. The benefit substantially outweighs the cost.

Other Concerns

There are a host of other issues that may be important depending on your circumstances. On the personal side, you will want to create a personal financial strategy to manage the proceeds from the transaction. You may also need to address estate planning issues prior to or in conjunction with the transaction. From a business perspective, you may want to begin laying a foundation with clients to ease transition of relationships and responsibilities. And from a transaction perspective, you may want to begin the process of selecting the financial advisors that will assist in negotiating the transaction.

By working toward the transaction in each of these areas, you will minimize the amount of work that has to be done at the last minute and be able to spend more time focusing on execution and running the business, ensuring that the business doesn't suffer as a result of the transaction.

Conclusion

If you are considering selling your company within the next few years, take action now to ensure that you extract the most value by getting the highest multiple on the largest earning stream possible when the sale occurs.

You could take the passive approach and simply go about your business between now and then and see how much progress you've made – when you get there. However, there are tremendous benefits in working to position the company properly. I believe you will not only enhance the value of the transaction by being proactive in positioning the company, but that you also increase the likelihood that you can get the deal done quickly and correctly when the time comes.

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