Dr. Tom McKaskill

ULTIMATE EXITS

THE SECRET BEHIND SELLING ENTREPRENEURIAL VENTURES AT STAGGERING PRICES

ULTIMATE EXITS occur when acquirers pay for high growth potential not current profit multiples.

Entrepreneurial ventures drive high financial exit prices by enabling the buyer to exploit well documented and achievable inherent revenue and profit growth.

Even small ventures which empower large corporations to rapidly scale an acquired asset or capability within their own organisation can achieve staggering exit values through a strategic exit.

Balance sheets and revenue statements fail to represent the real value in a business. You need to think about how the buyer will exploit the underlying potential in the business to extract its full value.

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Testimonials

'To get the ultimate deal you must put yourself in the buyer's shoes and seek to reduce business risk and increase growth potential. In the current market the benefit of this approach cannot be overestimated. Tom has set out a practical step-by-step process to extract maximum value from the sale of the business.'

Ian Knight, Partner KPMG, Corporate Finance Practice, Australia

"*Ultimate Exits* is the ultimate book for entrepreneurs – don't even think about selling your business without reading it."

Tony Featherstone
Tony Featherstone is a former managing director of BRW magazine

"A compelling read with lots of practical examples. This book turns conventional valuation methodologies upside down."

Martin Checketts - Partner, Mills Oakley Lawyers Melbourne, Australia

"Tom McKaskill takes years of detailed research coupled with real world experience and boils it down to fundamental approaches which are actionable and effective for any business. For anyone who dreams of selling a business at more than fair market value, Tom McKaskill offers proven strategies to do so. While exit advisors are on every corner, *Ultimate Exits* shows you how to get there at values of which you never dreamed. In my 35 years in business, I have never met a more wise and incisive exit strategist than Tom McKaskill. Tom is the real deal."

Philip T. Miner
CEO
The Miner Corporation
New Braunfels, Texas, USA

Testimonials

"Tom McKaskill has a profound understanding of entrepreneurial companies and what entrepreneurs need to do to maximise the value of their businesses on exit. I've used Tom's principles on exits over many years to the great benefit of numerous clients. His book is a must read for entrepreneurs wanting to sell their business for the highest possible price."

Geoff Green
Partner
BSG Legal
Melbourne, Australia

"Tom McKaskill's latest e-book, *Ultimate Exits,* is his best to date, providing a one stop shop for any business person or investor. Much of the earlier material is focused on business improvement and driving business growth. But then Tom turns to his forte, the theory and practice of driving valuable strategic exits. This should be essential reading for any CEO or investor, not just as a single read, but as a "bible" worthy of regular re-visits to ensure that the key messages are always top of mind."

Ergad Gold
Momentum Funds Management Pty Ltd
Caulfield, Melbourne, Australia

"Tom McKaskill helped me build a strategy for my small sports travel agency which resulted in a staggering outcome. The business broker told me I would be lucky to receive 4 x EBIT for my business, however, with Tom as my mentor I obtained 40 x EBIT. Tom helped me see how a large corporation could maximise the value in my business and how I should prepare it for sale and engage the potential buyers. The end result is a testimony to the rare insights Tom has to value creation and exit strategy."

Rob Cecconi
Executive Chairman and Founder
Sportsnet Holidays
Melbourne, Australia

Testimonials

"*Ultimate Exits* is a MUST OWN for any business owner, prospective buyer, stakeholder or anyone involved in the sale of a business. As a strategic planner for high growth businesses, a business owner and business broker who has been involved in hundreds of deals, I have never read a more comprehensive book on selling a business.

I was blown away with Tom's vision and brilliance. I have recommended the book to all my clients whether they were interested in selling in the future or not. There are at least 10 MUST DO things that I have asked my clients to implement which will be invaluable both in how they run their business and how they create value for the future.

I sincerely believe that this is the best book I have ever seen on selling your business. The context is right-on and the organization makes it easy to read, follow and understand.

An outstanding piece of work."

Richard Russakoff,
CEO Coach, Consultant/Speaker
Bottom Line Consultants, New York, NY, USA

"The key and critical distinguishing characteristic of Tom McKaskill's books has been the transformation of an exit strategy which quite often is a passive affair for the seller and is frequently left to the whims of the potential buyers or business brokers, into a Proactive Exit Strategy. His new book offers the definitive systematic process for this proactive exit strategy that can dramatically revolutionize and transform passive exits based on sometimes subjective multiples, into proactive strategic exits through the creation of an objective, undisputable and sustainable platform for growth. This book is a must for the harvesting entrepreneur or a family firm that has reached a succession or an internal family conflict impasse..."

George S Vozikis, Ph.D.
Edward Reighard Chair of Management Director, Institute for Family Business
California State University, Fresno, CA, USA

Testimonials

"Tom's book is a 'must read' for entrepreneurs wishing to maximize the proceeds from the sale of their business. Where the business has strategic value, a proactive sales strategy focused on acquirers with the largest opportunities and most urgent threats will extract the most value."

Jim McElwain,Director,
McElwain Consulting
Auckland, New Zealand

"In 2005 I attended Tom's class on selling your business for a premium and also read his earlier edition of *Ultimate Exits*. The additional material in this latest version of Ultimate Exits has further strengthened Tom's proven methodology for unlocking the value of your business. In less than a year after taking the course and reading the book I had sold my company, c360 Solutions, to a public company for roughly three times trailing twelve month revenues. Without positioning my business in terms of the value it could deliver to its new owner (as opposed to strictly the financial metrics) I might not have achieved as attractive an exit. The book and the course helped me to understand and properly position the value of my company as well as prepare the company so the due diligence and sales process were quick and easy. Ultimately, Tom's methodology brought more value to both buyer and seller."

John Gravely
Vice President, Marketing and Product Marketing Scribe Software
Bedford, NH, USA

"As an entrepreneur who has bought and sold businesses, I would definitely recommend this book to fellow entrepreneurs. This book contains many tips and pitfalls when selling your business and by just following a few simple but often forgotten steps will help you through the sale and will make you a great deal more money."

David Southwick
Managing Director
David James Investments Pty Ltd
Melbourne, Australia

Dr. Tom McKaskill

Global serial entrepreneur, consultant, educator and author, Dr. McKaskill, has established a reputation for providing insights into how entrepreneurs start, develop and harvest their ventures. Acknowledged as the world's leading authority on exit strategies for high growth enterprises, Dr. McKaskill provides both real world experience with a professional educator's talent for explaining complex management problems which confront entrepreneurs. His talent for teaching executives and his pragmatic approach to management education has gained him a reputation as a popular speaker at conferences, workshops and seminars. His approaches to building sustainable profitable ventures and to selling business at a significant premium, has gained him considerable respect with the entrepreneurial community.

Upon completing his doctorate at London Business School, Dr. McKaskill worked as a management consultant, later co-founding Pioneer Computer Systems in Northampton, UK. After being its President for 13 years it was sold to Ross Systems Inc. During his tenure at Pioneer, the company grew from 3 to 160 people with offices in England, New Zealand and USA, raised venture capital, undertook two acquisitions and acquired over 2,000 customers. Following the sale of Pioneer to Ross Systems, Dr. McKaskill stayed with Ross for three years and then left to form another company, Distinction Software Inc. In 1997 Atlanta based Distinction raised $US 2 million in venture capital and after five years, with a staff of 30, a subsidiary in New Zealand and distributors in five countries, was sold for six times revenue to Peoplesoft Inc. In 1994 Dr. McKaskill started a consulting business in Kansas which was successfully sold in the following year for 50 times the founder's investment.

After a year as visiting Professor of International Business at Georgia State University, Dr. McKaskill was appointed Professor of Entrepreneurship at the Australian Graduate School of Entrepreneurship (AGSE) in June 2001. Professor McKaskill was the Academic Director of the Master of Entrepreneurship and Innovation program at AGSE for the following 5 years. In 2006 Dr. McKaskill was appointed the Richard Pratt Chair in Entrepreneurship at AGSE. Dr. McKaskill retired from Swinburne University in February 2008.

Dr. McKaskill is the author of eight books for entrepreneurs covering such topics as new venture growth, raising venture capital, selling a business, acquisitions strategy and angel investing. He conducts workshops and seminars on these topics for entrepreneurs around the world. He has conducted workshops and seminars for educational institutions, associations, private firms and public corporations, including KPMG, St George Bank, AMP, AICD and PWC. His private strategic exit workshops for senior management teams, Directors and external investors is highly valued by venture capital firms. Dr. McKaskill is a successful columnist and writer for popular business magazines and entrepreneur portals.

To assist Angel and Venture Capital investors create strategic exits for their investee firms, Dr. McKaskill conducts seminars, workshops and individual strategy sessions for the investor and their investee management teams. Dr. McKaskill is an active member of the Gold Coast Angels, the Melbourne Angels and the Australian Assoication of Angel Investors.

During 2009 and 2010, Dr. McKaskill completed six e-books for worldwide distribution. He has also produced over 150 YouTube videos to assist entrepreneurs develop and exit their ventures.

Dr. Tom McKaskill
Gold Coast
Australia

January 2010

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The Ultimate Deal 1 *Selling your business*

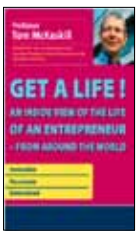
This book is aimed at those businesses which need to maximise their profit and growth opportunities in a sale to a financial buyer to leverage the best sales price. It sets out a breakthrough process which includes reducing risk, improving sustainable profits and building growth potential in the business to maximise the sales price. This world first process can increase the value of the business between two and ten times the conventional sales value of a firm.

The Ultimate Deal 2 *Get an unbelievable price*

This book uncovers the secret of how to leverage strategic value in the business to create a large revenue opportunity for a strategic buyer. Dr. McKaskill's is the world's leading authority on selling a business to a strategic buyer and sets out a comprehensive and systematic process for selling a business to a large corporation. Sales values of 40 times EBIT and/or many times revenue are highly probable using his Strategic Sale Strategy for a business with underlying strategic assets or capabilities.

Angel Investing *Wealth creation through investments in entrepreneurial ventures*

Designed to help high net worth individuals become successful Angel Investors. Angel investing involves active mentoring and coaching of an early stage management team towards sustainable profitability or additional funding, probably from a venture capital firm. This book sets out a comprehensive and rigorous process that will help the Angel generate deal flow, evaluate investment proposals and manage the investment and subsequent harvest. The book also provides a useful guide to managing operational risks in the venture.



Get A Life! *An inside view of the life of an entrepreneur - from around the world*

This book is a collection of stories from entrepreneurs around the world where they describe their work and their lives. They explain what it is like to be an entrepreneur, how they got started, the successes and failures of their ventures and the highs and lows of their personal and business lives. The stories are rich in content and provide deep insights into how entrepreneurs think. If you are an entrepreneur this will resonate with your inner being. If you are not, this will provide you with a great understanding of entrepreneurs.

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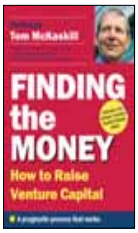

Finding the Money *How to raise venture capital*

The purpose of this book is to educate the entrepreneur on how Venture Capital firms work, what they seek in an investment and how they manage that investment through to an exit transaction. It helps the entrepreneur judge whether they have a venture suitable for VC investment and whether they wish to be part of such an activity. It lays out a comprehensive process that the entrepreneur can follow which will assist them in raising VC funding.

Winning Ventures *14 principals of high growth businesses*

Explains the major contributors to high growth success. Includes a comprehensive Growth Check list for each principle as well as a robust Growth Potential Index to help the reader judge the growth potential of their venture. Based on established theories of growth, venture capital selection criteria and the author's personal experience, this is a must for entrepreneurs.

Masterclass for Entrepreneurs

Creative solutions for resilience, growth and profitability

This book is a collection of published articles by Dr. Tom McKaskill. This volume expands on 30 of those articles to provide a wide-ranging guide for entrepreneurs on how they can mange their businesses more effectively.

Fast Forward

Acquisition strategies for entrepreneurs

In this book, Dr. McKaskill sets out a systematic and pragmatic process for identifying, evaluating, valuing and integrating financial and strategic acquisitions. He draws extensively on his own experiences as a CPA, entrepreneur and academic, as well as his experience with acquiring and selling his own businesses. He brings a systematic and comprehensive approach to growing business through acquisitions.

Order e-books from www.tommckaskill.com

Raising Angel & Venture Capital Finance

An entrepreneur's guide to securing venture finance

This book is aimed at those entrepreneurs who have high growth potential ventures and seek to raise finance to assist them to develop their business. To secure the finance, the entrepreneur will have to demonstrate that their business is capable of achieving a premium on exit, usually through a strategic sale. The book provides a checklist for the entrepreneur to assist in developing a strategy to raise finance.

An Introduction to Angel Investing

A guide to investing in early stage entrepreneurial ventures

Designed to help high net worth individuals become successful Angel Investors. Angel investing involves active mentoring and coaching of an early stage management team towards sustainable profitability or additional funding, probably from a venture capital firm. This book sets out a comprehensive and rigorous process that will help the Angel generate deal flow, evaluate investment proposals and manage the investment and subsequent harvest. The book also provides a useful guide to managing operational risks in the venture.

Invest to Exit

A pragmatic strategy for Angel and Venture Capital investors

Investors in early stage ventures need to focus on strategic exits if they are to achieve a high return on their investments. This book explains the characteristics of strategic value, how the investor should negotiate the investment and then how they should manage the process to a strategic trade sale. The book includes a very detailed discussion on the problems of high growth ventures, the unrealistic expectation associated with IPOs and the advantages of investing in strategic value ventures.

Order from www.investtoexit.com

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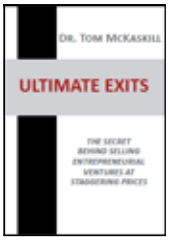
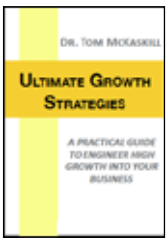


Ultimate Exits

The secret behind selling entrepreneurial ventures at staggering prices

High growth potential ventures have the opportunity to capture a premium on sale if they prepare their business for sale by reducing risk and package their business so that the buyer can readily exploit its potential. The entrepreneur should forget the EBIT multiple and historical performance and concentrate on building potential for the buyer. A financial sale exploits the revenue and profit growth within the business. A strategic sale enables the buyer to exploit an underlying asset or capability to counter a threat or exploit a large revenue opportunity through their own organisation.

Order from www.ultimateexits.com

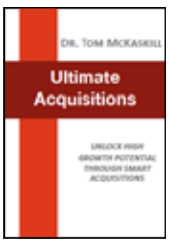


Ultimate Growth Strategies

A practical guide to engineer high growth into your business

High growth ventures all have a set of underlying principals which drive transaction velocity and operational management. Entrepreneurs who wish to engineer growth into their business need to incorporate these basic principals into their business. This guide steps you through each principal and offers pragmatic ways in which they can be incorporated into your business strategy.

Order from www.ultimategrowthstrategies.com



Ultimate Acquisitions

Unlock high growth potential through smart acquisitions

High growth potential ventures are often constrained by a lack of resources or distribution channels. With the right approach to the selection, evaluation, negotiation, integration and post acquisition management, acquisitions can be a very strategic way to overcoming these growth constraints. However, acquisitions need careful planning and management to be successful. This book is a very pragmatic guide to developing a successful acquisition program.

Order from www.ultimateacquisitions.com

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Preface

I have been researching and advising entrepreneurs, Angels and VC firms on exit strategies now for a number of years, however, I often feel as if I am pushing water uphill. Our commercial environment has brainwashed people into believing that mediocre exit prices are the norm and there is little they can do about it. Almost without exception, I have to ask them to erase most of what they know about business valuation in order to be open to a new paradigm. Once they 'get it', their lives are changed forever.

My own experience of selling several businesses at very high prices relative to their revenue and profits convinced me there was more to achieving high prices than just luck and timing. While you can be lucky once, it is hard to argue you can be lucky several times over a span of ten years. However, I was not alone in my experience. As I researched high value exits, I came to see a pattern in them which could be replicated. Without question, high exit prices can be achieved for any business with high growth potential.

We need to accept that business advisors can only work with the information they are given and with the models on which they have been trained. We teach people to value a business on its current revenue and profit, even if adjusted for current economic circumstances. We teach them to look at net assets, current profits and historical growth in order to calculate a valuation. Advisors apply industry norms of EBIT multiples regardless of the prospects of the business. Entrepreneurs are told buyers will not pay for profit improvements which they apply to the acquisition.

Educators and advisors reinforce the view that entrepreneurs have little control over the potential of their businesses and that future prospects cannot be used as a basis for valuation. But when you look at businesses which are sold for many times revenue or have been sold for huge prices even when they are not generating a profit, you have to admit that these may be invalid assumptions.

When I first developed and published the theory of strategic exits, I was pleased to see how quickly entrepreneurs grasped the fundamental concepts. Many have struggled for years with conventional valuations which failed to take into account the very heavy expenditures they were incurring to develop products and capabilities in their businesses. They rightly believed that the current valuation methodologies completely failed to appreciate the high growth potential of their ventures. They were right! The Ultimate Exits models made complete senses to them. However, understanding the concept and applying it have been a challenge for many.

If your accountant and business advisors have been educated on conventional valuation techniques, it is very difficult for them to accept that their life-long held beliefs are wrong. Even if they grasp the ideas behind the Ultimate Exits model, they quickly fall back into conventional thinking. Entrepreneurs often find they are a lone voice in the wilderness and have grave difficulty finding professional advisors to assist them with sale preparation.

In 2005 I published a book entitled '*Selling Your Business for a Premium - Securing the Strategic Buyer*'. I expanded on the strategic sale process the following year with a book entitled '*The Ultimate Deal 2 - Get an unbelievable price*'. I had also recognized that inherent revenue and profit potential could also be used to significantly increase the value of a more conventional entrepreneurial business. This approach to a financial sale was published in 2006 in a book entitled '*The Ultimate Deal 1 - Selling your business*'.

Since 2006, I have been developing these exit theories further. I have been engaged by many venture capital backed firms to develop exit strategies and have gained a greater appreciation of many of the operational details in devising and executing exit strategies. I have come to recognize that my approach to preparing entrepreneurial businesses for sale enables them to have a systematic methodology for incorporating high growth potential into their valuation calculations. I now refer to the entire process as the Ultimate Exits model. In 2009 I incorporated this new model into an e-book for Angel and VC investors called '*Invest to Exit*'.

The Ultimate Exits model is now being applied by Angel Investors as a fundamental approach to selecting and managing their investments. Many entrepreneurs have applied the model to secure high exit values and I know of VC firms which are implementing this for exiting their investments.

After you have read this book, you will have a completely different view of how exit values are created. The concepts are easy to understand and surprisingly easy to apply. I hope you find this book of great value in planning your exit strategy, that you achieve a staggering exit price and you become another champion for the Ultimate Exits model.

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January 2010

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Acknowledgements

A very large number of people have contributed to my knowledge of this topic. Hundreds of entrepreneurs who have been through my classes and workshops, Angels who have attended my training sessions and discussed their investee firms with me and VC executives who I have worked with on exit strategies for their investee firms. Each conversation, question and problem has helped me refine the Ultimate Exits model.

My life partner, Katalin Johnson, has been with me every step of the way, participated in the seminars, workshops and most of the conversations. She has assisted me greatly by asking the hard questions, reviewing the material and making her own contribution to the content.

1

Forget the Multiple

If you are serious about selling your high growth potential business then it might be best if you erase from your mental models whatever you have learnt about business valuation because I can assure you it will simply get in the way of you achieving a high premium on sale. Few people understand high growth ventures and even fewer understand how to value them for sale. In fact, to be really honest, selling a business is not about valuation, it is all about creating a compelling opportunity for the buyer.

Think for a minute about the manner in which you take a product to market. Without exception, you would start with the problem you are solving and then proceed to identify the customer you wish to address. Your focus is always on creating value for the customer. Why would they buy from you and not the competitor? What could give you a stronger competitive advantage? What approach would you use to put your solution in front of your target customer? How is it that we forget the basics of creating value when we come to sell the most important product we have - our business.

Instead of handing over the problem of selling your business to a stranger, start the process by thinking of your business as a product which you are going to package for a very selective customer - the buyer who will pay the highest price. With this enlightened approach, you will find the Ultimate Exits model compelling.

High Growth Ventures are Different

When you know your historical revenues and profits significantly undervalues your business, you can be forgiven for getting irritated at the professional advisors who tell you your business is only worth some small multiple of your current net earnings.

I have talked to numerous entrepreneurs who are planning the sale of their business who are totally frustrated with the valuation formula used by their professional advisors. They rightly argue they have spent their surplus funds in developing the potential of their businesses but they cannot see how this is reflected in their valuation. They are constantly being told to cut back on development costs and expenses and ramp up their profits to increase their value but this appears to be counter intuitive. Surely, they argue, a business with greater growth potential must be worth more than one which is just crawling along but has higher current profits.

They are right. The valuation methods applied by the vast majority of professional advisors, business brokers and investors have been developed around conventional businesses and were never designed to take high growth potential into account. So of course, the valuation calculated by their advisors does not make sense to the high growth venture entrepreneur.

The current methods of business valuation are backward looking. By that I mean they look to historical performance to measure a firm's worth. The assumption is that what was achieved in the past is most likely to be achieved in the future and this is the best indicator of the firm's future capability. Of course, if you remove this assumption, most advisors are lost in the wilderness and have no methodology and no theoretical models to enable them to develop a valuation.

If you are an early stage venture with little or no revenue history, they throw their hands into the air and state that they can't possibly value a business without documented historical performance.

My own experience of high growth ventures has shown me that using a conventional valuation as a guide to an exit valuation is almost always inappropriate and, usually, completely misleading.

Pioneer Computer Group

The first business I sold was a software business. Three of us had started the business in a dining room in the UK in 1979 and had grown it to 160 employees by 1991 when we sold it. That is a growth rate of about 36% pa, so it qualifies as a high growth venture. The business raised $1.5 million in venture capital, undertook two acquisitions, had offices in three countries and worked with over a dozen distributors around the world. In the last few years before the sale, we released the world's first ERP system for process manufacturing based on a relational database and a highly productive applications development system, both of which are still alive and well 20 years after being first released.

The business was generating revenue of about $10 million and a net profit of about $500,000 by 1990 when we decided to sell. Valuations at the time were about 4 x EBIT, so a sale at $2 million was possible. However, even then we thought this undervalued the business due to the potential of its innovative products. We had spent 22% of revenue on product development for many years when the industry norm was around 12%. Products like ours could take 5 to 7 years to bring to market and yet we were still being valued purely on our current performance. It seemed at the time to be grossly unfair but that was the prevailing valuation norm.

However, luck went against us in 1990 as the UK plunged into a recession. Instead of a profit, we found ourselves at breakeven with revenues declining by 20%. A business which was profitable was now worth very little. What is a business worth which has declining revenue, no profit and facing significant staff layoffs? Even though we had about 50% recurring income and would survive, it would still take several years for the economy to pick up and for us to get back into profit.

We abandoned our plans to sell the business to one of the larger software conglomerates in the UK and looked abroad to the US to find a buyer. We decided to take a different approach. Rather than sell on the basis of our profitability, we would sell on what we could bring to the table with our market

leading products. With some research into the US market, we finally decided on Ross Systems, a software company specializing in corporate financials, as our target buyer. Our approach to them was that we could assist them to enter the emerging process manufacturing software market away from the crowded corporate financials market and our development system could take them to the forefront of technology.

Ross were interested enough to invite us to a meeting in California. The result was they decided to enter into negotiations with us as soon as they had listed on NASDAQ, planned for the middle of 1991. Immediately after the listing, they begin serious negotiation and due diligence. Several weeks later we signed a contract to be acquired for Ross shares worth $9.6 million. At the time of sale our growth had stalled due to the recession in Britain, we were making a monthly loss and our prospects looked fairly bleak for the next few years.

Using a conventional valuation approach, our business would have been worth a fraction of the price paid, perhaps only some small value for the net assets of the business. Why did Ross willingly pay about one times revenue? Unless we can provide a convincing answer to this question, we do not have a comprehensive theory of valuation. If our conventional EBIT multiple valuation approach does not explain this sale price, what valuation model can we use? Clearly this valuation is about potential, not the seller's, but the buyer's. Unfortunately, conventional approaches to valuation do not take into account the buyer's potential in arriving at a valuation, yet potential is what high growth firms spend their time building.

CIMDEC Systems Inc.

While I was still working in Atlanta with Ross Systems, I assisted some colleagues to start a small consulting business in Kansas. I put up half the money, all of $10,000 and two others split the remainder. We acquired the US rights to some application software from NZ based CIMDEC Systems Ltd. The plan was for us to commence activities in about 6 months when my contract with Ross Systems ended.

Some months later, CIMDEC System Ltd. in NZ was acquired by a Scottish public company and we were approached by them to acquire back the US rights. We sold the rights back for $1 million. At no time had our venture undertaken

any customer transactions. We had zero revenue and had incurred only some minor incorporation costs.

If we applied a conventional valuation process to this business, we would have some problems. No revenue and a few expenses hardly provide the basis for valuation and certainly fail to explain our exit value. One could argue that this was an IP sale, but on what basis would you value something which had not been used?

Once again, our conventional valuation theory has come up short.

Distinction Software Inc.

Shortly after I left Ross Systems, a group of us started a consulting business with all of the gross profit going into software development. Our intention was to build a supply chain optimization software application for process manufacturing. The consulting income and some founder investment enabled the firm to establish itself and bring the first few software modules to market.

Just as we were beginning to see some success of our software products, a small firm called Red Pepper, the developer of a finite scheduling optimization product, was purchased by Peoplesoft for some 25 times revenue. Red Pepper had very few customers, revenue of about US$9 million and had only generated a small profit. A conventional valuation using a multiple of net earnings would have put their valuation at less than $2 million. Clearly Peoplesoft saw something in the acquisition which was important to them.

We used this opportunity to raise $2 million in venture capital for 20% of our business. At the time our net earnings would have been under $100,000.

Three years later, we had finished the suite of modules, acquired about 20 customers, grown to 30 employees and established strategic partnerships with several ERP vendors. Our revenue had grown to $2 million but we were putting all of our surplus cash into product development thus our net earnings were minimal.

Then our world collapsed. The big ERP vendors, SAP, Oracle, Peoplesoft, JD Edwards and Baan, all decided to develop products in our sector. Our

marketplace had been their customers and prospects and we lost those. We plunged into a loss situation and looked like we were heading for insolvency. In about 6 months we would have used up the balance of our VC money.

We decided to sell, but what is a business worth when it is losing $1 million per annum and with no future prospects and 6 months to live worth? What is the valuation when there is a multiple of a loss?

We knew we had little time to act and immediately contacted our strategic partners and competitors to see if we could recover something out of the ashes. By the end of the first week of discussions, we had 5 potential buyers with the best offer being $8 million.

At this time, we were approached by Peoplesoft and opened up negotiations with them. A week later we agreed a purchase price of $12 million.

Reflection

These three personal experiences convinced me that the conventional valuation methodology was unable to cater for unusual situations. It certainly was no guide to my final exit values, or was it simply that these valuation methods do not cater for high growth potential ventures.

The common theme running under each of my ventures was that they had the potential to generate high revenues and profits at some time in the future, perhaps in the hands of the buyer more than those of the seller. Surely this is where we have serious limitations in our conventional valuation methods. They don't cope well with future potential and they see the business as an on-going venture rather than one where the buyer influences the future.

The conventional valuation method, the EBIT multiple, is based on a number of implied assumptions about what the business will look like in the future, even in the hands of the buyer.

- The business will continue in the same product/market.
- Business strategy will continue unchanged.

- Management will continue to manage the business in the same manner in the future.
- Access to funding, networks and knowledge will not change in the future.
- Financial results in the near term future are assumed to be a linear projection of the near term past.

High growth potential businesses, however, seek to change their own future.

- They invest heavily in product, market and staff development to create future revenue and market penetration potential.
- Future revenue and product/market characteristics may be very different from the immediate past performance.
- Buyers are attracted to them because the buyer has the ability to exploit the underlying potential.
- The buyer will almost certainly change the management, increase funding and bring new networks, distribution channels and knowledge to the venture.

What this suggests is that we need a new approach to calculating the sale value of high growth ventures and, especially, high growth potential ventures. We need a valuation theory which explains how I was able to achieve such significant premiums on sale. Recall that these businesses were sold in the face of losses, declining or zero revenue and poor short term prospects. At the same time, we need a theory which explains why a buyer is willing to pay a premium in these situations.

Building Value in the Business

To begin to understand a methodology for calculating a sale value for high growth potential business, we need to start by examining the manner in which buyers see value in a potential acquisition.

I am continually amazed at how little entrepreneurs know about building buyer value in the business as part of a process of selling their business. They seem to have little appreciation for why businesses are acquired and what the

buyer looks for in an acquisition. Not that I should be that surprised having spent many years now educating business owners on how to best prepare their businesses for sale and how to generate a premium on sale. But the thing which constantly amazes me is the fact that their professional advisors and business brokers know little better.

There seems to be a disconnect between the way in which conventional business valuation is determined and the manner in which the buyer will extract value from the acquisition. Part of the answer lies in the fact that the question 'what is the value of my business?' neglects to ask 'for what purpose?' If the purpose of the question is to raise a bank loan, inform investors as to how the business is tracking or to see if the entrepreneur can bring in some external investors, then it is appropriate to determine the value of the business as a 'going concern'. However, if I wanted to know what a willing buyer would pay for my business, I should expect a different approach, use different assumptions and will almost certainly arrive at a different valuation.

If I am to value the business as a going concern, I will make a number of implicit assumptions about the manner in which the business is managed. Basically, I am going to assume that the business will continue with the same management, product/market strategy and access to networks and resources.

If the external environment relating to the economy and competitors is similar to the near past, I can expect the business to continue tracking along a path similar to the most recent performance. The best evidence I have to future performance is recent history. Calculating a valuation for the business is then a simple extrapolation of past performance. Perhaps this is the reason why valuations built on multiples of current earnings (the EBIT multiple formula) are so common.

Even in this simple application, few business owners understand the basis of a conventional earning multiple valuation or why a specific multiple should be used in a particular situation. In a recent conference, I asked a number of experienced entrepreneurs to tell me the valuation norm in their industry. The answers ranged from 1.5 to 8 times EBIT. They were surprised at the variation within their group. When asked why the multiples varied so much, they were

unable to explain why. When asked how they could improve their multiple, only one or two mentioned profit growth. There was clearly a lack of understanding about valuation methodology and about the factors which influence the valuation. More specifically, they were relatively ignorant about what they could do to substantially influence their own valuation.

However, let us change the objective. What if I want to know what value I would achieve on sale. If that is the purpose of undertaking the exercise, then why would you make the same assumptions in determining future revenue and profit?

Almost without exception, the entrepreneur leaves the business at the time of sale. Often several of the senior management leave at the same time, taking the opportunity to cash out and do something new. There is also no reason to assume that the new owner will manage the business in the same manner or not make changes in the product/market interface. You should also expect that any smart buyer will only purchase a business where they think they can bring something new to the table which will give them a premium for their knowledge, networks, resources or energy.

If that is the case, the basis for valuation on sale has to take into account what the buyer is likely to do to the business. If, for example, we know that the right buyer can significantly improve the growth rate, market penetration and/or profitability of the business, we should anticipate a higher value on sale than that which would be calculated for the business as a going concern.

Back to Basics

Essentially we are being misled by our conventional approaches to valuation. It is worth taking a little time out to consider what valuation implies about any business. The valuation basically determines what an investor would pay for the future stream of net earnings of the business. Fundamentally, it is all about investment theory.

My business is worth something (the investment) because it gives me back a series of future cash (income) payments. I can value any investment simply by applying a conventional Net Present Value (NPV) formula to the stream of future

cash flows. The NPV formula also asks me to state what rate of return I require from my investment. Using this interest rate, I discount the future income values back to the present. The NPV will calculate what I need to invest to generate that stream of income using the applied discount rate. Higher interest rates applied to the same stream of future income flows will give a lower NPV.

Applied to business valuation, this tells us that businesses with higher risk profiles or higher uncertain future income values require a higher interest rate to reflect the additional risk faced by the investor. A business discounted at a 30% risk rate will be worth much less than a business discounted at 15%.

The valuation of a business is simply an application of this NPV theory. The future income streams are determined by applying a number of assumptions to the business projections. The risk rate or discount rate applied reflects the level of risk in the business or the level of uncertainty in the income projections. The resulting NPV is the valuation of the business.

Clearly, if you change the assumptions about the future, you will change the valuation. Valuation of a business as a 'going concern' can be expected to be different from a valuation of a business for sale if we apply a different set of assumptions about what might happen to the business in the hands of the buyer.

Once we make the leap to an investment theory approach, we should focus entirely on the future to determine our valuation. The only contribution our prior history makes is to provide us with some evidence to validate some of our assumptions about the future. With this in mind, let us focus on creating value for the buyer and, from this, determine an exit valuation.

Creating Buyer Value

Fundamental to the sale process is an understanding of the value which the buyer will extract from the business. The purchase price (value of their investment) is derived from their estimate of the future stream of income discounted by their estimate of the risk rate or their required rate of return.

When you think about this a little more, you can see that a business which makes the effort to provide the buyer with a different, more positive, more profitable future for the acquisition, should get a higher price than simply a multiple of past earnings. This can lead to two possibilities: the buyer can extract more from the existing business than the seller or the buyer can utilize the assets and capabilities within a much larger business thus exploiting the underlying assets and capabilities much more than the seller could.

Given these possibilities, why is it that advisors and brokers force business owners to use past profits to value a business – normally using an industry EBIT valuation model which is more guess than science? The buyer does not invest in past income streams, they only invest in future ones. Our efforts in preparing a business for sale must concentrate on how we communicate the future income streams and risks to the prospective buyer.

If you want to extract the highest sale price for the business you should be seeking out a buyer who can exploit the business better than you can. The process of sale preparation should be to reduce risk in the business to the buyer and to create future potential for the business way beyond the current owner's capacity and capability. By finding multiple potential buyers who can generate greater value in the business in the future than that which could be generated by the current owner, the seller can readily achieve a premium on the sale.

If you are a business owner, you need to break away from the past and concentrate your preparation on what the future of the business might look like in the hands of a much more capable and better resourced buyer. Find those buyers who can best exploit the potential in the business. By setting them up in a competitive bid, you will be able to extract the best price for your business.

In this book I am going to examine in great detail the nature of business potential which allows us to create a different future for the business and assist us to attract the premium buyer. I will be looking at different models of business growth and how this impacts on the type of sale preparation you should follow. I will be explaining how to find the best buyers and what you need to do to bring them into a competitive negotiation. Using this process, you can be assured you will generate the best sale price possible and almost certainly one at a significant premium over a conventional valuation.

2

Strategic v.s Financial Exits

There are basically two types of ventures which attract acquirers. Financial ventures create value on exit via a financial trade sale or an IPO by assigning a value to the future profit generating power of the entity being sold. Alternatively, a strategic venture creates exit value, not on the basis of what profit it could inherently generate, but on the basis of what future profit could be generated by the buyer exploiting the underlying assets or capabilities of the entity being acquired. These are fundamentally different types of businesses and the entrepreneur has to ensure the business development process and the exit preparation align with the appropriate exit.

In order to assess the potential exit value of any entity, we must first understand how the business creates value for its buyer (financial or strategic sale) or its future public shareholders (IPO). Those businesses which deliver inherent profitability must create value for its future owners through enhanced profitability and future profit growth. By contrast, strategic value businesses create value by enabling a large corporation, the strategic buyer, to exploit a significant revenue opportunity created through the combination of the two companies. The strategic seller builds value by developing strategic assets and capabilities which a large company will exploit.

In the case of a strategic sale, it may not matter whether the selling business is making a profit, has revenue or is growing. This is in direct contrast to a

financial exit which is entirely based on revenue and profit growth which the business itself must deliver to its new owners.

Because these outcomes are very different, the manner in which the entrepreneur should plan the exit for their business depends greatly on which type of exit is most appropriate.

I have grouped financial trade sale and IPO under the financial exit as they both have the same basic value creating process, they both need to generate a future stream of positive earnings to create a successful exit event. The IPO exit is an extreme situation of a financial venture where the projected revenue levels and the projected market capitalization is very high. While the IPO exit requires a more sophisticated organization to be successful, the fact is that both the financial sale and the IPO require a proven, high growth potential business concept to generate a successful exit value.

Smaller firms and firms with limited growth potential which create value through projected net earnings need to be directed towards a financial trade sale as they will not be able to meet the rather high threshold of revenue and potential growth requirements needed for a successful IPO. Given that only a very small percentage of firms are able to achieve IPO status, the vast majority of firms need to be prepared for a financial sale. For the purposes of this discussion, I am going to refer to all financial exits as a 'financial sale' with the understanding that some exceptional firms will be able to achieve an IPO. Also, for the purposes of this discussion, I am going to assume that all financial exits will be to an individual or corporation, that is a 'financial buyer', and that the buyer is setting the purchase price based on the anticipated future stream of earnings from the acquired firm alone. That is, the buyer is not assigning any synergy or benefit to the acquisition based on what is happening, or could happen, in the rest of the buyer's organization.

The financial sale is very different from a strategic sale where value is created through the combination of the buyer and seller businesses. We have all heard of businesses which were sold for many times revenue and staggering multiples of profit. These situations are all cases where the business being acquired had something which the large corporation needed to counter a major threat or to chase after a major new revenue opportunity. Most of

these acquired businesses had unique intellectual property, deep expertise or well established brands or rights (e.g. to exploit forests, minerals, fishing etc). The assets or capabilities being acquired were considered by the buyer to be too expensive to copy, build or develop, or would take the buyer too long to assemble or to create internally. The delay in acquiring the asset or capability may also expose the acquiring corporation to an unacceptable level of risk.

In a strategic acquisition, a small business can often provide the means by which a large corporation can quickly generate many times the purchase price by leveraging its own assets and capabilities alongside those being acquired. Such acquisitions are bought, not on the basis of the profits of the acquired business, but on the value which can be generated within the combined entity. Few acquisitions, however, fit this profile. I will use the terms 'strategic sale' and 'strategic buyer' to describe a situation where a business is sold on the basis of its strategic value to the acquirer.

Businesses which are typically sold to a strategic buyer are those in biotechnology, information technology, research and development, designer fashions, mineral exploration, agricultural science, computer hardware and telecommunications. Also companies in consumer packaged goods with strong brands or with manufactured products which have global market potential can often secure significant premiums on sale. Acquisitions which can deliver very significant synergies in operating costs through integration would also fit into this category.

Probably about 95% of all private businesses which are sold are acquired by a financial buyer. In some, there will be synergies in the acquisition but these will be minimal and not sufficient to override the need for the acquired business to show its inherent profitability. Most companies don't have the type of assets or capabilities to leverage large scale opportunities for an acquirer. Instead, they build profits through their own inherent competitive advantages through a local customer base.

A financial buyer seeking an acquisition will often have many choices of similar businesses, although sometimes geographically separate. The buyer may be buying a business to own and manage or a corporation undertaking a consolidation strategy by acquiring many businesses of a similar type. What the

financial buyer is acquiring is a profit stream and so the basis of the purchase is simply how much profit the firm makes now and is likely to make in the future. Purchase value is calculated almost purely on the inherent profitability of the acquisition with little regard to the combination synergies in the acquisition. The seller to a financial buyer must put effort into increasing profit and profit potential.

Businesses which would normally be sold to a financial buyer are professional services firms, marketing firms, management consultancies, distribution companies, trucking companies, most retail businesses, wholesalers, import/export companies, agricultural enterprises, printers, professional practices, builders, construction companies and so on. Non complex manufacturing also attracts a high proportion of financial buyers. Basically, any business which does the same as many other businesses will fall into this group.

Businesses acquired to be operated as a stand alone business will be purchased on the basis of their inherent profitability as there are no synergistic benefits in the deal for the acquirer. Therefore, a business bought by an individual who wants to invest retirement or redundancy funds to buy a business to manage will be a financial sale. Similarly, a business purchased by a private equity fund which intends to increase its profitability through new management, increasing its debt level and refocusing the business will also be a financial sale.

Businesses acquired by corporations can be expected to have both financial and strategic contributions. Many acquisitions are undertaken for roll-up, consolidation or expansion purposes. These businesses typically are purchased to add revenue and profit generation through their own inherent operations although the acquirer may gain some synergistic benefits from operating at a larger scale or some benefits through reducing duplicate functions, but the prime consideration is generating operating profit from the business purchased. The purchase price would be driven by the current and potential profit of the acquired business itself. While the additional synergies may make it more attractive, the seller would need to prepare the business for a financial buyer.

Acquired businesses which are expected to contribute significant synergistic benefits to the acquiring corporation may contribute little inherent profit. They

are acquired because of the benefits which the acquiring corporation expects to achieve through the combination of the businesses. In most cases, these acquired businesses bring some asset or capability to the acquirer which the corporation is able to leverage through their own operations thereby generating significant future revenue and profits for the acquirer. A seller who was able to make such a contribution would seek out a strategic buyer.

Some firms will be able to do both. That is, they will have good profit capabilities and also be able to provide strategic benefits to the acquirer. But one will be more significant than the other. To the extent that strategic value benefits are greater than inherent profitability benefits, the seller would be much better off seeking a strategic buyer. Financial sales are always going to be limited by the profit generating capability of the seller. A strategic sale, however, is only limited by the size of the opportunity generated within the acquiring corporation. Thus, a very large corporation which can significantly leverage the strategic contribution of a small acquisition may be prepared to pay many times its financial sale value to ensure it receives the benefits of the acquisition rather than allow it to be acquired by one of its competitors.

I have extensively examined the process of a financial trade sale and have documented a methodology in my prior book, *The Ultimate Deal 1*, which can be used by business owners to significantly improve their sale value. *Ultimate Exits* will incorporate this material and provide some new insights into financial exits.

My prior book, *The Ultimate Deal 2*, examined strategies which owners of businesses with strategic value will use to sell their businesses to a strategic buyer. Angels and VC investors who wish to understand how to identify strategic value investments and the strategic sale preparation process in greater detail should also read my e-book '*Invest to Exit*'. *Ultimate Exits* will cover this material from the viewpoint of the entrepreneur preparing a business for sale to a strategic buyer.

Financial or Strategic Sale – Which One?

I often confront entrepreneurs with a stark choice – what is the best strategy to prepare your business for a sale – build up the profits or develop underlying assets and capabilities for a strategic sale. You might well ask 'Why can't you do both?".

Financial v.s Strategic Buyer Strategies

Attribute	Financial Buyer	Strategic Buyer
Source of value to the buyer	Profitability, risk minimization, growth potential.	Threat elimination and/ or revenue potential in the combination of the two businesses.
Value created by	Increasing profits, reducing risk, future growth and proven growth potential, roll-up or consolidation opportunities.	Underlying assets and capabilities which the buyer will leverage to eliminate a threat or exploit a large revenue opportunity.
Additional value created by	Increasing current profits, increasing growth rate, developing additional substantiated growth potential.	Reducing integration time, increasing rate of scalability and speed of exploitation, adding additional strategic assets and capabilities for the buyer to exploit.
Buyer	Individual, investment trust, private equity firm, corporation undertaking a roll-up or consolidation strategy.	Large corporation which can exploit the strategic assets and/or capabilities in a large customer base.

Attribute	Financial Buyer	Strategic Buyer
Impact of increased profitability	Major impact on value.	May be irrelevant. Profits are only needed to ensure survival prior to a sale.
Size	Any size.	Large acquisitions may have difficulty creating sufficient new incremental revenue.
Existing growth	Significant impact on value.	Size must be sufficient to allow a critical mass platform for opportunity exploitation. Growth itself may not be important.
Growth potential	Significant impact on value.	May have no impact on the buyer's opportunity.
Underlying assets and capabilities	Must deliver competitive advantage within the seller's business as a stand alone entity.	Must deliver a sufficiently large and robust base for exploiting a strategic opportunity in the combination of businesses.
Inherent risks	Must be eliminated wherever possible.	Must be eliminated wherever possible.
Succession planning	New buyer must be able to run the business if the senior management leave.	Key manager and key employees needed to exploit the opportunity must be retained.

Attribute	Financial Buyer	Strategic Buyer
Advisors	Business broker, professional services firm, business advisor	Large professional services firm, investment banker.
Preparation time	18 months to 2 years	18 months to 2 years.
Level of integration	Most often continues as a sole business or might be loosely integrated bolt on acquisition. May contribute administrative synergies in a consolidation.	Varies. Often fully absorbed. Sometimes integrated into only one part of the business. Could be left as a stand alone entity passing products, IP or processes to group.

I am sure some companies have both financial and strategic value, but when they look at the processes involved and the priorities which will determine where to use their surplus cash, you often see a clear choice – they don't have the resources to do both so they need to decide which strategy is going to generate the highest exit price.

There is sometimes the possibility that a single venture can throw off more than one exit. This can happen where the firm has developed IP across multiple markets or solves quite different problems. It may be worth separating the different IP into distinct ventures and preparing each for an exit.

Another possibility is that a single venture may have quite different activities each of which could be directed towards their own sale, perhaps with some being financial sales and others being strategic sales. This can happen, for example, where IP is the basis of a sales transaction of a product but is then followed by maintenance or service sales. The IP may appeal to a global corporation but they may have no interest in the local services business. In such a case, it may

be worthwhile splitting the business and selling the different parts to different buyers.

Companies which are sold as a financial sale are those which provide the buyer with a platform which enables the buyer to generate a stream of future earnings through the use of the resources contained within the acquired business. While these might be augmented by the buyer through the insertion of better processes, more capable management and better funding, essentially it is the same underlying business which is generating the profit stream. Thus any acquisition valuation will be based on the net present value of those future earnings. Most businesses fall into this category. Financial buyers typically buy retail, wholesale, light manufacturing, transport, property and services based businesses.

You increase the value of such businesses by reducing the inherent risks for the buyer, improving the visibility and reliability of future earnings forecasts, improving on-going profitability, building growth into the business and finding ways to create growth potential for the buyer. The preparation process involved in selling a business to a financial buyer will be extensively reviewed in later chapters.

By contrast, those businesses which appeal to strategic buyers have some underlying assets or capabilities which a large corporation can exploit through the buyer's own organization. Small companies will often develop products or services which can be sold by the acquirer through their very large distribution channels. In the right circumstances, a buyer might be able to scale the revenue by 50 to 100 times that of the seller just by having the right access to global customers. The key to a strategic sale is to find a large corporation which can exploit the underlying asset or capability of the seller to generate very large revenues. In these situations the size, revenue, number of customers or employees or level of profits of the seller may be entirely irrelevant. It is the size of the revenue opportunity of the buyer which is the key to strategic value.

A business which has the right type of assets or capabilities which can generate strategic value may be much better off putting additional effort into developing those assets and capabilities to provide greater or earlier revenue generating power for the intended buyer. A higher exit price will be achieved if

the buyer can scale or replicate the asset or capability faster and can integrate the seller's business quicker. The only size consideration for the seller is to be big enough to provide the launch platform for the buyer to fully and quickly exploit the strategic value. The process of preparing a business for a strategic buyer will be reviewed in later chapters.

Entrepreneurs need to be sensitive to these two types of ventures as it directly impacts on the manner in which the business would be developed for an exit.

Financial Exits

3

Leveraging the Valuation Model

To achieve the highest price on sale, you first need to understand what you can do to influence the outcome. You also need to know whether the advice you are receiving from your professional advisors is good advice. Once you have a better understanding of how buyer value is created and the manner in which you can change your business to substantially impact its valuation, you might very well question the advice you have received in the past. We start this exercise by examining the way in which valuation formula work. In this way we can identify those aspects of the business which we can change which will have the greatest impact on its valuation.

Even experienced entrepreneurs have difficulty estimating a valuation for their business. While many will have been exposed to valuations of publicly listed corporations, such as 14 to 16 times EBIT, this can be very misleading if applied to a private corporation. Listed corporations pose less risk for the retail investor as they have greater disclosure requirements and, clearly, greater liquidity. Where the investor has lower risk, a higher multiple of earnings will be applied to a valuation.

Most business owners have a good understanding of what their business is worth. They will have their own financial records showing their business net worth, some understanding of valuation norms in their sector or had prior discussions about this matter with a professional advisor. After all, many will

have spent years in business and have personal networks where the valuation of a business is a common topic of conversation. They will have known colleagues who have sold businesses, many of them successfully in their eyes. They may have had conversations with their banker, accountant and maybe even a business broker or undertaken a valuation to raise money or to buy out a shareholder.

Those who have a better understanding of valuation techniques will generally have a view on valuation based on some multiple of sales, some earnings or profit multiple or a formula commonly used within their sector based on some aspect of their trading volumes. While all these methods do reflect the underlying value of a business, they can be seriously misleading. The basis of what most owners' think their business might be worth is based on what other people have done, not what they might be able to do. Very few business owners take the trouble to understand how business value is created or lost in the valuation process, nor do they set out to create a business 'product' which will attract the right buyer and provide a convincing argument on value for money.

In order to understand how to maximize the value of your business on sale, you have to understand the basics of how value is created and packaged. If you then want to actively increase the valuation, you need to be prepared to undertake a process of creating additional value which might take a number of years. While most business brokers know the fundamentals of valuation, few of them can advise you on how to best develop your business to create buyer value. At best, they help you do some window dressing but they rarely think that perhaps there is a fundamentally different way of thinking about what the business is and what it could do for a knowledgeable buyer. If you only think about what the business is rather than what it could be, you severely limit what the business could be sold for.

So forgive me if I cover the basics – but understanding where value is created is fundamental to getting the best price for your business.

Valuation Models

"How is the valuation of an investment determined?

Valuation is the process of estimating the monetary amount that the firm is worth based on its future expected returns. Valuation is a function of risk and return, and considers:

- the expected return from the firm
- the expected returns from other comparable firms
- the risks associated with the expected return
- any other relevant characteristics of the firm or the industry/geography in which it operates

A more conventional definition of market value is:

> *The price that would be negotiated between a knowledgeable and willing but not anxious buyer and a knowledgeable and willing but not anxious seller acting at arm's length within a reasonable time frame.*

In the absence of an independent offer to buy the firm, the valuation of a private company is a highly judgemental process. Valuation models are each designed with different purposes in mind. The major valuation models are:

a) Asset based:

- Going concern value
- Realisation value

b) Industry specific based

c) Market value:

- Rules of thumb
- Earnings based
- Capitalisation of future maintainable earnings
- Discounted future cash flows

a) Asset Based Valuations

Asset Based valuations are really only appropriate in a few circumstances such as:

- Where a company is making continuous losses
- A company is close to liquidation
- Where assets are readily saleable and their tradeable value best reflects their ongoing value

Thus, for valuing a business which is a going concern, Asset Based Valuations are not an appropriate valuation model.

b) Industry Specific Based Valuations

Some sectors have conventional models such as a percentage of sales, a multiple of revenue or a price per customer or agreement, but they are all surrogates for an underlying valuation method which is based on ongoing profitability at the current level. There are, in fact, some very good reasons why these models are used, not least of all because everyone can easily understand them. Secondly, it does represent a variation on a more sophisticated valuation technique based on future earnings.

These methods are often referred as The Market Value and Rule of Thumb methods and could be used as a cross check to discounted cash flow valuation models in certain industries or circumstances. They should not be used as a primary valuation method as they do not take into account the firm's earnings/ cash flows.

c) Earnings Based Valuations

Most owners think of valuation as a multiple of their earnings. Let's go back to basic valuation theory to see why this conventional approach has gained so much use.

How is the valuation of an investment determined?

It is simply the present value of a future stream of earnings. Thus if I invest $100 at 10% interest per annum, I would expect to receive $110 in one years'

time. Thus, working backwards, $110 in one years' time is worth $100 today if the interest (discount) rate used is 10%. Thus any business can be valued simply by taking its future earnings stream and discounting those back to arrive at what the business is worth today. Of course, we still have to determine the future earnings stream and we need to establish the discount rate. The discount rate is a reflection of the risk in the deal. Thus a higher risk would reflect either greater uncertainty about the external environment or a higher fear about the ability of the business to sustain its current performance into the future.

Earnings Based Valuation methods take into account the firm's future earnings/ free cash flows.

(i) Capitalisation of Future Maintainable Earnings

Capitalisation of future maintainable earnings methodologies include:

- Price Earnings Ratio ("PER"); and
- Pre tax earnings multiples such as Earnings before Interest, Tax, Depreciation and Amortisation ("EBITDA"), Earnings before Interest, Tax and Amortisation ("EBITA") and Earnings before Interest and Tax ("EBIT")

Earnings based valuations are used as a proxy for the Discounted Cash Flow ("DCF") methodology.

The PER can be applied in two ways:

Total value of the firm:	PE multiple x net profit after tax (NPAT)
Value per share:	PE multiple x earnings per share (EPS)

The PER is applied to an estimate of earnings after tax. The value derived using a PER is a valuation of the ordinary shareholders' interest. This is described as an equity value.

Valuations based on EBITDA, EBITA or EBIT multiples calculate the Enterprise Value of the firm before factoring in the way it is funded. The Enterprise Value is typically adjusted for the following items to calculate an Equity Value.

- Interest bearing debt
- Surplus assets
- Contingent liabilities
- Future capital expenditure

To further explain the difference between Enterprise Value and Equity Value consider the following example of somebody's house:

Item	$	Value
Market Value	500,000	Enterprise Value
Bank Debt	400,000	
	100,000	**Equity Value**

Sectors often have established valuation norms based on earnings multiples. These can vary with economic cycles reflecting likely growth or depression trends. Multiples applied to mature industries with little likelihood of growth are generally lower than multiples applied to growth sectors. Firms which have experienced higher than average historical growth will usually command a higher multiple on the basis that future growth is also expected to continue at higher than average rates i.e. history is often used as a prediction of the future.

Most valuations adjust the Net Profit forecasts to improve comparability between similar businesses. Thus interest and taxes are added back to reflect differing debt/equity ratios and different tax situations. Often depreciation and amortization are added back to reflect the differing ages of underlying assets and the variations in write-off methods. The final number, whether it be EBIT (earning before interest and taxes) or EBITDA (earning before interest, taxes, depreciation and amortization) may still be adjusted to bring the owner's salary and perks into line with an arms' length cost. In the end, what you are trying to find out is the cash surplus generating power of the business.

The earnings used in your valuation need not be the actual historical earnings. Earnings should be adjusted for abnormal, extraordinary and non-recurring items to determine a normal level of earnings. If the entrepreneur can show highly probable growth with achievable revenue and profit targets, future earnings might be used to calculate a market valuation. However, it

is important to avoid double counting growth by using future earnings and applying a "growth multiple".

The problem of using the Capitalisation of Future Maintainable Earnings as the valuation method is that you need to arrive at a single number for the earnings component. As I will demonstrate later in this chapter, the key to an increased valuation is to progressively lift the profit earned in successive future periods. This method does not allow for such adjustments and therefore can seriously misinform the potential buyer about profit potential.

> *In a seminar for the Law Society, Tony Frankham stated "the methodology and value ultimately chosen will be a matter of judgement" and spoke of "considerable uncertainty" in the absence of a reliable database of market EBIT or EBITDA multipliers. Another ex-President and Life Member of ICANZ, John Hagen, confirmed in another seminar that a 10% variation from the mid-point of the range was not unreasonable.*
>
> *Market experience proves that price can vary significantly from value depending upon the motivations and negotiating skills of the parties.*
>
> *Source: http://www.clythbiz.con.nz/view_news.cfm?key=88 Accessed 12th February 2006*

(ii) Discounted Cash Flow

Another way of looking at the valuation of an investment is the discounted cashflow model (DCF) which calculates a Net Present Value (NPV) based on the following formula.

$$NPV = \sum_{i=1}^{n} \frac{values_i}{(1+rate)^i}$$

Each cash inflow/outflow (*value*) is discounted back to its present value (PV). Then they are summed. Therefore NPV is the sum of all terms , where

i - the time of the cash flow

rate - the discount rate (the rate of return that could be earned on an investment in the financial markets with similar risk.)

Looking at the equation above, one can see that the DCF model has two elements:

- Forecast of future cash flows of the firm for a number of years into the future. The formula allows each year to be specified separately thus it can readily reflect changes in the level of future net cash flows.
- The discount rate which penalizes the cash flows back to a net present value taking into account the riskiness of those cash flows.

Thus any business can be valued by taking its future earnings stream and discounting those back to arrive at what the business is worth today. However, this method does present some challenges:

How do we select an appropriate discount rate and how long should you forecast the cash flow?

How do we accurately forecast Free Cash Flows for a number of years into the future?

It is important to realize that these factors do not operate independently but are intrinsically linked to each other. The discount rate should represent the risks associated with generating the expected earnings of the firm. Thus, the consistency of the future cash flow streams will affect the discount rate which is applied to the valuation.

The discount rate is a reflection of the risk in the deal. Thus a higher risk would reflect either greater uncertainty about the external environment or a higher fear about the ability of the business to sustain its current performance into the future.

You can try this formula within Microsoft Excel. Just use the NPV formula with some simple numbers until you understand how it works and then you can try modeling your future profits using different discount rates.

Where there is no clear method which is being implemented to determine valuation and where the parties are ignorant of the underlying logic, the seller is at the mercy of advisors and brokers who may not know any better. This also leaves the smart buyer in a position to seek out bargains.

Let us take a moment to look at some basic calculations which will demonstrate the use of DCF and the impact of increasing the discount rate.

Typically an investment in the public stock market should anticipate a return of 12 – 15%, so let us use 15% as a discount rate for a very reliable business. A 25% rate would be a rate for a riskier business and 50% rate could be used for a high risk business.

For arguments' sake, let us assume that a business was generating a positive cash surplus each year of $1m. We can use a set of increasing discount rates to reflect increased uncertainty about the future earnings of the business.

The scenario set out in the table below would never occur realistically as discount rates of 25% or 50% would never be applied to consistent, low risk cash flows. However, this scenario can be used to illustrate the severe effect a higher discount rate has on a firm's valuation.

Impact of Different Discount Rates on Net Present Value

End of Year	Free Cash Flow $ '000	15% Discount Rate $ '000	25% Discount Rate $ '000	50% Discount Rate $ '000
1	1,000	869	800	667
2	1,000	756	640	444
3	1,000	658	512	296
4	1,000	571	409	200
5	1,000	498	328	129
6	1,000	432	262	88
7	1,000	376	210	58
8	1,000	327	167	39
9	1,000	284	135	26
10	1,000	247	107	18
Total NPV		**$ 5,018**	**3,570**	**1,965**

You can see how severe the effect of a higher discount is on the current value of the business. If we added further years to the table, a conventional valuation based on '4 times earnings' would equate to a discount rate of 25% while a multiple of 6 would represent a discount rate of 15% (if earnings continued further into the future). A 50% discount rate would equate to 2 times earnings.

Improving Your Valuation

The most appropriate method of valuation for a high growth potential venture is the DCF method as it best reflects the future pattern of increasing revenue and profits and allows the user to apply a risk factor to the projections. Now that we have seen how this works, we can use this knowledge to focus our attention on those parts of the business which will have the greatest influence on its valuation.

The two major factors in the formula which we can work on are:

Risk (the discount rate); and
Profitability (the projected values)

Reducing the Risk Profile

The initial point of attention should be on the risk profile of the business. We can increase the value of the business by reducing the discount rate. Since the discount rate reflects uncertainties surrounding the future cash surpluses of the business, obviously the more certain future cash surpluses are, the lower the risk associated with the business and the higher the current valuation. The first task of the business owner is to provide much more certainty around future earnings.

A business which is generating Earnings Before Interest and Tax (EBIT) of $1,000,000 could be worth anything from $2 million to $6 million, depending on the level of perceived risk of future profits. In my mind, it would be worth a great deal of money to the seller to improve the certainties around the future profit.

The discount multiple is often a judgment call on the part of the buyer. The buyer will argue that a lower multiple should apply because of factors which either limit the future income generating power of the business or increase the volatility of the future earnings.

Factors which reflect higher risk are:

- Strong competition
- Reliance on a few large customers
- Old products which may become uncompetitive
- Reliance on one major product
- Outdated plant and equipment
- Poor management team

Factors which represent lower buyer risk and result in higher multiples are:

- Strong brands which still have further potential
- Diversified product range and large customer base
- Strong management team below the owner
- Limited competition and a market leadership position
- Unused capacity with plant and equipment

However, these are also only indicators of how the business is expected to perform. If profits are expected to decline this is reflected in a lower NPV for two reasons:

- Free cash flows are smaller; and
- Future cash flows are considered to be more risky.

If, on the other hand, profits are expected to increase, this would increase the NPV of the firm.

Increasing Profitability

If the value of the business is based on the stream of future profit, naturally more is better. However, many owners only think about increasing profits when they finally decide to sell their business. They rapidly cut back expenses in some discretionary areas, reduce overheads where they hope it may not be noticed, cut back on advertising and R&D and trim their personal expenses. What they don't appreciate is that the wary buyer is expecting this will happen and is looking for such changes. As soon as they are able to identify this type of 'window dressing', they know they will have to dig very deep to discover the real costs of the business.

There is nothing wrong with improving profitability. Many owners are what you might call, 'asleep at the wheel' and improvements in productivity and profitability are relatively easy to implement. A business which has been going for many years may well be somewhat lazy at watching expenses, driving sales productivity or managing the right mixture of debt and equity to generate better profits. In fact, the owner may have been living a very comfortable and relatively stress free existence because they were not pushing the business. This means there is scope for improving profits.

Improving profitability is going to take some level of investigation to uncover areas where improvements can be made. Resources and time will need to be allocated to put in place new systems and processes or other changes to effect the desired improvements. You should not think that your profit can be increased overnight. It may take many months, if not years, to put in place the changes needed to substantially improve sustainable profitability. This is

an incremental exercise and some gains can be made quickly while others will accrue gradually over time.

When making changes to the business, the crucial question is:

"Is the new level of revenue and expense sustainable?"

This is really the only relevant fact. An owner who decides to put his or her business on the market and systematically work through the business processes to ensure the business is running as effectively and efficiently as possible, has nothing to fear. Providing of course they can show the changes they have made are sensible, reasonable, have implemented standard best practice processes and that the final result is a more profitable and sustainable level of activity.

This is a challenge for the owner.

How do you prove that the changes you made are reasonable and sustainable and were not made solely to push up short term profits to lift the sale value of the business?

How do you show that the changes will not harm the long term profitability of the business?

If you don't have a convincing argument – the result may be a lower EBIT multiple than you otherwise might have achieved and the overall effect might be to reduce the value of the business, not increase it.

I am going to show, in a later chapter, how to undertake changes in a way which can be validated and will prove to be sustainable.

Any change in long term profitability can have a significant effect on the valuation. Using the data from the earlier example let me show you just how much an impact it can have.

Impact of Different Growth Scenarios on Net Present Value

Scenario	A. Flat Profit ($'000)	B. Step Change ($'000)	C. 10% Growth ($'000)	D. 20% Growth ($'000)
End Year	**EBIT**	**EBIT**	**EBIT**	**EBIT**
1	1,000	1,500	1,100	1,200
2	1,000	1,500	1,210	1,440
3	1,000	1,500	1,331	1,728
4	1,000	1,500	1,464	2,073
5	1,000	1,500	1,610	2,488
6	1,000	1,500	1,771	2,985
7	1,000	1,500	1,948	3,583
8	1,000	1,500	2,143	4,299
9	1,000	1,500	2,357	5,159
10	1,000	1,500	2,593	6,191
Discount 15%	**5,019**	**7,528**	**7,895**	**12,732**
Discount 25%	**3,571**	**5,356**	**5,291**	**8,044**
Discount 50%	**1,965**	**2,948**	**2,626**	**3,571**

These scenarios show the dramatic increase in value from improving profitability. Using scenario A as a base, a small increase in average profits (B) will immediately impact the NPV. Even a small growth rate in profits (C) can lift the NPV considerably. A larger change in the growth rate (D) can have a dramatic effect.

Scenario B 'Step Change' may be achieved by just being more efficient with the use of existing resources. Rent out unused warehouse and office space, sell off obsolete equipment and inventory and be more careful with expenses. This is not rocket science but simply being more diligent in utilizing assets. You can see a simple step change in profits can have a dramatic impact on overall valuation.

A 10% on-going increase in profits might come from taking advantage of additional business which could be generated from the current customer base. This might be generated by less than a 10% increase in overall revenue. More attention to customer relationships, cross selling and incentives for staff to work just that little bit harder may be the key to such an improvement. A 10%

increase in profits over a 20 year period at a discount rate of 15% would double the NPV. That is, you would double your sale value by increasing net profits year on year by 10% - certainly a target well within the reach of most businesses.

A 20% increase in profits may take more creative thinking but could be achieved through more aggressive selling; some additional sales staff to work with existing customers and acquiring new customers. Even this rate of growth is not dramatic, especially with some investment in innovation to drive it. A 20% increase in profits over a 20 year period at a discount rate of 15% would increase the NPV by a factor of FIVE. That is, you would increase your sale value by five times by increasing net profits year on year by 20%. While this may be a stretch, many businesses achieve this over a number of years.

As you can see, minor improvements in profit growth combined with improving the reliability of the profit forecasts and/or reducing inherent business risks, can move the business from a 50% discount rate to a 15% discount rate and dramatically impact overall valuation (in this 10 year example, SIX times).

Building Growth Potential

If growth makes a difference in the valuation, then significant growth would have a dramatic impact on valuation. However, few businesses can maintain high rates of growth over a long period of time. It is estimated that only 4 firms in 1,000 can manage growth rates over 20% for more than 4 years in succession. These firms, called 'gazelles', are, therefore, the exception. Projecting growth rates in excess of 10 to 15 percent over any extended period is going to require some very convincing supporting evidence.

Short term increases in growth or step changes in growth are certainly feasible. Whether this is achieved through innovations within the firm, a series of acquisitions or the introduction of new lines of business, such changes are common and easy to demonstrate. This can be easily validated if the change has already taken place and the results are already contributing to actual profits.

Projected increases in growth are often dismissed by buyers as the owners don't have a track record to show the growth can be achieved or sustained. Buyers require a lot of convincing before they will accept growth potential as

part of a valuation formula, however, it is not impossible and I will show in a later chapter how this can be done. In the meantime, it is clear that such changes can have a dramatic effect on the valuation.

Impact of Different Step Changes in Profits on Net Present Value

Scenario	A. Flat Profit ($'000)	B. Small Step Change ($'000)	C. Large Step Change ($'000)	D. Large Change + 10% Growth ($'000)
End Year	**EBIT**	**EBIT**	**EBIT**	**EBIT**
1	1,000	1,200	1,300	1,430
2	1,000	1,500	1,700	2,013
3	1,000	1,700	2,200	2,764
4	1,000	1,700	2,500	3,370
5	1,000	1,700	2,500	3,707
6	1,000	1,700	2,500	4,077
7	1,000	1,700	2,500	4,484
8	1,000	1,700	2,500	4,932
9	1,000	1,700	2,500	5,425
10	1,000	1,700	2,500	5,967
Discount 15%	**5,019**	**7,946**	**10,701**	**16,431**
Discount 25%	**3,571**	**5,542**	**7,301**	**10,648**
Discount 50%	**1,965**	**2,919**	**3,669**	**4,878**

Again, you can see the dramatic impact of adding a growth component to the profit of the business. Such step changes are certainly possible given some planning and, perhaps, some investment on the part of the current owner. Most entrepreneurs know how and where their business could be developed, either given additional resources or simply more time and energy from the owner. You can see the impact of a step change of about 70% (by year 3) in the first example added between 100% to 200% to the value of the business. When a larger step change was combined with a 10% cumulative increase in profits, the valuation dramatically jumped 250% to 350%. In a situation where there was a step change, a continuing increase in profits and a significant drop in risk (discount rate movement from 50% to 15%) the increase in value was over EIGHT times.

While achieving actual or step change in growth might be beyond the capabilities and resources of the current owner, it is possible to put in the groundwork for growth, what I call the 'Platform for Growth'. That is, what can you do now to provide future profits in the business even if the actual results have not yet materialized? This is profit potential. Buyers are very hesitant to accept such projections but that is not to say they won't, they just need to be convinced.

Highly probable future profits based on projects which the firm undertakes before the sale which can clearly demonstrate profit potential can often be counted in with existing profit trends. In a later chapter I will show you what you have to do to provide a convincing case for profit potential.

Summary

This chapter is about valuation fundamentals. While many readers will have a grasp of how valuations are often undertaken, they may not have ever considered how to leverage the individual components of the formula to their best advantage. Too often conventional valuations are done by taking an historical average and multiplying it by an EBIT multiple to arrive at a 'fair valuation' without in any way justifying the result. Too often owners have accepted a valuation technique without questioning it because 'it is the norm in the industry'. However, these norms don't really give you a chance to be proactive in the way you prepare the business for sale.

Once you understand the basic theory behind valuations of high growth ventures, you can see that there are aspects of the business which you can work on to positively impact the valuation.

In the end, valuations are really very simple concepts. If you generate higher profits, your business is worth more. If the buyer has greater certainty of achieving the projected revenue and profit values, the buyer's risks are reduced and they will use a lower discount rate which in turn increases the value of the business. If the buyer sees greater potential in your business compared to other businesses they are evaluating, yours should be the one which is most attractive.

Look at what you may be able to achieve with a business which has a current EBIT of $1 million.

Activity	Impact Index	Value ($ million)
Current business (50% discount)	100 (1)	2.0
More efficient use of resources (+25% EBIT)	125 (2)	2.5
Reduction in risk (50% to 15% discount)	378 (3)	7.6
10% Annual Growth in profitability	664 (4)	13.3
Step change (year two increase of 20%)	728 (5)	15.5

Notes:

1. Assume that the current business has a valuation of 2 x EBIT and that little has been done to prepare the business for sale.
2. Some quick improvements in profits can be achieved with better use of resources, getting rid of idle assets, improving basic use of staff and watching expenses. Let us assume that this has increased profits by 25%.
3. Reducing inherent risks in the business and improving the reliability of revenue has a dramatic impact on the choice of discount rate. In this example the rate has gone from 50% to 15% thus increasing the EBIT multiple from 2 to 6. The reduction in discount rate also extends the number of future years that are considered thus increasing the impact of future growth.
4. By adding even a small incremental growth into future profits, the valuation can be substantially improved. In this example, I have added a compound 10% growth to profits.
5. Finally I have added a short term step change in forecast profits based on creating 'platforms for growth'. In this example the growth was relatively small only a 20% increase in year two profits but that amount of additional profit was then added to each future year.

More than a SEVEN times increase in value at sale!!

Even if the discount rate was increased to 25% to reflect a higher uncertainty of future growth, the increase in value would still be about 4 times the initial valuation.

Can this be achieved – absolutely! It just takes the determination to do it. It may also need some professional advice and some additional investment.

If the business was acquired by a publicly traded corporation, there is further upside potential as the normal PE of a listed company means they are trading at an effective discount rate of 5-7%. If the selling firm was able to extract some of this additional multiple into the sales price, it could add a further 25 – 100% to the sale value.

In the next few chapters, I will show you what you need to do to prepare your business for sale and how you can apply these approaches to leveraging your profit and profit potential to dramatically increase the price you receive for your business.

4

Increasing Sustainable Profits

Every business broker and professional advisor will tell you that you need to improve profitability if you want to increase the value of your business for sale. But where do you start and what process should you use? You look around your business and everything looks like it is running efficiently and you think you are doing a good job – so why would you think that you can easily increase the level of profits?

When you are running a business, you are consumed with the day to day operations and fixated on getting business in the door to cover the payroll. Rarely do you ever sit back and take the time to systematically review your business operations with a view to increasing profits incrementally. But this is what it takes to lift overall profitability – not the big bang, but little steps which gradually improve the overall productivity of the business.

Nor are you expected to know everything about how to do it. You may have attended a few seminars, heard some interesting speakers or even undertaken a degree program in management. But when it gets down to a list of things which you can do – for some reason the information is hard to find. In some cases it is worth bringing in a consultant, but only do so when you can see where they can make improvements – that is, have a good idea of where an improvement can be made even if you don't know exactly how to go about it yourself.

This chapter is not a silver bullet for increasing profitability but will guide you to where you might find some nuggets. What I am going to set out here are some common approaches to expense reductions, revenue increases, process improvement, better asset utilization and more productive use of personnel which can help you build a roadmap for your business improvement. Some will not be applicable because you are already doing a good job, others won't apply due to the industry you work in but some will open your eyes to new techniques. It does not matter what works, as long as some do. The end result should be a lift in your overall profitability and that will then be multiplied several times into your business valuation.

My approach is to do the simple things first and then tackle the more complex changes later. The list will cover the following:

- Increase revenue
- Clean up the business
- Follow the Money
- Benchmark your business
- Undertake process improvement

Increase Revenue

Most approaches to increasing profit focus on cutting costs and some of these techniques will be explained in this chapter, however, by far the most effective and certainly the most rewarding approach to increasing profits is to lift revenue through an increase in marketing and selling expenses or greater productivity of current sales and marketing resources.

A focused approach to revenue generation which examines systems and processes in marketing and sales will almost certainly uncover areas where improvement can be made. Many smaller businesses simply do not take advantage of the productivity tools now available for sales force management, customer relations management or lead tracking, yet significant increases in sales force productivity can be gained with the application of technology.

Research into high growth businesses has shown that they typically spend more on selling than marketing, focus on creating excellent customer experiences and generate a significant part of their new sales through referrals. They also have very high recurring revenue through both increased usage and cross selling. The lesson here is obvious – to what extent are you working your current customer base and what is the untapped potential under your nose?

Recurring revenue can be increased through longer term purchasing agreements, quantity price discounts, loyalty schemes, more frequent and personal contacts with customers, engagement of customers in business events and so on. Cross selling can be increased by introducing complementary products and services. Improving customer relationships should have a knock on effect on referrals.

By examining how sales resources are used, you will often find that sales staff are spending too much time on administration and this time can be better used if additional systems are introduced or additional administrative support provided. Where sales staff are overworked, additional sales staff can often greatly improve the productivity of existing staff.

Increasing recurring revenue and referral sales has a knock on effect on valuation. First, it can increase the profitability of the firm but, more importantly, it can increase the reliability of the revenue forecasts. As forecast revenues becomes more reliable, the discount rate used in business valuation decreases thus significantly improving the valuation of the firm.

Clean Up the Business

It is always easier to sell a tidy house. Sometimes it is as simple as putting things away, getting rid of the rubbish, mowing the lawns, trimming the trees, fixing the broken gutters and presenting the house in the best possible light. Some of what you are doing is temporary but other things you do will have a long term effect. The same logic applies to your business. There is nothing wrong with making the place look good and there is a lot you can do to make it more efficient.

Think about some of these activities:

- Sell old and unused equipment
- Remove rubbish, broken equipment and unwanted files
- Rent out unused space in the office, warehouse and factory
- Stop paying for activities which don't contribute to your business
- Remove your personal expenses from the business
- Outsource those things which can be done better and cheaper by someone else
- Consolidate operations which use too much space or resources
- Rent out unused car spaces
- Renegotiate your bank fees, volume discounts, telephone charges and other recurring fees
- Sell obsolete inventory
- Reduce loans with surplus cash to reduce interest costs
- Eliminate loss making product lines and loss making services
- Sell or lease out surplus land

Sometimes we just need a reason to look in all the cupboards and behind all the doors to see just how much we can save by doing the obvious.

Follow the Money

A very simple process for prioritizing where you should look for savings is to rank all your expense lines from the largest to the smallest. Too many people look for savings in things which are obvious but insignificant in the big picture. Thus saving 10% of the fax paper bill is peanuts compared to 10% off the payroll or manufacturing supplies. Once the items are ranked, start at the top and look for ways in which each expense can be reduced.

Ask the following questions:

Is this necessary?
Do we need to do it to this extent?
Could we do it better?
Could we achieve the same outcome with fewer resources or at a lower cost?

Could someone else do it better than us for less expense?
Where can we find out about how to do it better?

It is often simply a matter of attention. When an activity is not under scrutiny it tends to become less efficient over time. Don't try to do everything at once, just take them one at a time and work at it. Also, don't try to solve every problem yourself, involve other people in the process. You will be surprised what a little bit of collective and creative thought can do for generating ideas for improvements.

You don't have to improve each item by much to generate an overall impact on the bottom line. But remember that the change you make has to be sustainable. Taking costs out of the business which will have a detrimental effect long term will undermine your valuation, not improve it. Whatever changes you make should be documented and you should be willing to justify your changes to an informed buyer.

Benchmarking

Benchmarking is a process of comparing your operations with other similar businesses, with best practice in your industry and with world class companies. The purpose of benchmarking is twofold, it allows you to identify areas for improvement and it provides you with a strong and defensible case for changes which you make to improve your profitability.

Benchmarking can be used on both revenue and expenses. By reviewing the marketing and sales productivity of similar businesses, the firm may well be able to readily identify ways of generating additional revenue from its existing resources. Often firms find it easier to generate additional revenue than cut costs as there is a limit to how far costs can be cut before the fabric of the firm is undermined.

The key to any change is to be able to show that you made the change in such a way that the long term impact is positive and sustainable. Any change you make which you cannot justify on the basis of common sense or using an external standard is going to come under investigation. If it can be shown that the expense reduction was made simply to 'window dress' the business, the

buyer might withdraw, considerably increase the due diligence effort looking for other instances of manipulation or simply increase the discount rate. A short term gain could result in a significant drop in the value of the business.

A precondition to using benchmarking techniques to improve your business is that you need to implement metrics or performance measurement within your business in order to measure your performance against others. So the first thing you need to do is work out how you can measure performance across the entire company. In the initial phase, you do not need to set targets, you simply need to implement reliable measurements. Once they are in place, you can then begin to examine each one to see what improvements can be made. In some cases it will be obvious, especially those which have unreasonable fluctuations.

Ask these questions:

What can we measure?
How would we measure it?
How often can we or should we measure it?
What can we discover by measuring?
What can we do about it if we do find a problem?

Once you have made some progress in understanding the underlying factors which are impacting the level and fluctuations in activity level, you can start to establish targets for what you consider to be reasonable levels of acceptable performance. With more investigation, you should be able to find ways of improving performance.

Benchmarking Methodology

Unlike many management tools, benchmarking is an ongoing process. To support this continuous process, APQC uses a four-phased methodology that has proved successful for more than 25 years. The phases are: **plan, collect, analyze, and adapt.**

Plan

During this phase, the study focus area, key measures, and

definitions are established and clearly documented. Additionally, the data collection tools are refined and finalized, and research is conducted to identify the best-practice organizations to study. Representatives from the sponsoring organizations select the best-practice organizations to be visited.

Collect

This phase has two distinct objectives: 1) collect qualitative data and 2) learn from the best. The study questionnaire is administered to all participants, and the site visits are conducted at the best-practice organizations selected in phase one.

Analyze

Key activities during this phase include analyzing trends and identifying practices that enable and hinder superior performance. The study team presents a final report containing key findings and insights at a knowledge transfer session. At this concluding meeting, the sponsors discuss the key findings and have an opportunity to interact with each other and the best-practice organizations.

Adapt

Adaptation and improvement resulting from the best practices identified throughout a consortium benchmarking study occur after the participants take the findings back to their organizations. For an additional fee, APQC staff is available to help study participants create action plans tailored to their organizations based on the study findings.

Refining the Process

Organizations refine this model to meet their needs as they become more experienced in benchmarking. The number and names of steps are not as important as the use of an integrated, systematic approach to benchmarking. The time frame for each phase is typically:

30 percent - Planning the study,
50 percent - Collecting information, and
20 percent - Analysing performance gaps.

Source:http://www.apqc.org/portal/apqc/site/generic?path=/site/benchmarking/methodologies.ihtml Accessed 13th Sept 2005

Some activities will be deemed critical for performance setting and performance appraisal of an individual, group or department. These are often called Key Performance Indicators or KPIs. Improvements in KPIs are considered to be very important for improving the overall efficiency and effectiveness of an individual or group. Some care needs to be taken with KPIs however. It is very easy to measure the wrong activity or to set unrealistic targets. As a guideline consider the SMART guidelines for KPI use.

Use the SMART test

S = Specific: clear and focused to avoid misinterpretation.
M = Measurable: can be quantified and compared to other data.
A = Attainable: achievable, reasonable, and credible under conditions expected.
R = Realistic: fits into the organization's constraints and is cost effective.
T = Timely: doable within the time frame given.

Key performance indicators should be trendable, observable, reliable, measurable, and specific.

Source: http://www.mt-online.com/articles/0405meridium.cfm Accessed 12-9-05

Basic improvements should be quite obvious. More refined improvements might require more extensive investigation and, perhaps, external advice. At the same time that you are undertaking this activity, you should also be assigning responsibility for the activity. A principle of what has been called 'Open Book Management' is that every expense should be assigned to an individual. The cost or revenue item should be assigned to the person who has the most influence over the activity, or the most knowledge of how the expense is incurred. Their

task is to manage the activity or expense, suggest ways to make improvements and provide projections of that activity or expense for budgeting purposes.

Open Book Management

Post the numbers. Put up the numbers in an easy-to-understand format where everyone can see them. Set up a thermometer, a wall chart, or an area on your intranet. Pass out financial and operation reports with critical numbers highlighted. Ask for a volunteer scorekeeper. The scorekeeper's job: update the board as often as possible. Get the word out any way you can.

Teach the numbers. An important financial or operational number that nobody understands is meaningless. How do we measure operating efficiency? What counts as a warranty expense? Everybody in the company should know (and ideally be able to explain) the importance of key numbers. Give some pop quizzes, and hand out gift certificates or $20 bills for correct answers.

Brainstorm. How can we affect our numbers? Gather feedback from the people closest to the numbers. Conduct experiments. Get volunteers to research key variables and report back to the group.

Forecast the numbers. Can a department accurately predict where its numbers will be next month? Next quarter? If you can forecast a number correctly, you truly understand it.

Play critical-number games. Managers and employees set a short-term target for their critical number, with a small reward for success.

Develop critical-number bonuses. Your bonus system can be pegged to yearlong targets for your company's critical numbers.

Critical numbers get everyone in a company (not just managers!) looking at the same metrics and thus working toward the same goals.

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Source: http://www.inc.com/articles/1999/12/15979.html Accessed 4th January 2006

A critical part of any plan for releasing business productivity potential is to involve people from all over the company. You need to tap into their knowledge, ideas and enthusiasm and encourage them to be part of the improvement process. Developing measures of activity, setting targets and assigning responsibility, changes the way people think about their contribution to the firm. Asking them to get involved in forecasting activity levels taps into their intimate knowledge of what they do – probably a much better basis for forecasting than using a spreadsheet to assign numbers to expense categories.

> "The launch of the first "bottom-up" budget took months of coaching (and about 90 hours of managers' time) over a six-month period. Three budgets later, the process is much smoother. And the results are persuasive. Explains Wilson, "Employees were always saying, 'Why doesn't the company do this?' Now every issue comes down to a financial matter. The biggest payoff is that there are fewer disputes over day-to-day spending decisions." Also, expenses are running 15% below their 1991 levels now that 17 people control costs. That's helping profits: for 1994, net pretax income was expected to come in at 11.3% of $5.6 million in sales, up from 3.5% three years earlier."
>
> *Source: http://wwwinc.com/tools/2000/10/13788.html Accessed 12th Sept. 2005*

Active involvement of responsible individuals in setting and measuring performance will generate some interesting issues, such as:

Am I properly trained for the job I am doing?
What further education would I benefit from?
How are other people doing this job and what can I learn from them?
Do I have the right equipment to do the best job I can?
Am I in the right job – is there another job I am better suited for?
Do I have the right information to do the job I am doing?
What can I do in my job which could make someone else more effective?

The next step in using a benchmarking approach is to look for benchmark data for your industry and for world class companies which you can apply to your business. There are numerous sources of benchmark data in most countries and for most industries. You might start with your industry association and the department responsible for business activity in your local city, state or national

government. Ask colleagues in similar companies as well as customers, suppliers and strategic partners for contacts. A quick search of the internet will provide an extensive list of organisations which undertake benchmarking studies.

> The Benchmark Index is arguably the world's most extensive benchmarking resource for small businesses. It's aim is simple - to help you improve the competitiveness and profitability of your business.
>
> Run by the DTI and delivered via 2000 trained advisors from Business Links, trade associations, and private business support organisations, the Benchmark Index holds the financial data of over 156,000 companies and has a database of benchmarked performance data for a further 12,000.
>
> *Source: http://www.benchmarkindex.com/sb-fs.html Accessed 12th Sept. 2005*
>
> Each individual Benchmarking Guide title (over 80 of them) shows you step-by-step how to benchmark your business against your industry. Over 200 pages of essential information, split into 11 tabbed sections covering:
>
> What is benchmarking
>
> How to benchmark your business
>
> Key performance indicators
>
> Detailed industry statistics
>
> Identifying your strengths & weaknesses
>
> Action strategies
>
> Managing costs & suppliers
>
> Managing cash flow
>
> Managing personnel
>
> Marketing strategies
>
> Financial management

Benchmarking business planning

Business Resources

Source: http://www.ebc.com.au/product/product.asp?loc=4 Accessed 4th January 2006

Some benchmark studies are done within franchise networks. They share information between members to identify areas of improvement. Often managers contact each other to request comparison information and this way they learn what has worked best for others.

For example, my local supermarket receives regular reports from their Franchisor with regard to turnover ratios. Thus, if their percentage of sales from, say, fresh vegetables are below the national average, they can request advice on how they can improve.

Not all companies within an industry compete, especially if they are geographically dispersed and serve only a local region, thus sharing best practice information can help each company improve. Industry associations provide a useful forum for sharing such information. Often those who take the initiative to provide advice to others find they get back more than their share of useful ideas.

Once you have the benchmark information, you can start to identify areas where your performance is below industry average. This is where improvements should be made but also where improvements can be most easily justified to a potential buyer. The key question you always need to be able to answer is "Is this change for the better and is it sustainable?

Process Improvements

Process improvement is a technique which you can use internally to improve productivity, reduce costs and increase profitability. It can be used on any activity within the business including revenue generating processes. There are many approaches to process improvement which have been developed, often with a specific industry or activity in mind. Consider the following popular approaches:

Total Quality management (TQM)
Value Chain Analysis
Six Sigma
Value Engineering

You will see from the references below that these techniques all have a similar approach. In specific situations, specialist consultants may be required to assist in their implementation or to undertake a specific project. The overall objective is to move the business to a culture of continuous improvement.

a) Total Quality Management (TQM)

The Ten Steps to TQM are as follows:

1. Pursue New Strategic Thinking
2. Know your Customers
3. Set True Customer Requirements
4. Concentrate on Prevention, Not Correction
5. Reduce Chronic Waste
6. Pursue a Continuous Improvement Strategy
7. Use Structured Methodology for Process Improvement
8. Reduce Variation
9. Use a Balanced Approach
10. Apply to All Functions

Source: http://home.att.net/~iso9k1/tqm/tqm.html#Total%20Quality%20 Management%20(TQM) Accessed 13th Sept 2005

b) Value Chain Analysis

Value Chain Analysis is a useful way of thinking through the ways in which you deliver value to your customers and reviewing all of the things you can do to maximize that value.

It takes place as a three stage process:

Firstly with Activity Analysis, where you identify the activities that contribute to the delivery of your product or service;

Secondly with Value Analysis, where you identify the things that your customers value in the way you conduct each activity, and then work out the changes that are needed; and

Thirdly with Evaluation and Planning, where you decide what changes to make and plan how you will make them.

By using Value Chain Analysis and by following it through to action, you can achieve excellence in the things that really matter to your customers.

Source: http://www.mindtools.com/pages/article/newTMC_10.html Accessed 12th Sept. 2005

c) Six Sigma

Six Sigma stands for Six Standard Deviations (Sigma is the Greek letter used to represent standard deviation in statistics) from mean. Six Sigma methodology provides the techniques and tools to improve the capability and reduce the defects in any process

Six Sigma methodology improves any existing business process by constantly reviewing and re-tuning the process. To achieve this, Six Sigma uses a methodology known as DMAIC **(D**efine opportunities, **M**easure performance, **A**nalyze opportunity, **I**mprove performance, **C**ontrol performance).

Six Sigma incorporates the basic principles and techniques used in Business, Statistics, and Engineering. These three form the core elements of Six Sigma. Six Sigma improves the process performance, decreases variation and maintains consistent quality of the process output. This leads to defect reduction and improvement in profits, product quality and customer satisfaction

Source: http://sixsigmatutorial.com/Six-Sigma/Six-Sigma-Tutorial.aspx Acessed 13th Sept. 2005

d) Value Management and Value Engineering

The value methodology works through a VM study that brings together a multidisciplinary team of people who own the problem and have the expertise to identify and solve it. A VM study team works under the direction of a facilitator who follows an established set of procedures - the VM job plan - to review the project, making sure the team understands customer requirements and develops a cost-effective solution.
The VM job plan includes pre-study and post-study phases, as well as the value study itself, which is composed of six phases:

Information

Function analysis

Creative

Evaluation

Recommendation

Implementation

Source: http://www.value-eng.org/benefits.org/benefits.php Accessed 11th Sept 2005

Summary

Improving profitability by 10%, 20% or even 50% may not be that difficult – it all depends on where you start. What it does require, however, is a deliberate effort to do it, allocate time and resources to the activity, involve people throughout the business and to stick to it. Some of the methods you use will be very basic but they can have a dramatic effect. Others will require some homework and you will need to spend some time understanding how the techniques or approaches work.

Don't be so absorbed with improvements that you forget about running the business. Go for the easy ones first and put the others into a longer term schedule which can be undertaken as a background task when people have

spare time. For a larger business, consider bringing in an improvement specialist who can project manage the activity.

Watch out for quick fixes. There are lots and lots of business improvement methodologies which have been tried and few last more than a couple of months. They tend to go into the 'too hard' basket after some time. Look for ones which similar businesses have used with success. Talk to managers who have implemented improvements and find out what worked and what didn't. Make sure that what you take on, you have the expertise, motivation and commitment to see through.

There are numerous areas where improvement could be made, again 'follow the money', spend your time and effort where you can have the greatest impact. Use an '80/20' rule, 80% of the improvements will come from 20% of your business. Finally, make sure that whatever you do you can justify and will show you have made a lasting improvement.

5

Build a Platform for Growth

Business owners can substantially increase the value of their businesses if they can demonstrate that future levels of profit are higher than those currently generated. However, acquirers are skeptical and will need to see strong supporting evidence that the future profits can be achieved. Thus the onus is on the business owner to provide convincing evidence. Also, the more reliable future profit projections are, the lower the discount rate which will be applied to them.

We often forget that a forecast is simply an estimate of what might happen in the future. A forecast based on existing business and one based on potential business are only forecasts. Until one looks at the probability of the revenue occurring, you have no basis to judge the projected revenue. In fact, an agreement for a large project which has just been signed may be much more probable than some of the existing customer projections. A reduction in expenses which flow from the implementation of a new process may be relatively certain even if the adoption of the process has not yet commenced.

What we need to do in preparing our business for sale is to look at all the different ways in which the business could be improved/expanded and then select those which have a high probability of success.

There are many possible strategies for expansion which the owner could use. Consider, for example, the following:

a) New Products or Services to Existing Customers

New products or services could be developed which could be sold alongside existing products and services. These should be complementary to the existing range and able to be sold through the same distribution channel. The likely outcome could be demonstrated through market research, early customer orders and showing the channel has the capacity to handle the increased volumes.

b) Existing Products or Services to New Customers

Most businesses have a good idea of where they can expand their market, but they may not have the capacity or funding to undertake the expansion. The business owner would need to show market research to substantiate the market demand and perhaps show early customer orders to demonstrate this. A business proposal should show the investment required to penetrate the new market with projections of revenue, resources required and profits achievable.

c) New Products or Services to New Customers

The business may have the capability and capacity to introduce new products and services to a clearly identified new market. This may be based on underlying capabilities in product development, opportunities in importing or knowledge of available distribution channels which could readily support new business. This would need to be supported by an identification of the products or services to be introduced, a demonstration that the business has both the capacity and capability to be able to implement the new operations and market research to show the probable revenue and profit outcomes.

d) Product Extensions

It may be possible for the business to show avenues for increased revenue, either through higher prices and margins or through additional cross selling opportunities arising from further development in existing products. This would need to be evidenced by market research and/or requests from existing customers for such additional features. The extent of take up of the new developments would need to be substantiated with customer surveys and

perhaps early purchase commitments. The business would need to be able to demonstrate that it had the knowledge, experience, capability and capacity to develop and deliver the new offerings.

e) Additional Capacity to Meet Unmet Demand

A business which is able to show it has unmet demand could develop an investment proposal to increase the capacity of the business to satisfy the additional demand. The business proposal would need to show the business had the capability to undertake the expansion in management, operational and physical aspects. The unmet demand would need to be proven from lost orders, unmet enquiries and market research.

f) Potential Productivity Gains

The business may have the opportunity to take on new production or administrative processes which can show a well proven impact on revenue productivity or cost reduction. The new processes would need to be evidenced by similar gains in equivalent businesses. An investment proposal would need to demonstrate the applicability of the process as well as show the business had the capability and capacity to implement it successfully.

g) Expansion Through Acquisitions

Acquisitions can be made to expand the business. They could be undertaken to increase channel bandwidth, acquire strategic competencies which can be used to improve productivity, strategic assets which can provide additional channels to market or additional products or services which could be sold to existing or potential customers. The nature of acquisitions, however, shows that only a minority prove to add positive value to shareholders' net worth. Most fail due to inherent problems within the acquisition or through the integration process. The latter is often caused by a conflict of cultures or a management team inexperienced in acquisitions.

Thus possible acquisitions can be seen to be problematic by potential buyers unless the business can clearly demonstrate the firm can deliver on the profit potential. The target acquisition must be able to satisfy a serious due diligence and the acquiring business must have both the capacity and capability to undertake the integration and reap the benefits. Clearly this is a high hurdle

and would take some strong evidence of probable success. However, a business which can demonstrate a track record of acquisition success would have a strong case.

In the case of a potential acquisition, forecast revenue would only be capable of being included in the projections if the deals were either concluded or capable of being concluded within the near future. The due diligence would need to have been completed and a plan developed for integration and exploitation of the acquired business.

h) Acquired Rights

The business may be able to show it has potential revenue and profit growth through the recent purchase, or option to buy, new rights which have yet to be utilized or exploited. These could be based on patents, copyright, mining or forestry rights, or regulated licenses. Rights are especially attractive if restricted in supply or unique. The business would need to be able to show the revenue and profit potential of such rights and show it had the management, operational expertise and capacity to exploit them. Revenue and profit potential may be able to be demonstrated by prior activity, activity of similar businesses or guarantees associated with the rights.

i) Scalable Activity

A business may be constrained by a resource such as management, funding, plant and equipment or personnel. Expansion might require the buyer to resolve the constraint in order to take advantage of the potential. If it is simply funding, then the business owner should seek out a buyer who can inject new funds. If it is management capacity or other aspects of the business, the seller might wish to seek out someone within their own industry who could readily provide the assets or competencies to resolve the constraint. In all cases, the seller would need to show that the rest of the business would be able to meet the potential growth requirements once the constraint was removed and that the customer demand and profit potential could readily be achieved as a result.

j) Debt Leverage

The business might have the capacity to service additional debt but the current owners may not have taken advantage of that capacity. If the business

can show increased profit generation through the use of debt, such as providing funding for expansion, acquisition, overcoming constraints or implementing process improvements, the profit potential could be estimated. The business would have to demonstrate that it could manage the increased level of activity.

k) Underutilized Assets

The business may have spare capacity in assets which it has not utilised. A plan could be developed to show how the unused capacity could be put to work. The business owner would need to show the business had the capacity and capability to use the released resource productively.

Evidence of Potential

Claiming value in the sale price from potential business is difficult and requires the current business owners to produce evidence to validate the revenue and profit potential. Given that the acquirer is effectively paying in advance for business yet to be achieved, the quality and reliability of the evidence needs to be very high indeed. However, there are a number of techniques which can be used to demonstrate the validity of the projection.

a) Contracts or Agreements in Place

Where possible, a probable outcome should be turned into an established fact. Thus an actual contract or agreement which clearly ties up the potential of an activity carries considerable weight. Examples might include:

- Future customer orders
- Booked production capacity at a supplier
- Outsourced agreements
- Acquisition agreements
- Accepted offers of employment
- Options to purchase rights, locations and assets
- Agency or distribution agreements

b) Available Capacity

The ability to generate future revenue may require additional capacity

from a supplier, manufacturing, distribution, sales or management resource. Where spare capacity can be identified and shown to be relevant to the activity being planned, this will provide additional evidence to the acquirer. Supplier capacity might be shown by requesting available capacity or possible shipment dates from the supplier. Internal capacity might be demonstrated by showing utilization rates.

c) Process Impact

A new process could be internally developed or acquired. If internally generated, it would need to show the potential impact through trials or a partial implementation. Thus a new customer relations management system designed to increase account penetration might be trialed with a sample of customers to estimate overall impact. An acquired process may be able to use case study examples from the supplier backed up with testimonials or references from similar businesses. The business would need to show it had the capability to introduce and support the new process.

d) Prior Experience

Replication of a prior activity which has been demonstrated to be successful can be evidence of a potential improvement. Thus a business which has successfully grown by opening new offices might be able to show a plan of expansion with clearly targeted locations. Each location would need to show how it conformed to a set of attributes which in the past had been shown to be successful. At the same time, the business would need to show it was able to staff the locations with skilled employees and that it could handle the integration and administrative issues arising from the additional growth.

e) Market Analysis

Market research can be used to show that new products or services will be positively received into the market. However, a good deal of skepticism exists with respect to market projections as many have not proven to be very reliable in the past. The business may be able to show past market studies which have proved to be reliable, similar studies of other businesses in distant locations which prove market demand or in depth customer case studies which provide convincing evidence of meeting a clearly defined customer need.

Examples

Each business will have its own way to demonstrate potential growth. The reliability of that potential will, however, depend on how convincing the evidence is. Here are some examples of how potential could be demonstrated.

Example 1. Catering for Excess Demand

A restaurant owner is planning to sell his business but wants to increase the value on sale. He reviews his current business and notes that he has been turning away people on the busy nights and wants to capture this excess demand in the value of the business but knows that, unless the demand can be satisfied, it cannot be incorporated into his future sales forecasts. In reviewing the layout of the restaurant, he notes that the upstairs bar area is not generating the same revenue per square foot as the downstairs dining area. He thus develops a plan for renovating the upstairs area into a further dining area and reducing the bar area. At the same time he reviews the capacity in the other areas of the operation to ensure the extra dining needs can be satisfied.

The final renovation plan requires an investment of $150,000. This includes a new bar layout, decorating and furnishing the upstairs dining room and some additional equipment in the kitchen. He estimates the projected additional revenue from the renovations would add $30,000 net to the business each month. As part of his preparation, he applies and obtains planning permission for the renovation.

The key to this proposal is the validation of the excess demand. This could be done by personal inspection by the potential buyer on the busy nights or by examining the booking sheets. The projections by the restaurant owner need to show both evidence of excess demand as well as a viable plan to satisfy that demand. The additional demand projections could easily add a further $1.25 million to the sales value of the business.

If the excess demand was less predictable, the restaurant owner may need to go ahead with the renovations and show early uptake of the additional facilities. This would produce a sharp increase in the monthly profit but it could be shown that this was a permanent change given the new capacity. If the full impact over an entire year was not able to be demonstrated, the buyer may

discount some of the projected revenue but, even so, a substantial increase in sales price would still be achieved.

Example 2: Excess Warehouse Space on a Merger

A specialist textile manufacturer was considering selling the business. Prior to taking this decision, they had been seriously considering a possible acquisition of a similar business in an adjoining state. The two businesses were of similar size, each generating about $7 million in revenue and about $500,000 in EBIT. Both businesses import cleaning cloths for the catering industry from common suppliers in Asia. They had been in discussions for some time but had not concluded an agreement. Combining the businesses would result in excess overall warehouse capacity and it is estimated that one of the two major warehouses could be closed with an annual savings of close to $200,000. The overall impact on the sale price of the business could be $1 million.

In preparing the original business for sale, the owner could put up a proposition showing a potential buyer the advantages of acquiring the second business with the subsequent savings, however, a proposal of this nature has high risks associated with it. What if the other business decides not to sell? What if there are union problems with closing the warehouse? There are simply too many unknowns. While it may make the original business more attractive, it is unlikely to add to its sale value.

If, however, the acquisition deal had been negotiated and an option to buy put in place and a viable plan for warehouse consolidation produced which could be examined by the buyer, the buyer should be willing to add some of the additional projected profits to the value of the business. Of course, if the consolidation had already been achieved, the resultant savings could be proven. Future profits would then be at a much higher rate than historical ones.

The acquisition option could have been more substantiated if the business owner had shown there were several possible target acquisitions and that the potential savings applied to a number of them. If the first acquisition had already been assimilated, a plan to show additional profit growth through replication of the strategy would certainly add to both the attractiveness of the business as well as to the potential profit growth.

Example 3: Development of a Financial Planning Business

The founder of a financial planning business is considering selling his practice but wants to generate a higher value than he can justify from his current revenue and profit stream. His business is located along the coast and services local tradesman, retail shop owners and professional practices. In seeking additional revenue and profit opportunities, he has identified a number of strategies:

- Cross sell additional planning products and advice to existing clients
- Move high net worth clients to a high touch advice model and less wealthy clients to a low touch transaction support model
- Acquire other poor performing local financial planning practices and improve their productivity and profitability
- Open new offices in nearby coastal towns
- Add additional planner capacity so that his own productivity increases

While all these strategies are possible, it is unlikely that a buyer will pay for unproven potential, therefore the business owner needs to implement each strategy sufficiently to be able to validate the impact of the new activity on the business profitability.

A trial cross selling project into a sample of clients could prove out the cross selling opportunity and the long term impact on the business could then be estimated. The same approach could be taken with a sample of high net worth individuals. The acquisition potential could be examined by targeting some local practices, doing some due diligence on their practices, identifying the differences in practice profit through benchmarking and then putting selected practices onto an option to buy. If this process had been used in the past to expand the existing business, it would have even greater credibility.

The strategy of opening a new office would be somewhat speculative unless some market research could support the extension to the business. This would have more credibility if an office location had been found and potential staff for the new office had been identified. The impact of an additional planner could be shown by demonstrating unmet demand or long lead times for existing transactions.

Summary

Businesses which have higher growth rates and can demonstrate an increase in profits in the future are able to command higher selling prices. The common way of valuing businesses has been to demonstrate the maintainability of past growth rates as evidence of future potential, however, without supporting evidence, there is nothing to suggest that such growth can be sustained in the future. Most business owners think that they can only prove the capability of the business by showing actual historical profit achievements and that is all they anticipate getting value for. However, potential profit which can be well documented and strongly backed with evidence can provide the basis for a significant increase in sales value.

Building a platform for growth means putting in place the capability to produce additional revenue and profit in the near future, it does not necessitate that the products, processes, rights and activities be fully implemented, only that they can be with a high degree of probable success. While building such capability might incur current costs, the future potential might provide significant returns on such an investment. The business owner should take time to consider the various ways in which additional future profits could be generated and then consider which activities would need to be undertaken prior to the sale to clearly demonstrate that the potential profits can be readily achieved.

The message here is compelling; potential profits can be drawn into a sales value to the extent that the business can show that the buyer has a high probability of achieving them, even if this requires additional investment into the business.

6

Finding Financial Buyers

There are two major types of acquisitions, strategic and financial. The strategic buyer seeks out businesses which have underlying assets or competencies which the buyer can leverage to create significant revenue opportunities through the combined operations. They might be looking for products they can sell through their own distribution channels or for underlying intellectual property which they can utilise in a wider business. The other type of buyer is a financial or investment buyer who is buying a business to receive the profit benefits of that business, often without consideration of any synergies which might be gained through integration or central administration. It is this latter type of buyer which is the focus of this chapter.

Financial sales can still have some synergistic benefits for the buyer. Some financial buyers seek acquisitions because they are consolidating a number of similar businesses where the aim is to build cumulative capacity in terms of revenue. The synergy in the consolidated business comes through economies of scale. In this situation, it is very difficult for the selling firm to achieve a premium unless they are a key firm in the industry and their acquisition can convince others to join the consolidated entity. Alternatively, they could have some management processes which can take additional costs out of the combined entity. However, since the dominant benefits come from the inherent revenue and profit generated by the acquired business, this is still regarded as a financial sale.

Businesses which are valued at under $2 million are often purchased by individuals. These might be people with inherited wealth or have come into a windfall through a lottery or insurance payout or have received a redundancy payment or golden handshake on leaving their prior employment. They may also be retired and looking for somewhere to invest their funds. While some may have come from the same industry as the vendor, many will simply be looking for a business to buy. Most often they will be working with a local professional firm or business broker.

Larger businesses are normally purchased by companies looking to expand or investment funds or trusts seeking a good investment for their funds. Business buyers for larger businesses will normally work through a larger professional firm or investment bank. The majority of buyers for larger businesses come from companies which are already in the same industry. They may be seeking to expand vertically by buying a supplier or customer or horizontally by buying a similar business. If it is not a strategic acquisition in an unrelated industry, they can still gain synergies from economies of scale in administration and central services, but they prefer to buy businesses in industries which they understand.

A vendor is normally in a much better position to influence the sale process if they already have some knowledge of the buyer. The vendor may already have some knowledge of prior acquisitions which the potential buyer has undertaken and therefore know how they treated prior owners and acquired staff and they may also know how well the acquisitions turned out. Clearly, as a seller, you would prefer to deal with a company which had a good track record of acquisitions. Contact may be able to be made some time in advance of actually deciding to sell, thus allowing the potential buyer to know that a future sale is possible. This then puts your business on their acquisition map and allows them to start thinking about how to best take advantage of the potential opportunity.

Once a potential acquisition is registered with a sophisticated acquirer, they undertake some level of investigation into the business, its products, its customers and management. They start to accumulate information about the business for future reference. Often they will take steps to build an informal relationship with senior management to get to know them, to begin understanding their business culture and their future career objectives. These

discussions often occur at industry functions, charity events and local public celebrations.

Somewhat open discussions have a considerable advantage for both sides. The potential buyer is given notice that a related business might be coming onto the market and can do some preliminary investigation to see if they are interested. This will later greatly speed up the due diligence process. On the other hand, the vendor is building up interest, hopefully across a number of potential buyers, so that when they want to sell, they can quickly set up a bidding process.

Even smaller firms can benefit by promoting their business within their region and in their industry to executives who might be looking to run their own business. Thus active participation in the industry association, local business development activities and local charities, will bring the business owner into contact with a network of potential buyers. At some point, the owner will need to indicate that he or she is interested in retiring or selling, but this can be done without putting pressure on the business or without indicating that the business is in a fire sale.

There are a number of guidelines and questions which can be used to identify likely buyers:

- Who has a similar business and has expansion objectives?
- Which companies in my sector have recently undertaken acquisitions?
- Which companies in my industry have surplus cash?
- Which companies in my industry have announced a public listing?
- Which companies have recently announced a consolidation program?
- Which companies have recently sold off part of their business?
- Establish contacts through recently sold businesses
- Which businesses are similar to mine in different geographies?
- Who sells to the same customers I sell to?
- Who needs my people?
- Can I sell out to my managers and/or employees?
- Are there industry executives retiring who might buy?
- Are there industry executives being made redundant who might buy?

- Use your networks
- Use the broker networks and 'Businesses for Sale' magazines

Who has a similar business and has expansion objectives?

Often there are companies within an industry which are aggressively expanding. Some companies have a desire for growth, have the management team willing to put the energy in to expand and manage multiple businesses across several locations and have access to finance to execute expansion plans. Often they have a strong competitive position, are achieving above average profits and are using these to fuel an expansion strategy. They may be backed by a wealthy individual or a private equity firm or be publicly listed and have access to the funds for acquisitions.

While they are seeking profitable firms, they also bring greater scale to the acquisition and can often generate additional profits through more economical central services, better procurement, more sophisticated internal systems and more experienced management. They will often have mapped out the industry and identified potential acquisitions and be actively working with professional advisors on current acquisitions.

The good news for the vendor is that these firms are relatively easy to find as their acquisition activities are openly known within the industry and to the established professional advisors. Thus an approach can be made directly or through a professional advisory firm indicating your interest in a future transaction.

Which companies in my sector have recently undertaken acquisitions?

Any company or investment fund which has recently undertaken an acquisition is a potential acquirer. The vendor should search out any acquisitions which have been undertaken over the last several years. Any company which has been through a successful acquisition could be interested in looking at another acquisition, especially one which is well prepared and has good profit potential. The vendor can often access this information through public sources. Certainly

a professional services firm which has a mergers and acquisition (M&A) practice should be able to obtain details of these transactions. The vendor might also be able to gain information on such acquisitions through industry networks.

Which companies in my industry have surplus cash?

While many transactions are made for stock, the majority of smaller acquisitions are made for cash. Thus a larger company within the industry which has a healthy cash surplus might be interested in looking at an acquisition if presented in the right light. A lot of companies are wary of acquisitions because they often don't have the expertise or management time to undertake the due diligence and integration process but a firm which is well prepared might be able to overcome that resistance with a convincing case.

Which companies in my industry have announced a public listing?

A public listing is often a forerunner to an acquisition program. Companies which have listed on a public market need to maintain growth in revenue and profits to capture the interest of the public investor and to maintain and increase their share price. In fact, many newly listed firms are quite open about seeking acquisitions. These companies can be approached and a tentative discussion started. While they are consumed with their listing, they probably won't wish to pursue the discussion actively, however, sometimes they wish to undertake an acquisition before going public to gain greater attention or have the acquisition in the pipeline for a time soon after the listing to gain traction.

Which companies have recently announced a consolidation program?

Some companies openly announce an acquisition or consolidation program in order to gain the attention of potential vendors. Clearly it is easier for them to have a discussion with an owner who is open to an acquisition than to knock on doors randomly. An approach can be made to them directly or via a professional advisor. Details of the selling business can be passed to them confidentially by a professional advisor without providing identification information to see if they have an active interest.

Which companies have recently sold off part of their business?

Larger companies which sell off part of their business often do so to rationalise their operations. At the same time, they often wish to expand their core activities and have the cash from the divestment to finance new acquisitions. Professional advisory firms normally have information on divestments and can advise whether the funds are being used to pay down loans or to make future acquisitions. Again, a discreet inquiry directly or through a professional advisory firm can be made.

Establish contacts through recently sold businesses

A firm which has recently been sold which is similar to yours may have had several potential buyers, only one can be successful. The prior owners may be willing to pass your details on to those who were not successful since clearly they are in the acquisition process and looking for your type of business. The entrepreneur may also be willing to advise you on which ones are the better ones to deal with.

Which businesses are similar to mine in different geographies?

Acquisitions are often made by entrepreneurs seeking to expand by buying a similar business in another geography. Since they already operate a similar business, they know what they are getting into, understand the market, the target customer and the risk of working within the sector. They may not have publicly expressed a desire to expand through acquisitions but may be interested if the right proposition presents itself, especially if the vendor has created an efficient business which can be managed at a distance.

Who sells to the same customers I sell to?

Scanning customers to find another company which sells complementary products or services to them will often indicate a potential buyer who can capitalize on knowledge of that customer sector. They may be able to cross sell products or utilize their own distribution channel to introduce new products.

Who needs my people?

Some industries have a real shortage of qualified staff. A business which has a desire to expand may be frustrated by not being able to recruit good staff. An

acquisition might be attractive to them if it comes with some employees who can be used more widely across the business or can fill important executive positions in the larger entity. A business which is increased in size through acquisitions might also offer their existing staff more career prospects and thus retain employees who might otherwise leave.

Can I sell out to my managers and/or employees?

Management buyouts are quite common where the owner is prepared to wait for all or part of the purchase price. Often the sale will be secured on assets of the firm or the assets may be split with the owner holding title to a building or other property. Additional debt may be raised from the business to assist with the buyout. The difficulty many owners have with this type of sale is that the payout may well depend on how well the business performs after the sale. The profits from the business may be used to fund the buyout or the retirement of personal debt which has been used to finance the sale. If the business gets into trouble, the funds may not be realised to finalise the purchase. The owner may have to come back into the business or find another buyer for a company which is failing.

Are there industry executives retiring who might buy?

Retiring executives, or executives wishing to make a change out of a large corporate business, are often very interested in buying a smaller company where they can build wealth through capital gains. However, these individuals don't normally advertise that they are looking and therefore you need to actively network within the industry to have your name brought to their attention. Promoting your company in the trade journals through public relations activity, writing articles and advertising can help establish your name with interested parties. Being active at trade functions and getting involved in trade association activities will also help bring you into contact with other business owners and industry executives.

Are there industry executives being made redundant who might buy?

Large corporations often retrench in downturns and will often make generous payments to senior executives they wish to let go. If you know of this happening, you might contact their HR department to see if they would be

willing to provide you with a list of introductions. You might be interested in hiring an executive or in taking on a possible General Manger who, in time, could buy you out.

Use your networks

Most often businesses are bought through some personal connection. This could be within the industry, through a trade association, a charitable organisation or through business contacts in your local community. You should be casting the net reasonably wide to give yourself the best opportunity of finding the right buyer.

Use the broker networks and 'Businesses for Sale' magazines

There are numerous web sites advertising interested buyers. These are investors looking for general businesses, companies looking to expand and executives looking to buy with their retirement funds. By searching through these sites you might be able to establish a database of contacts you can use at a later date. When there is no pressure on you to sell, you can be making contact with the site owners to establish your interest. The same applies to magazines advertising sellers. Simply make the contact to see who the buyers are and what their interests and timescales are. Some buyers are always looking and often buy. Having them in a database to contact at a later stage will make the final part of your sale easier. Instead of looking for buyers, you will already have a database of interested parties.

"If you're not so concerned with keeping your plans quiet, you may want to consider a campaign targeting thousands of potential buyers via direct mail. Wellesley (Mass.)-based New England Business Exchange, the M&A specialist that sold Knight's business, sends out up to 10,000 letters to investors and CFOs in related industries, among others, describing the company for sale in generic terms. A mailing typically gets 50 to 250 responses. After interested parties sign a confidentiality agreement and send a preliminary letter, marketing books get sent out. Ultimately, five or so prospects end up bidding against one another. ``This auction process will get you a higher price than a quiet deal,'' says Stephen Madden, president of the New England

Business Exchange. Since it will also likely turn up rivals as buyers, it may not be best for companies with patents, trade secrets, and other confidential information to protect.

Source: *PUTTING YOUR COMPANY ON THE BLOCK , By: Gutner, Toddi, Dunkin, Amy, Business Week, 00077135, 01/26/98, Issue 3562*

Split sale

You might discover that your business is too large or too complex for a single sale. It may be more productive to split the business up into components, each representing a well defined stand-alone business. Preparation for sale could also be phased over time where each segment could be positioned and developed prior to sale.

Further Considerations in Selecting the Buyer

With smaller firms, the acquisition might be done by an individual, either a cashed up entrepreneur, a retired executive, a wealthy individual looking for a business to run or someone wanting to move out of a large corporation into an activity where they can build wealth. Larger businesses, say over $2 million, will normally be out of the price range of individual buyers. For the larger business, the buyer might be a corporation looking to expand and seeking complimentary acquisitions or an investment fund or trust looking to add a profitable business to their portfolio. Finally, it could be a private equity fund seeking a business which could be developed and sold or listed. Each of these groups of potential buyers has very different objectives and very different criteria for what they are seeking.

A. Non-Corporate Buyers

Most medium sized businesses are acquired by corporations who want to expand or want to take advantage of some economies of scale. However, there are other buyers with different motivations.

1. Individuals as Buyers

An individual seeking to buy a business is most often a cashed up executive, either from the sale of a previous business, or has accumulated money from an insurance payout, a retirement fund or been made redundant and has been given a generous redundancy package. Most of these potential buyers are seeking businesses they can develop themselves. Not that they are necessarily looking for bargains or fire sales but they anticipate working in the business to create personal wealth and thus want to see how their own knowledge, capabilities and networks can be used to develop the business.

A business which is well run, profitable and on a growth curve, may not be of great interest to them as they will have to buy future potential rather than develop it. This type of buyer normally expects to take over as the CEO and is likely to want to retain the senior management team. Sometimes they are interested in the prior owner continuing to work in the business, but normally only as a transition arrangement.

The vendor will wish to find a buyer who can clearly execute on the growth potential of the business. Thus the buyer should, ideally, have experience with a somewhat larger business so that they understand how to manage the business which the vendor's firm will grow into. They should be familiar with the industry, have good networks within the industry and be able to show they have general management experience rather than come from a specialist functional role.

Potential buyers who have already operated a similar business successfully and sold out, will be of special interest to the vendor. Their background can be investigated, past employees can be interviewed and the buyer of their previous business can be asked to comment on the state of their prior business before and after it's sale.

Business brokers and smaller professional services firms often know of individuals seeking to buy a business. Thus making contact with local firms, networking within the industry and advertising the business through trade journals and via businesses for sale websites is probably the best way to generate a list of interested names.

Here is an example of such a listing:

"**HADDONSTONE THE STONEMAKERS** *Manufacturer of reformed sandstone at its factory in the NSW Southern Highlands. In operation for 22 years it produces high quality paver, pool coping and dry walling plus an extensive range of architectural products for the residential and resort markets. Sales $2.5m and capable of significant growth. Indicative asking price including stock $1.3m.*

BUILDING MATERIALS SUPPLIER *Distributor and reseller of products used in commercial and industrial construction. Sole agency for imported product line and manufactures own brand major product. Established over 30 years has an excellent market reputation. Backed by experienced sales and operational team using focused IT systems. Annual sales approaching $5m achieving 25% GP.*

CIVIL CONSTRUCTION AND DEVELOPMENT GROUP *Highly profitable business undertakes civil engineering/construction projects for both private and government clients and its own land subdivisions. It owns all premises, plant and equipment and a residential land bank, which is being constantly developed and replenished. Managed by experienced and loyal staff the business has been profitable for over 20 years with 2004 pre-tax earnings exceeding $11 million.*

STORAGE AND HANDLING EQUIPMENT *Manufactures wide range of storage and handling equipment for hospital, food service, supermarket, commercial kitchen and cold storage use. Proprietary lines are protected by patents. National distribution network comprises 350 dealers. Annual sales $6 million with return to owner/operator of around $700,000."*

Source: http://www.jamiesons.com.au/businesses-for-sale.html Accessed 10th Sept. 2005

Individuals buying businesses often search through business for sale listings looking for an appropriate business to buy.

2. Investment Buyers

Some individuals, property trusts, investment trusts and private pension or superannuation funds are interested in investing in a private business purely for an economic return and have no intention of actually running the business. They look for well run companies with strong management teams and good sustainable profits. Their normal mode of operation is to renegotiate the senior management team employment agreements to ensure the senior executives are motivated to stay with the business and to build the business over time. They would normally restructure the Board of Directors and implement a Board of Advisors if they deemed that useful.

This is normally not a quick path to retirement for the prior owner however. Unless the investor can be convinced that the chosen successor has the experience and ability to take over the business, this is something which might have to be planned over a longer period of time. For the entrepreneur who wants to phase out of a business, or simply wants to cash up to fund their retirement but doesn't want to give up working in the business, this may be a very successful strategy.

3. Private Equity Firms

Private equity (PE) firms usually manage investment funds on behalf of wealthy individuals, pension or superannuation funds or investment trusts. The money is pooled and then invested and managed on behalf of the private investors. Most funds have a limited life of ten years by which time they need to have sold their investments and returned the funds, plus any capital gains, to the private investors. PE funds seek a return above the rate of return which could be achieved by investing in property or the public securities market. Thus returns in excess of 15% are expected from a PE fund. However, because some investments may fail to deliver the anticipated returns, the PE firm will look for opportunities where a 25%, or greater, return can be achieved.

In some cases, PE firms will seek out under-performing businesses to purchase. They anticipate they can redevelop these, put them on a higher profit run rate and generate growth through better management. Other businesses are purchased which can be put together with one or more acquisitions to create a business which can be sold to a large corporation as a strategic sale or listed on the stock exchange. Thus a business which is well run, profitable and growing may not present the ideal vehicle for a PE firm to leverage its investment.

A well run business with good systems, a strong management team and good growth potential might, however, provide the keystone in a roll up strategy. In this strategy, the initial acquired business is used as a platform to undertake further acquisitions until a much larger entity which can benefit from economies of scale can be built. At this stage, the business might be floated on the stock exchange or sold to a large corporation.

Roll up strategies seem to work best in fragmented industries where there are numerous potential acquisitions which do similar work in different regions or where products or services complement each other when they are aggregated. Often the PE firm is prepared to take on the task of management of the business at a Board level, putting in place a new or restructured senior management team. The PE firm will often inject new funds into the business as well as take on further debt to finance business restructuring, acquire updated plant and equipment, introduce more formalised reporting systems and fund complementary acquisitions

PE firms are also prepared to work with entrepreneurs on a phased acquisition or a longer term joint exit. In this scenario, the entrepreneur sells down part of their equity enabling them to liquidate part of the wealth locked up in their business. The PE firm then works with the entrepreneur to build the business for a trade sale or public listing.

B. Corporate Buyers

Most acquisitions above a few million dollars are done by corporations which are interested in expanding or consolidating firms within a specific industry. Selling for cash is obviously desirable if your tax situation can be optimised for this type of transaction. However, there is little point in being acquired if you don't achieve your priority objectives. If harvesting the value in your business is the primary objective, selling for shares in a privately held business where you are a minority shareholder is not an effective exit. This makes the publicly listed corporation a much more attractive target. Once the listed shares are held past the lock down period, they are normally able to be freely traded, although if you continue to work for the acquirer you may be subject to some restrictions. Alternatively, selling the business operations but keeping the freehold title to land and buildings might be an attractive option. Part financing the transaction may be an option but you need to review the possibility that the business may get into trouble and/or the new owners are unable to repay the loan.

Normally you would want to exclude any corporation which does not have a healthy business in terms of potential growth and reasonable profits. You need to be assured they have the capacity to execute on the deal and won't be wavering when something else goes wrong with their existing operations.

Your selection criteria for the buyer should also look at their experience in acquisitions, whether they have dedicated staff to handle the negotiations and integration and whether you think they will be a willing rather than a reluctant buyer. You don't want to spend your time educating the buyer on how to do an acquisition nor do you want to be dependant on them making it work where you have some possibility of a claw back or potential litigation if they fail.

While it might look attractive to squeeze the last drop out of your buyer, you should try to avoid the naive buyer. There are some very good reasons why you may want to limit your selection of potential buyers to those companies which have a good track record of successful acquisition.

There is now considerable research available on acquisitions and their impact on the acquiring corporation. A 1999 study by KPMG found that 83% of mergers failed to unlock value. A 2004 study by Bain & Company of 790 deals made by US based companies from 1995 to 2001 confirmed prior research that '70% of all deals fail to create meaningful shareholder value". It would seem that the likelihood of success in a merger or acquisition is against the acquirer.

A more recent Bain & Company study of seventeen hundred large public companies in six industrialized nations spanning the time period of 1986 to 2001 did uncover corporations which were consistently successful in their M&A activities.

Bain found that corporations which were successful had several characteristics in common:

- They were frequent acquirers. That is, they had an M&A program which undertook regular acquisitions;
- They typically started with small deals and gradually became more expert at acquisitions, then progressed to larger deals;
- The size of the deals was generally small – often less than 15% of the parent company's capitalized worth;
- A clear return on investment case was made for the acquisition and they were prepared to walk away if their criteria was not met;
- A comprehensive due diligence was undertaken of the potential target with a strong emphasis on the integration effort. This included a serious consideration of the culture match between the two businesses;
- Frequent acquirers set up benchmarks so they know the integration effort is on track and have processes to deal with under-achievement; and
- Successful acquirers have an acquisition strategy which targets potential firms which offer value to their core business and build relationships with them prior to formal discussions.

Source: David Harding and Sam Rovit, Mastering the Merger: Four Critical Decisions that Make or Break the Deal , Harvard Business School Publishing, November 2004

Culture is seen to be critical in most acquisitions. Only where there is almost no integration can unlike cultures co-exist. The more integrated the planned, combined operations will be, the more critical it is that pre-acquisition cultures are compatible. The seller needs to acquire a good feeling of the match between cultures. Spending some time with the other party pre-acquisition is essential to avoid a disaster.

It is in the best interest of the seller for the acquisition to be successful, even several years after the deal is done. A successful acquisition will minimize the likelihood of post acquisition litigation. Where there is a choice between potential acquirers, the seller should give the culture match serious thought. You want a successful integration of your business into the buyer's and for them to achieve the benefits of the acquisition.

The experienced acquirer will have a senior member of their executive team who has primary responsibility for assessing potential acquisitions. This also makes your task easier as there is a name for you to contact. Since that person performs only by making acquisitions, they need to have a pipeline of possible acquisitions. Their job includes setting up relationships with potential targets and thus you are helping them achieve their objectives by approaching them with a possible future deal. This makes your task easier as they may assist you in setting up other contacts within their firm so you can better understand how your firm might fit into the larger business.

The strategy for the potential seller is very straight forward. Identify those corporations in your industry or adjacent to it which can best manage your type of business, establish a relationship with them to allow dialogue and then build a case to show them how the acquisition can work for them. Give preference to those corporations which have been successful in prior acquisitions as they tend to be more serious, more diligent in their approach and more likely to conclude a deal which makes economic sense. Then, wait for the offer or decide when to make an approach to them.

The Right Buyer

Clearly successful acquirers rarely overpay for their acquisitions and so it would appear that your chance of generating a high multiple on the sale of your business which takes into account future profit growth potential would be minimal. However, it is clear that successful acquirers also look carefully at the potential acquisition and will do their own investigation of the forecasts. If the numbers hold up to serious scrutiny and the profit potential has a high probability of being realized, a higher price can be obtained. The firm which can show it is efficiently managed, has limited risks in the acquisition, is prepared for the transition and where future growth can be readily generated, should be a good acquisition target.

Your proposition to a potential acquirer should show the buyer how they can exploit the growth potential in your business. Most private firms are constrained by limited resources, lack of funding, an inability to recruit the best people due to their size, a limited distribution channel or small customer base. Often these elements are exactly what larger corporations have in abundance. This presents a great opportunity for the acquirer to provide the resources needed to grow the vendor's business. The key is to find the right buyer which can readily exploit its potential. If you can show how additional revenue and profit can be generated, it is certainly possible to extract a higher EBIT multiple on the sale of the business.

There are some other good reasons why you might want to look for competent and successful acquirers. Generally they understand what to look for, thus their due diligence will be thorough. If they find a serious problem they will request it be fixed, make an allowance to fix it or walk away. That means there are unlikely to be hidden rocks which can catch you out later on. The last thing you want is for the buyer to litigate you over something which could have been discovered during the due diligence process. A buyer which is making lots of money from an acquisition is less likely to worry about a few problems which they uncover. However, a deal which goes sour will find the buyer going over every inch of the business trying to find how they can litigate to get their money back.

The successful acquirer who pays a high price for a business which incorporates growth potential is also less likely to get rid of your employees.

They acquire the business because they see potential in it. It is most likely that the potential needs to be supported by your previous employees, thus you are also taking care of your loyal employees by finding the right buyer. Successful acquirers also understand how to manage the handover process and are less likely to lose good people through a lack of understanding of the degree of change they are being put through.

Frequent acquirers will almost certainly have a formal process of evaluation, due diligence and integration. They will have learnt from their mistakes and built up an accumulated knowledge of what works and what does not. This should mean they won't waste your time while they figure out how to do the deal. They also might be willing to share some or all of that information with you in a friendly deal so that the final outcome is better for both parties.

If they have a formal process, you might be able to review it to see if you fit the acquisition and return on investment (ROI) criteria. Again, this helps you weed out potential acquirers where you are not able to meet a critical requirement. However, where you clearly meet their conditions, this helps you gain more attention during the relationship building phase.

Frequent acquirers know the importance of undertaking friendly acquisitions. Companies which have been through hostile takeovers understand the levels of stress placed on both organizations, the loss of staff during the process and the difficulty of later integration. Where they can, acquirers would rather build a mutual case where both parties are comfortable with the acquisition. By undertaking this over a period of time, both parties can sort out the most appropriate integration level and use the time to convince the best people to stay with the merged business.

If the potential buyer has made prior acquisitions, part of your due diligence should be to examine the success or failure of their previous acquisitions. Serious acquirers understand this and should be willing for you to interview the founders and some of the former executives who stayed with the merged business and perhaps some of those that left. Your objective is always to produce a deal which works for the buyer while allowing you to achieve a good sales price. By reviewing their prior acquisitions you can see if they have a track record of making deals successful for the sellers as well as for themselves. Were

the sellers happy with their deals? Were any of them sued after the event? Did any of them stay with the merged company – what was their experience? How did the earn-out conditions work out?

Strategic Exits

7

Threats and Opportunities

Fundamental to the strategic value exit is the identification of those assets or processes which the seller has which can solve an urgent problem or open up a significant new revenue opportunity for a select group of potential acquirers. To fully appreciate how a strategic exit is created, we need to have a good understanding of the nature of threats and opportunities and how we match these to assets and processes to create strategic value. In the next chapter we will review the criteria which can be used to identify which assets and processes are appropriate for strategic value exits.

The nature of strategic value is that it directly impacts on the ability of a large corporation to achieve its strategic objectives. Thus any threat to its existing business needs to be countered with a solution. This is often acquired from outside the corporation if the price is less than the loss which would be incurred without the acquisition. Similarly, revenue objectives may be enhanced by introducing into the corporation an asset or capability acquired through an acquisition.

Large corporations don't just make acquisitions to solve problems, we should be alert to the fact that most large corporations buy in their revenue generating innovations. Thus a small company which can offer an innovation which enables

a large corporation to generate significant new revenue would be an attractive acquisition as long as the investment provided a healthy return.

Note that in both these situations the strategic value of the acquisition is related to the problem or opportunity being addressed by the acquirer not the conventional financial value of the business being acquired. This is the key to extracting a premium on sale.

Finding Buyers with an Urgent Problem

One approach to finding the right strategic acquirer is to find a potential buyer who has a serious problem you can solve. This may seem simplistic but there are countless acquisitions which are made for exactly this reason. The task of the seller is to be proactive in seeking out corporations where the firm can take away a serious problem or threat. Those targeted potential acquirers which have a serious problem which can be resolved by the selling firm should offer a significant chance for the selling firm to achieve a premium on the sale of their business.

To better understand the circumstances which drive this type of acquisition, think of the 'problem' or threat as a potential or actual reduction in current or forecast revenue if no counter action were taken. Normal business life is littered with such threats stemming from price wars, introduction of new technology, new legislation, loss of a major distribution channel and so on. External threats occur when the corporation has no effective control over the event, however, it will impact on their ability to compete or execute if no counter action is taken. The other from of threat is from internal situations which disrupt the business, reduce capability or create a negative change in its future plans.

The strategic value for the acquirer is created where the threat can be solved, mitigated or reduced through the acquisition of the vendor's business.

The 'problem solving' approach to achieving a strategic sale of a business is to identify situations in which the firm's assets or capabilities can counter an existing or emerging threat for a corporation which has both the capacity and willingness to enter into an acquisition.

External Threats: (examples)

- Major customer defaults
- Major supplier defaults
- A major supplier is likely to be purchased by a competitor
- New competitors enter the market
- A competitor introduces a more advanced product
- Current competitor becomes more effective
- Change in legislation
- Disaster (natural or terrorist)
- Loss of major contract
- Loss of distribution channel
- Changing customer buying patterns

Internal Threats: (examples)

- Loss of key employee
- Lack of funding
- Major delays on product development
- Serious personal health or family issues of senior executives
- Urgent need to buy out investor or partner
- Need to liquidate to retire

Below are some detailed examples which demonstrate threat situations.

Pioneer Computer Systems acquired a supplier to gain control over a strategic component of their product development infrastructure.

Example: (Author's italics)

In 1984 Pioneer Computer Group (PCS) utilized a 4th generation language from North County Computer Services (NCCS) in Escondido, California. At the time the language, USER11, ran on the RESTS/E operating system on the Digital Equipment Corporation's PDP 11/70. With the introduction of the VAX series of computers, the USER 11 product was ported over to the VAX to provide an identical programming and end user environment. However, this failed to use any of the new features inherent in the VAX and thus PCS faced a decline in its market acceptance. NCCS were determined to stay with a transparent interface thus threatening the survival of the PCS applications written in USER 11. ***To solve the problem PCS raised $1.5 million in venture capital, acquired NCCS and rewrote the USER 11 product to utilize the advanced features of the VAX.***

Source: Dr. Tom McKaskill, Former CEO, Pioneer Computer Systems

Agere Systems acquired Massana rather than let their initial investment be lost.

Example: (Author's italics)

Agere Systems announced Monday the acquisition of an Irish semiconductor-maker that designs broadband network chips that are 10 times faster than current technology.

The startup has only produced a prototype, which several companies are sampling, including possibly Cisco Systems and Apple. The privately held company has not turned a profit. It has received about $30 million from U.S. and overseas venture capital firms. Agere will have to inject cash

to cover research and employee salaries, without revenue coming in immediately. It will assume a small amount of debt.

The Dublin company is a startup venture founded in 1996 that began as a provider of engineering services. It has collaborated with Agere for the last year on developing gigabit Ethernet chips used in high-speed broadband networks. Agere produces chips for slower speed Ethernet connections.

Massana was on track to fulfill its contract, ***but Agere decided it wanted more control over the project so it decided to buy the company,*** said Sohail Khan, executive vice president of Agere's Infrastructure Systems.

Source:http://www.mcall.com/business/ accessed 7th September 2003

Chinadotcom acquired Ross Systems Inc., a supplier of ERP systems. Ross Systems had a history of poor management which made them vulnerable to takeover. Chinadotcom may have decided to acquire rather than let them pass into a competitor's hands.

Example: (Author's italics)

ATLANTA (Dow Jones)–Chinadotcom Corp.'s CDC Software unit signed a definitive agreement to ***acquire Ross Systems*** Inc. (NasdaqNM:ROSS- NEWS) for $5 in cash and $14 worth of chinadotcom common shares.

In addition, CDC Software has been a master distributor of Ross Systems' enterprise business solution, iRenaissance suite, in the Greater China region.

Source: http://www.rosssystems.com/ accessed 6th September 2003

Peoplesoft acquired Distinction Software as a counter to the announcement by SAP of a suite of supply chain optimization products.

Example:

In early 1998 SAP announced a suite of supply chain optimization products replacing their alliances with a number of small software companies. Within a few months their major competitors including Peoplesoft, J D Edwards, Oracle and Baan all made similar announcements. However, these were mostly development initiatives and not completed products. Peoplesoft took the opportunity in late 1998 to acquire a small software house, Distinction Software Inc. which had a complete suite of products in order to counter the move by SAP.

Source: Dr. Tom McKaskill, former CEO, Distinction Software Inc.

Solving a serious problem, negating a threat, overcoming an obstacle or removing a constraint are ways in which the selling firm can offer strategic value to the acquirer. The buyer needs to see value beyond that which is represented by the earnings on the seller's income statement. It is by creating this additional or 'strategic' value that the seller can achieve a premium on the sale of the business.

Most business owners know their industry and understand their own assets and capabilities. We can think of these as 'things we own' and 'things we do'. The process of seeking out strategic buyers based on solving a problem is to think of how other businesses would use the assets or capabilities of the firm. Those businesses which could use these assets or capabilities to overcome a problem or threat are target acquirers.

Example:

In 1990 the owners of Pioneer Computer Group (PCG) decided to sell their software firm. They had 160 staff over three locations; Northampton and London in England and San Diego in California. They developed 4th generation languages for the PDP/11 and VAX computers and then used these languages to develop ERP systems for discrete and process manufactures. After investigating the UK for potential buyers, they were disappointed in the low valuations and turned their attention to the USA. There they found Ross Systems Inc. that was also using the VAX computer but using a 3rd generation language and only selling corporate financial systems. Ross recognized that their future looked bleak unless they could compete with new software technology and gain access to a larger market. PCG's successful approach to Ross was to show how they could provide ROSS with a new development capability and enable them to enter a growth market in the manufacturing sector. The sale was 200% higher than the valuation they could have achieved in the UK.

Source: Dr. Tom McKaskill, former CEO, Pioneer Computer Group

Finding the strategic buyer with a threat or problem your business can solve can take some time. The buyer must have both the need and the capability to buy. In the 'problem solving' scenario, it requires a search for corporations which need what the firm has which could overcome a problem or threat, however, few corporations publicize their threats. A well networked industry executive may be able to spot opportunities but generally it requires a systematic approach to cultivating relationships where such situations are discussed. Sometimes it just requires boldness to initiate discussions with industry firms to discover where a strategic fit might occur. Generally it is only by participating in industry and professional networks that a firm will find out about a corporation with a problem which they can eliminate or reduce. Professional services firms are often tasked with finding an acquisition in these situation, thus being known to such firms can assist in creating this type of strategic exit.

Finding Buyers with a Huge Opportunity

Most acquisitions are made to take advantage of synergies which can be leveraged through combining the businesses. The most attractive of these scenarios is where the buying corporation can leverage the acquired assets or capabilities to open up new markets and/or generate significant new revenue.

A business is faced with an 'opportunity' when a favorable set of circumstances is presented in which they are able to achieve an increase in revenue. Opportunities are often situation and time specific. An opportunity for one firm may not be open to another due to the knowledge possessed or the assets or capabilities needed to execute to deliver the benefits. Opportunities are almost always driven by a change in some aspect of the external environment. It is the business which can exploit that change which will generate new revenues.

Opportunities:

- Changing needs of customers
- New legislation
- Failure of competitor
- Disaster (natural or terrorist)
- New solutions to old problems
- Dramatic improvement in product utility or functionality
- Significant reduction in cost of a product or service

Often large corporations see external opportunities but do not have the assets or capabilities to take advantage of them. This is fertile ground for small companies who have products or services which can be used by large corporations to pursue such opportunities. The strategy of the acquiring company is to utilize the acquired assets or capabilities to take advantage of an opportunity.

The objective of the selling firm is to identify the match between what they have or do with the potential opportunities which those assets or capabilities

create. They then have to find those large corporation which have the capabilities and capacities to clearly exploit one of these opportunities through an acquisition. To the extent that the selling firm is more able to provide the solution (better fit, more timely, less problems in the acquisition), or more able to enhance the opportunity (fit, scalability, less problems in the acquisition), the better the price which can be negotiated.

Opportunities can often be very large in potential returns if circumstances permit. Here the key to the price the buyer may be willing to bid is scalability of the opportunity and rarity of the solution. The more the activity can be scaled, the greater the potential financial reward to the buyer. The seller is in a more powerful negotiating position if theirs is the only possible solution. This may be a factor of location, timing, size, culture, technology and so on.

Opportunities can be described using the business development matrix:

Market Development Strategy	**Existing Markets**	**New Markets**
New or Enhanced Products	Increase Frequency Increase Margins Cross Sell	New Business Creation
Existing Products	Increase Frequency Increase Margins Cross Sell	Expand Markets New Customers

The challenge for the seller is to show how their assets and /or capabilities can leverage additional business in one or more of these market development areas.

Enhancing Existing Products/Markets

The seller may provide the capability for the corporation to reduce costs and/or enhance the sales value of their existing products thereby increasing margins. This may be through technology, better processes or capabilities in sales or marketing. Additional benefits may come from combining operations to gain lower cost through economies of scale or learning curve effects.

Increased customer penetration or frequency of use may come from finding additional uses of an existing product by incorporating new components, replacing components, changing packaging or changing the marketing messages. The seller may be able to show how their technologies, processes or knowledge may enhance existing products to create new business within existing markets.

> ***Example:*** (Author's italics)
>
> San Jose, CA, July 8, 2003 -- Pericom Semiconductor Corporation (Nasdaq National Market:PSEM) today announced that it has signed a definitive purchase option agreement to acquire the net assets of privately held SaRonix LLC of Menlo Park, CA., subject to the completion of due diligence and customary closing conditions. SaRonix and Pericom are executing joint marketing and product development initiatives for crystal based products including clock recovery, frequency translator and timing modules.
>
> ***The acquisition will add to our core competencies by enabling technologies for new products,*** enhancing customer service and streamlining value added solutions for the combined customer base. Both Pericom and SaRonix focus on the computer, networking, telecom and storage markets, have many common major customers and complementary geographic strengths
>
> Source:http://www.pericom/corporate/ accessed 8th September 2003

A very common reason for an acquisition is to reduce costs through new technologies or to build additional differentiation or competitive advantage into existing product offerings.

Example:

Inxight acquires Information extraction technology nxight Software, a leading provider of software solutions for accessing and using unstructured data, announced that it has acquired the technology assets of WhizBang! Labs, of Provo, Utah.

The strategic acquisition, the first following the company's recent $22 million investment round, extends the company's text analysis, classification and retrieval capabilities.

"This technology acquisition demonstrates our commitment to providing the most powerful solutions for accessing and understanding corporate data assets" says John C. Laing, Inxight's president and CEO.

"Combining the acquired functionality with our existing technology enables us to better serve customers, expand our market share and serve notice to the Unstructured Data Management market that Inxight truly is determined to dominate."

Source:http://content-wire.com/taxonomies/index.cfm?ccs=82&cs=2328 Accessed 18th February 2006

Example:

The potential acquisitions are targeted on the basis that they should bring synergies to ComOps' existing businesses, both in terms of cost savings and, more importantly, in revenue opportunities created by enhancing our product offerings to our already long list of quality clients together with new customers.

Source: http://www.comops.com.au/client_images/330102.pdf
Accessed 22nd April 2008

New Products to Existing Customers

Many acquisitions are made by corporations to acquire products which they are able to sell through their current distribution channels to their existing customers. Expanding the portfolio of products can be very cost effective as relationships with customers are already in place or their brand is already known. Creating differentiated products through an expanded solution set may be a very effective hedge to competition. Alternatively, adding complementary products may allow corporations to increase their penetration into existing market sectors.

> ***Example:*** (Author's italics)
>
> South African industrial services group Bidvest (BVT) will continue to look for ***acquisitions in South Africa and abroad to expand its service offerings.***
>
> Executive Chairman Brian Joffe said on Monday that Bidvest remains acquisitive by nature and committed to expanding its distribution, services and trading strategy.
>
> "Bidvest uses acquisitions not to achieve breakthrough, but rather to accelerate momentum. Finding the right acquisitions at the right price and at the right time requires skill and patience.
>
> Source: http://www.bday.co.za/bday/content/direct/ accessed 7th September 2003

> ***Example:***
>
> "This acquisition is a significant investment which reinforces and expands our emphasis in security related products," said HPIC's Chairman/CEO, Kim Kelley. "Keeper adds cargo management capabilities to our collection of branded, high value, easy-to-use security hardware and related accessory products for the home, vehicle and workplace. In the first

year alone, Keeper's sales will represent about one-third of Hampton's overall sales."

Source:http://www.theautochannel.com/news/2006/01/23/208192.html Accessed 18th February 2006

Current Products to New Customers

The selling firm may have access to a customer base where the buyer has none or little presence. This could be a new geographical area or a new sector. Often firms buy their competitors for this reason. They can then switch the customer solution across to their own products providing economies of scale benefits as well as taking out a competitor.

This strategy is also used to increase coverage within a sector, especially for expansion overseas where the buyer will be acquiring a presence in a market and thus access local knowledge, local capability, a distribution channel and achieve critical mass. This strategy can be especially effective where the selling firm has a very large customer base but few products. A corporation which has a wide range of products which can be sold to an acquired customer base is effectively buying a readily developed channel to market.

Another form of expansion is to find a new mission for existing products by selling into a different sector where the product might be used differently. Often with this type of acquisition, the buyer is seeking to acquire knowledge of the sector. Every market has its own ways of doing business. Acquiring a firm, for example, which undertakes government contracts, would allow a firm to acquire deep knowledge of how to secure new business in that sector.

Example:

Lion Nathan's $10 million acquisition of its third brewery in China earlier this month confirms its plans to expand in the world's largest beer market despite $230 million of cumulative losses. The acquisition which will make Lion the largest brewer in the town of Changzhou.

Situated between Nanjing and its existing brewery in Wuxi, the Hua Xia brewery in Changzhou is Lion's latest move in

a strategy of expanding its foothold in the rich Yangtze River Delta region.

It will not only give Lion access to some 22 million litres of capacity in the city, where the brewery markets the Linkman beer, but will make it easier to sell its other China brands in the region. The China business is on the look out for more acquisitions in the Yangtze River Delta.

Lion Nathan bought a brewery in Wuxi, 120km northeast of Shanghai in 1994 after a two-year search for an acquisition in China. Lion Nathan access to the biggest beer brand in the city, called Taihushui.

Lion Nathan is now looking for more acquisitions like the Changzhou deal which will give it access to more markets in the region.

Buying a local brewery is as much about buying access to the local beer market which is often fiercely protected by local business and political interests.

Lion wants to continue to expand volumes and seek the market dominance that brings more control over pricing.

Source: The Australian, 31st December 2003, page 19, Great Creep Forward for Brewer, by Glenda Korporaal

Example:

'Moreover, etalk's customer base of over 1,500 contact centres and 35 of the Fortune 100 companies will gain access to the world's leading technology, offering them a competitive edge over any other solution, based on Autonomy's unique ability to understand the content of the call.'

Source:http://www.cambridgenetwork.co.uk/pooled/articles/BF_NEWSART/view.asp?Q=BF_NEWSART_156736 Accessed 18th February 2006

Cross Selling of Products to Both Customer Bases

The selling firm may have a set of products which can be sold into the existing distribution channels of the acquiring corporation. At same time, the buying corporation may have products which are able to be sold back into the customer base of the firm being acquired. Such an acquisition is especially attractive where little additional resources have to be expended to introduce the new products into the existing distribution channels. In these situations, the return on investment for the acquirer can be especially high and the payback on their investment relatively short. The selling firm which can clearly articulate this opportunity is well positioned for an acquisition.

This strategy can also used to effect an entry into a new market where local knowledge and local products can be readily enhanced with the corporation's own set of products. At the same time, the acquired products can be brought back to benefit the corporations existing distribution channels.

Example:

San Jose, CA, July 8, 2003 -- Pericom Semiconductor Corporation (Nasdaq National Market:PSEM) today announced that it has signed a definitive purchase option agreement to acquire the net assets of privately held SaRonix LLC of Menlo Park, CA., subject to the completion of due diligence and customary closing conditions. The transaction is expected to

Both Pericom and SaRonix focus on the computer, networking, telecom and storage markets, ***have many common major customers*** and complementary geographic strengths

Source: http://www.pericom.com/corporate/ accessed 8th September 2003

Example: (Author's italics)

Software mergers are notoriously difficult to pull off, from both technology-integration and go-to-market perspectives. PeopleSoft certainly said all the right things: its products and customers seldom overlap, its sales force is in training and is ready to go, it will realize more than $200 million in merger-related cost savings and some of the most popular products will be integrated by year's end.

Even if the truth is a little less optimistic, a stream of PeopleSoft executives made a compelling case for a successful integration. Indeed, PeopleSoft focuses mainly on sales to large companies while J.D. Edwards' expertise is in the mid-market, or companies with $1 billion or less in revenue. According to Phil Wilmington, executive vice president of PeopleSoft's Americas business, that means more cross-sell and up-sell opportunities. "More products mean more revenue," he says.

Michael Gregoire, head of services at PeopleSoft, says "JD Edwards looks like PeopleSoft did three years go." He says only one-quarter of JD Edwards sales come from existing customers. "This is too small. They need to upgrade."

Surce:http://forbes/2003/09/05/ accessed 7th September 2003

While merged businesses may have their own niche markets, they can often have parts of their operations which are similar. These areas would provide cost synergies in additional to the revenue opportunities of cross-selling.

Example: (Author's italics)

Also buying their way deeper into EBPP are InteliData and Avolent. The former announced earlier this month that it is acquiring Home Account Holdings Inc., of Emeryville, Calif., its Home Account Network Inc. subsidiary and its suite of Unix-based Internet banking and EBPP products.

InteliData, of Reston, Va., already offers remote banking services to financial institutions. The deal ***gives the company a broader customer base***—including credit card issuers—and a fast handle on Home Account's current client roster, including some of the country's top financial institutions, such as Bank of America Corp., Citigroup Inc. and First United Corp.

Source: Acquisitions help spur EBPP ,By Renee Boucher Ferguson January 22, 2001,http://eweek.com/ accessed 6th September 2003

Example: (Author's italics)

For instance, Gupta said, by the fourth quarter, J.D. Edwards' real-estate management tools ***will be available to PeopleSoft customers***. The latter, as a group, own more than 5 billion square feet of real estate, said Gupta. "Talk about an opportunity," he added.

Conversely, Gupta said J.D. Edwards users will soon have access to PeopleSoft's supplier-relationship-management tools. Gupta said J.D. Edwards customers spend more than $50 billion annually on procurement.

Source: http://www.internetweek.com/breakingnews/ accessed 7th September 2003

New Products to New Customers or New Market Entry

This type of acquisition is an expansion strategy where the firm desires to break into a new sector but requires a new capability to do so. This could be in a related sector where there is some commonality in market approach or could be in a very different sector where the firm has no synergy to leverage. This strategy is often used by firms aggressively seeking growth or by companies trapped in declining sectors and needing to find new sources of revenue.

Example: (Author's italics)

eTime Capital Inc., InteliData Technologies Corp. and Avolent Inc. are acquiring companies to jump-start their respective EBPP offerings, while iPlanet E-Commerce Solutions and MetraTech Corp. have announced EBPP additions to their applications.

EBPP lets companies send bills over the Internet to business and consumer customers and allows those customers to pay online.

eTime Capital, which provides transaction reconciliation and settlement services, will announce this week its acquisition of Dynamic Transactions Inc. The purchase of DTI, best known for its PayPlace service, which settles payments between online buyers and sellers, ***will propel eTime Capital into the EBPP space and shave months off product development time,*** according to officials of the Sunnyvale, Calif., company. For its part, San Francisco-based Avolent last week said it had completed the acquisition of Solant Inc., which has expertise in business-to-business electronic bill payment, reporting and analysis.

Source: Acquisitions help spur EBPP ,By Renee Boucher Ferguson January 22, 2001,http://eweek.com/ accessed 6th September 2003

Many companies pursue a build out policy to offer more products to existing customers as well as to break into new markets.

Example:

SenseStream's acquisition is the first by Adamind since its flotation in February 2005 and marks a major strategic move by the Company to expand into mainland China, Hong Kong and Taiwan as large amount of monies are being invested in telecommunications infrastructure to cope with demand in the run up to the Olympics in 2008 and beyond. The acquisition

is highly complementary with Adamind's footprint in the region with recent wins in Australia, Philippines and Singapore. It will enable the Company to accelerate its penetration into one of the world's fastest growing and largest mobile markets, namely, China, Taiwan and Hong Kong.

Source: http://www.adamind.com/press_02_08_06.php/ Accessed 18th February 2006

Example:

Satyam Computer Services Limited announced the strategic acquisition of Citisoft, a specialist business and systems consulting firm for the investment management community. The deal was for $23.2 million, with an additional performance-based payment of up to 15.5 million to be paid over three years. ……. Yet the acquisition highlights a pattern that has begun to form, in which offshore firms, once viewed as outsiders, are acquiring companies with more established local presences in the markets they serve.

Source: http://www.a1technology.com/blog/2005/10/satyam-computer-services-limited.htm Accessed 18th February 2006

Current Products and New Product Potential

The selling firm may have products which the corporation can utilize immediately within its existing distribution channel. This alone may be sufficient to justify the acquisition. A firm which, in addition, has products under development which can open up new markets or technology which can be used over a longer period to enhance existing products from either company, can offer very attractive long term benefits to the acquirer. While the selling firm may not be able to extract a premium for longer term potential, the acquisition may gain greater favour within the acquiring corporation thus ensuring a greater commitment to get a deal completed.

A solution which offers new products to existing customers while opening up new customer sectors can be very rewarding to an acquiring firm. The initial investment can be recovered quickly by selling into the existing customer base while the new customer base is being evaluated and a strategy to penetrate it put into place.

Threat and Opportunity Synergy Acquisitions

The best position for the seller to be in is to have solutions which play to multiple needs, especially of reducing a threat while offering access to new markets. The threat places time pressure on the buyer while the rewards of new products or new markets allow them to more easily justify a premium price. Threat solutions can sometimes be resented as the buyer may feel compelled to complete the acquisition but may feel no upside in the deal. Reward deals are more easily negotiated with a premium as the buyer can demonstrate how the investment can be recovered through increased sales.

Find the Match

The key to a strategic deal is to find the match between what the selling firm has or can do with a set of large corporations which either need or can greatly exploit the assets and capabilities of the vendor. In order to optimize this match and determine where the highest sale price can be secured, you need a very good understanding of how to identify strategic assets or capabilities and also an understanding of how to identify the best strategic buyers. We will examine how to identify strategic assets and capabilities in the next chapter.

8

Identifying Strategic Value

Entrepreneurs with experience of multiple exits will acknowledge that strategic deals are not only possible but desirable, however, very few can set out a formal methodology for identifying which firms lend themselves to strategic sales. Nor do they have the methodologies to help them identify which assets or capabilities inside those firms could be used to leverage a strategic sale. This problem is compounded by our training in business valuation where we see only profit generation within the existing business as a measure of worth.

To move to a strategic value based valuation, we have to completely break away from conventional valuation norms. Furthermore, we have to be willing to go on a discovery mission to look inside our business to discover what we have or do which can leverage such deals. The fact that our business may not be using the specific asset or capability to generate revenue, or may not even be aware of its existence or may be incorrectly applying it, simply makes the task harder.

Strategic value is found in an asset or competency within the acquired firm which a large corporation can leverage to solve a major problem or generate a significant revenue opportunity. To understand its potential, we need to look inside the buyer's organization to see how it might be exploited. But, if we don't

know who the buyer might be because we have yet to identify the strategic value we are at an impasse.

The strategic potential to a buyer is only relevant within the context of the buyer's organization and marketplace. If the vendor is working in a different marketplace or does not have the capability to exploit its underlying assets and capabilities, it may be harder to work out which asset or capability is the one to leverage into a strategic deal. We should never assume that the asset or capability being used by the vendor is the one which will generate the highest exit value. To be brutal, the vendor may simply not have the capability to exploit it, might be in the wrong marketplace or simply using it to solve different problems. Of course, there will also be those firms where the strategic value is obvious and they have already made significant progress to prepare the business for a strategic sale but lack resources or knowledge to see the process to a conclusion.

Whatever the situation, it is worth taking the time to review the underlying assets and capabilities of the business to ascertain whether the firm has strategic value potential. In 90% of the situations I examine, I have been able to find and enhance strategic value potential.

What we need to do is to go back to basics and build a model of a strategic asset or capability and then look inside our firm to see what we can find. We can do this with a set of metrics around what creates high strategic value. This may end up confirming what we already know, but it has the strong probability of uncovering additional potential.

Strategic assets in this context are those things which a business ***has*** which can eliminate threats or provide opportunities for the buyer.

Examples are:

- Intellectual property (patents, trademarks, brands)
- Customer base
- Distribution channel
- Technology or a technical process
- Documented or codified knowledge

- Agreements or contracts
- Physical property, equipment and inventory
- Locations
- Advisors, Directors, managers and employees
- Access to specific institutions and organizations
- Licenses, membership status, authorizations
- Social, government or business networks

Strategic competencies or capabilities are things which the firm ***does*** especially well which can be leveraged or can solve a problem for the acquirer. Competencies are based on the knowledge and skill of the people employed. Thus, while an asset might possibly be sold in isolation, competencies go with the people.

Examples of strategic competencies are:

- Marketing and promotion
- Product development
- Product design and manufacturability
- Sales and after sales support
- Procurement and quality control
- Networking
- Managing distributors
- Managing large complex projects

With any potential strategic asset or competency, the key is to think in terms of how this might be used by a potential buyer. Often firms don't appreciate what they do well. Very often the most valuable skill is part of an overall process but not the most obvious. Firms often focus on their sales results or their bottom line without recognizing what they do well to get there. Their most valuable skill might be product design rather than sales. In the hands of a strong marketing and sales company, such a skill might be used to leverage considerable revenue.

An asset or competence which the firm has may not necessarily be contributing to the existing business. The key question here is, not whether it is

a key asset or competence within the business being sold, but whether it would be strategic to the buyer. Often a smaller business simply does not have the resources to exploit all the assets and knowledge it has. There may be patents registered but not used in the business. There may be offices, warehouses or factories underutilised or in excellent locations which could be better exploited in a different business.

Even a business which is running smoothly, operating at a profit and providing the owner with a comfortable salary, may not be extracting the maximum value from its resources. In the hands of a different owner, underused and unexploited assets and capabilities might generate significant revenue. The acquirer may be able to bring new energy, increased funding, new distribution channels and complementary skills to the situation thus releasing untapped potential.

We need to have a way of isolating the strategic potential of the underlying assets or capabilities, often in isolation of what the current business is doing with them.

One exercise which is worth doing is simply to look inside the business and list all the things which the firm has or does which could be leveraged into creating significant value for a potential acquirer. Try asking these questions:

> *If we didn't have that asset or capability, where would we be competitively and financially?*
>
> *What do we have, or do, which some other firm would find attractive or which another firm could leverage much more than us?*
>
> *What constraints do we have on our ability to grow which another firm in our sector does not have? How could they develop our potential if that constraint were removed?*

Strategic acquisitions are undertaken to leverage off an asset or capability of the seller. This would normally imply some level of scalability of the activity associated with the strategic asset or capability. If you can foresee this as a likely path, how easy will it be for the buyer to exploit the potential?

Assume you were given the resources to generate 10 times the revenue from your products or services. What would you have to do to build the capacity to support that level of activity? What resources would you have to put in place to get started? Would you be able to clearly articulate what would need to be done if that opportunity were to present itself? Now, which corporations already have the capability and capacity to provide the environment to quickly reach that target? When you start to look at what constrains your business, you can see what a possible buyer could do to release the potential.

If you had the resources to grow faster, which products or services would you choose to concentrate on?

What you are looking for are products or services which can generate significant revenue. Why did you choose those specific ones? What was there about them which encouraged you to choose them rather than others?

Another technique you can use is to review a conventional list of intellectual property or intellectual capital to identify what exists within the firm. That list will include patents, brands, copyrights, licenses, rights, trademarks and other registered IP as well as areas of deep expertise or competence.

When you are examining the various forms of assets and competencies of the firm, think about how these might be leveraged by a large corporation.

Access rights, licenses, patents or brand names

Corporations can sometimes be frustrated in expansion plans within a sector through the lack of intellectual property. This might be a license to operate, a recognized brand or access to technology which is protected by patents. A lack of such rights when competitors have rights or acceptable alternatives can be a threat to future revenues.

In areas of emerging knowledge, the number of experts or specialists with deep technical expertise or specialist knowledge is often limited. If competitors have such expertise and are leveraging it to gain market share, a corporation is threatened unless they can also acquire such expertise.

Sometimes the only way for a critical mass to be acquired quickly is to buy a firm which already employs such people or has developed such capability.

Example:

"Eastman Kodak Co. Monday announced plans to buy two companies that make digital printing systems and said the acquisitions would reduce its 2004 earnings. For Kodak, whose shares were down 3.6 percent in early trading, the deals are part of a drive to invest more in digital imaging. The company has been hurt by the waning film market"

Source: http://www.forbes.com/newswire/2004/03/08/rtr1290006.html. Accessed 7th April 2004

Gateway capacity or technology

Often in a specific sector, the ability to compete may depend on owning a share of a channel or access path. If, for example, capacity within a channel is only able to grow at a limited rate, the corporation which has control over part or all of that capacity has considerable influence over market share. The same logic would apply to a market where existing suppliers have effective control over the market due to high switching costs to their customers of moving to a new entrant.

Example:

'As part of its expansion plans and strategy to enter the Internet business, Kuoni Travel Group India has acquired Resnet from Traveljini.com, which is an investee company of ICICI Venture, for an undisclosed sum.

The acquisition of Resnet from Traveljini.-com is the first and primary initiative in the overall Internet strategy of Kuoni India, the company said in a release.

Resnet is an on-line booking engine and a comprehensive reservations solutions provider to the hospitality industry and

represents various hoteliers on the GDS and Web platforms."

Source:http://www.financialexpress.com/fe_full_story.php?content_id=56473. Accessed 7th April 2004

Example:

"U.S. RealTel, Inc. (OTCBB: USRT), a national broadband services holding company operating primarily through its wholly owned subsidiary, Cypress Communications, Inc., today reported its consolidated operating and financial results for its fourth quarter and fiscal year ended December 31, 2003.

The acquisitions of Cypress Communications and WorldCom's Intermedia Advanced Building Networks (ABN) unit in 2002 provided a platform from which to launch a strategy ultimately designed to increase shareholder value."

Source: http:// www.tmcnet.com/usubmit/2004/Mar/1027229.html. Accessed 7th April 2004

High profile customers or hard to acquire customers

Entry into a market or expansion beyond a certain point may require the corporation to secure the business of certain key accounts. If these are already being serviced by another firm, the only way forward may be to acquire the existing supplier.

Key locations or launching pad for expansion

The costs of entering a new market from scratch may be prohibitively high in terms of time and/or investment. Existing businesses may, however, have built sufficient critical mass and infrastructure that they can provide a launching pad for further expansion into the market.

Example:

"Axon Group plc, the business transformation consultancy, announced that it has agreed to acquire the entire issued

share capital of MyDruid Services SDN. BHD, an offshore services partner based in Kuala Lumpur

Axon says the acquisition supports its strategy in two key areas. Firstly, it provides a beachhead into Asia, from which Axon intends to grow the local client base, focused initially in Malaysia, Singapore, China and Korea. Secondly, the Applications Management centre in Malaysia will become Axon's off-shore and on-shore capability centre for the region, providing resource to support both local and global clients. The acquisition will not have a material effect on the Group in 2004."

Source: http://www.consultant-news.com/article_Display.asp?ID=1420. Accessed 7th April 2004

Products which can fill out a portfolio

In markets where the number of products is large, channel members try to limit their administration load by working with partners which can offer a wide range of complementary products. A firm may be faced with erosion in its market if competitors can offer wider ranges of products. Acquiring a firm which can complement a product line and counter competitor pressure may be a successful method of retaining existing business.

A similar argument can be applied to integrated solutions in engineering and software. The success of the large ERP vendors such as SAP and Oracle has come from their wide portfolio of products. Such firms often make acquisitions to provide a more comprehensive solution to customer's needs. Sometimes they may be forced to seek an acquisition to counter a product development at a competitor.

Highly networked or well known industry leaders

A corporation threatened with a loss of contracts may seek to acquire a firm with highly networked management or high profile individuals who can secure them a place on tender processes.

Experienced management team

A corporation with a poor performing business unit or a situation which requires unusual expertise might seek to acquire a smaller firm just to be able to acquire a fully operational management team.

Reduce risk

Example:

"Malaysian conglomerate Sime Darby has agreed to buy a controlling stake in three companies involved in auto distribution and parts manufacturing as part of moves to expand its motor vehicle business.

It said the proposed acquisitions were expected to give its motor vehicle business a boost as Hyundai was one of the best-selling and fastest growing brands in Malaysia.

Sime Darby chief executive Nik Mohamed Yakcop said the proposed acquisitions would provide a more balanced portfolio of marques and reduce its exposure to the euro."

Source: http://www.channelnewsasia.com/stories/afp_asispacific_business/view/78679/1/.html. Accessed 7th April 2004

Example:

In 1987, Userware International, a distributor of the COMMAND ERP solution, was the preferred supplier to a nationwide mattress manufacturer that sought to replace its existing systems across 26 plants. Finally, however, the manufacture acquired a competing software firm. They argued that the risks of such a large project justified the cost of buying the software firm and dedicating their staff to the implementation which was expected to take 3 years.

Source: Dr. Tom McKaskill, President, Userware International

Example:

While on the surface these types of moves appear particularly strategic for the acquirer, Dan Houlihan, Citisofts managing director of US operations, said the deal held advantages for the acquired as well. Prior to the acquisition talks, Citisoft had identified outsourcing as one of the specific threats to its business. Many investment management clients have outsourced key functions, and much of the work we do onsite could be done elsewhere, he said. Through the merger, he added, the two firms could provide very complementary services, pairing Citisofts expertise from its on-site consulting experience with Satyams technology and offshore capabilities.

Source: http://www.a1technology.com/blog/2005/10/satyam-computer-services-limited.html. Accessed 18th February 2006

The examples shown above demonstrate that acquisitions are often made to resolve a difficulty or to exploit an opportunity, or both. The selling firm's task is to take control of that process by being proactive – by seeking out corporations where they can add strategic value. By doing so, they can secure a premium for the business, sometimes many times greater than their conventional EBIT based valuation.

While every asset or capability you review might have some value to a large corporation, we are really trying to isolate those which have the potential to leverage a strategic sale. For that we need to screen for those which can generate high growth in the hands of the buyer.

High Growth Criteria

The end game is to find something which a large corporation can leverage either to solve a threat or to create a large revenue opportunity. Generally speaking, a higher strategic premium can be gained where the buyer generates new revenue rather than solves a problem. We also need to recognize that early revenue is more valuable to the buyer than revenue earned in later future

periods. Thus focusing on what the firm has which can drive significant revenue over a short time period inside a large corporation immediately or soon after the acquisition will most likely identify the best strategic assets or capabilities.

Our search for strategic assets or capabilities should be directed towards those which have high growth potential. High growth potential assets and capabilities tend to have certain attributes. Remember that strategic value potential needs to be seen within the context of the potential buyer's business not that of the vendor. Attributes commonly found in high growth assets and capabilities are :

- The problem being solved or the need being met is of a high compelling nature
- The product or service has a high, sustainable competitive advantage
- They target a well defined customer who is able and willing to pay
- The market size is significant and often global
- The customer is not price sensitive in this specific application
- The product or service must be scalable or easily replicated.

What we are seeking are those assets or capabilities which have the potential to generate high velocity in sales. When you have a product or service with these attributes, you have the following outcome:

- Short sales cycle
- Insensitive to price
- High referral rates

This scenario is especially effective when you are targeting a large well identified niche market which has the capacity and willingness to buy at the price you wish to sell the product or service.

Given that you are anticipating that the large acquiring corporation will have the capacity and capability to fully resource the sales, operational and service needs of the marketplace, you have an environment where the right assets or

capability can be exploited. In high growth situations, sales will experience a lower per unit selling and marketing cost and high referral rates.

These are the key attributes which need to be well understood if they are to be used as the screening criteria to identify strategic assets or capabilities. It is therefore worth spending a little more time examining them.

The compelling need to buy

Achieving high growth is about gaining momentum in the chosen market. Think of this as a freeway. You are really looking for a smooth uninterrupted path. You either want an empty lane or one where the traffic is travelling at an even pace. You will notice that when traffic is interrupted, it starts to backup and ultimately creates a roadblock, often for no obvious reason. The same thing can happen to growth momentum. If it slows down, then resistance builds up along the supply chain which ultimately results in bottle necks and disruptions, which in turn stalls growth.

The greatest source of friction in the growth curve is the decision making process of the target customer. To the extent that the prospect can choose not to buy, choose to delay the purchase or choose alternative products, the growth rate will be sporadic and slow. When external events such as economic cycles, man made and natural disasters and business interruptions impact the willingness to proceed to buy, the rate of sales will be unpredictable and the momentum needed to drive high growth will be lost.

When a product or service is being offered for sale, it has a value proposition to the customer. That value proposition can be composed of many elements of which utility is the one most people focus on but this may not be the one which triggers a specific purchase. In the case where there are close alternatives, other factors such as design, smell, taste, image, ease of purchase, risk in use, after sales help, environmental impact, an association with causes or celebrities, availability, warranties and so on, can influence the purchase.

Few people understand just how hard it is to build a value proposition which compels a customer to buy. Most products are chosen on a whim, can be readily deferred or have many alternatives and substitutes.

For each of your products or services, test their growth potential with these questions.

- *What problem are you solving? How important is it that the customer solves that problem?*
- *Are you satisfying a need or a desire?*
- *What degree of compliance (penalty or cost) results from not buying?*
- *What happens if the customer does not buy?*
- *What alternative to your product or service could they buy?*
- *Who is required to solve the problem? What happens if they don't?*

Clearly the most desirable position for any firm to be in is for their product to be needed desperately by a set of customers. This does not mean something they desire or would like to have, or even something they want to have. This refers to something they must have and, better still, must have now! You might well argue that few products can ever be so compelling but, in fact, many basic products would fit that need. Each person has a need for food and water, basic accommodation and security. Without electricity, water and sewage services, life in urban areas would be impossible. This is possibly the major reason why these services were initially provided by state owned enterprises and are often regulated. Food is of course satisfying a basic need although there are many alternatives. But the compelling need is still there.

Some conditions do create compelling needs. Virtually all regulations have compliance requirements and associated penalties for non-compliance. Thus a product or service which stops you from being fined or going to jail has a high compelling need to buy. Products and services which neutralize or reduce physical or psychological pain and suffering easily fall into the class of products which have a compelling need to buy.

Potential customers are not always aware they have a need for a specific product. Many products come onto the market through the use of fear marketing. For example, they inform you of the millions of bacteria lurking on your tongue or millions of germs hiding in your toilet. Having made you aware of the danger to your health, they immediately offer to solve the problem with their latest product – which of course will kill all those nasty bugs.

Within the software industry we had the FUD factor (fear, uncertainty and doubt). The sales pitch was to show the customer how much money they were losing by not solving a specific problem and then of course offer the solution. The best products of course uncovered a long forgotten regulation which had severe penalties for non-compliance. My favorite software sector was always payroll as the penalties and disruptions for not getting it right were severe.

In many sectors there are quite severe penalties around health and safety in the working environment. Products which are known to reduce risks are often mandated under specific working conditions. Many factory environments have quality control requirements specified under regulations. Failure to comply can be severe, even to closing down the facility.

It is very difficult to gain growth momentum if the problem you are solving is not serious enough to justify immediate attention. To the extent the customer is willing to live with the problem or is willing to delay solving the problem, the sales pressure is severely weakened. This was the case in the applications software industry. Basically the essential processes were being undertaken manually or with basic transactions software. However, when value added tax was introduced these systems all had to be replaced. The customer had no choice but to upgrade or to purchase a new system. Then they were locked into continual upgrades as the regulations changed.

Products which have many close substitutes have real problems creating sales pressure. Almost all basic food and beverage products exist within this class. There are simply countless products on offer to satisfy basic food and drink needs. In these markets, the sales message has to move beyond utility to appeal to other factors of value creation. Alternatively, the vendors need to package the product for a specific market – non-spill, high energy, lactose free, etc. The marketing objective has to identify a market with a higher need and to move away from markets with alternative or substitute products. This is where competitive advantage plays its role. We will look at that attribute next.

For many businesses, the task is not to drop the product; it is to find the right problem to solve. The task of the producer is to find the customer with the most compelling need where the product or service will be truly appreciated. The ideal situation is also where there are no alternatives or close substitutes.

With a high compelling need, the decision time is normally greatly reduced, the sale is not sensitive to price and the customer will be willing to refer you to others with the same need. Often a firm will have the potential of a much better target customer and much better product fit with a compelling need but may not have the capacity and capability to pursue that market or may be unaware of its existence.

New technologies often find themselves in a situation where they can be used to develop products to solve serious problems which have not been addressed previously. This is one of the reasons why breakthrough inventions are often found in rapid growth firms. What you have is pent up demand, no alternatives, a compelling need and short decision times. Many biotechnology discoveries have spawned global products by solving medical problems which have defied medical science for generations. At the time of discovery, they are normally the only solution available. With such a background, high growth rates are almost guaranteed.

What if you have a product which has low utility. It can still drive high growth sales if it satisfies a psychological need. Clearly, if the need is not in the utility of the product itself, the value or need can still exist through intrinsic or perceived value. This is the marketplace of designer brands. They create need through an association with an image of self or with high profile celebrities. Need can be associated with self image, ego, peer group pressure, a need to 'belong' or a need to be admired, respected or envied by being in possession of a specific brand. In industrial products or services, the need might be satisfied through an association with an admired and/or leading business customer or through being an 'approved' supplier of choice to a much admired corporation.

Even if a product does not satisfy a compelling need, it can still achieve a high rate of sales if it can be closely associated with one which does. Multiple products can be pulled into a sale by being complementary to a product which solves a compelling need. The sale opportunity is created by having one component of the sale satisfy a compelling need but the sale process itself takes the opportunity of presenting other complementary products. For example, an applications software vendor might open the door with a payroll, tax reporting or OH&S reporting system but sell an entire system on the back of it. Consulting

firms have compliance audit services which gain them access to clients and then sell general consulting services in cross sell opportunities.

A compelling need reduces the costs of selling as there is little selling effort required. This in turn helps create higher profitability in the business. However, where there are close competitors, this advantage can be readily lost and deals will ultimately be won on lowest price. The ideal position to be in for any business is to have a product which satisfies a compelling need in a medium to large growing market, has no close competitors and is able to protect its competitive advantage for some period of time.

Compelling Need Check List:

- How important is it that the target customer solves the problem you have identified?
- How readily is the customer willing to defer the purchase?
- What alternative products or services can the customer purchase to solve the same problem?
- What is the impact on the customer if they don't buy?
- Are there penalties for delay or non-purchase?
- Will the customer suffer mentally or physically by delaying or not purchasing?
- Will the problem get worse during the period of non-purchase?
- How well does the customer understand the impact of non-purchase?
- Can the effect of non-purchase be measured in terms of future expense, lost revenue, penalties or disruption?
- Is there a shortage of supply?
- Is demand increasing relative to available supply?
- Are there local, regional, state or national regulations that are violated through non-purchase?

- How important is image or status in having the product or using the service?
- Can celebrity endorsement increase the value of the product?

Strong competitive advantage

While it would be an advantage to have a rapidly growing market in which even the poorest of the competitors could find space to grow, few markets offer this situation. Most businesses compete in either mature markets or markets with slow growth. Yet, even within mature markets, some companies manage to carve out a place and grow rapidly. This was certainly the case with Starbucks, Office Depot, Walmart, Aussie Home Loans, Virgin Records, Virgin Blue and Bendigo Community banks. They all found a way to compete which resulted in a significant shift in market share. Yet look at the products they sold, all well established products which had been around for some time. All these companies found a new business concept or process which dramatically increased customer value compared to their competitors.

It is easy to see how an invention can provide a competitive advantage. A major change in functionality, a new attribute of performance or a major reduction in cost will clearly unseat established firms. Innovation in product characteristics which taps into an unmet need can provide massive growth opportunities. At the same time, a major development in process innovation can lead to a raft of new products which can provide a first mover advantage which might give the business time to seize a leadership position in an emerging market.

Some competitive advantages are in fact monopolistic and provided under statutes or regulations. For example:

- Patents
- Trademarks
- Registered brands
- Copyright

- Licenses
- Legislated rights (forestry, mining, fishing and so on.)
- Regulated approval to sell (TGA, FDA)

While these vary in the degree of protection offered, they all provide some level of exclusive use and thus a competitive advantage.

However, if you have a product or service in a marketplace which is simply littered with comparable offerings, you have very little hope that your venture is going to gain the traction needed to support any significant level of growth. The market place is crowded with 'me-too' products. With little to differentiate them, customers will buy on a whim or simply treat them as a commodity and buy the one which is the most convenient or the cheapest. In these markets, shelf space and price are the dominant competitive dimensions. Unless you can control the shelf space or ensure you are the lowest price, your ability to forecast and control sales is limited.

The answer is to identify a niche market where your products and services better match the needs of the target market than your competitors. However, if everything you do to be different can be readily copied with little effort, clearly you are in a business with little chance of substantial growth.

Competitive advantage arises from having a superior position on one or more attributes which your target market values. In the case of customer value attributes, that superior position needs to be not only obvious to the prospective customer, but they must value it to the point where it is the major factor in their choice between competitive offerings. If the difference is strong enough and important enough for the customer, it is also the attribute which can drive a premium price position. In the case of internal operations, the attribute must result in a significant cost advantage which results in superior profit performance.

Few markets have customer utility and customer buying experience around a single dimension. Consider these aspects of the customer interface:

Utility:

- Functionality – How well does it do the job (specifications)?
- Safety – Some products are safer to use than others
- Fun and Image – Interesting colours, design, style and brand
- Environmental – Does it impact the environment and has this been taken into account in the design?
- Convenience – How easy is it to put away, carry and use?
- Simplicity – How simple is it to operate?

Purchase:

- Availability – How easy is it to find and buy?
- Information – How easy is to find out about the product and have questions answered?
- Delivery – What is involved in getting it delivered and picked up?
- Supplements – What after sales help, warranty, training etc can you access?
- Ease of use – How easy is the product to use?
- Disposal – How do you get rid of it when you don't want it any more?
- Maintenance – How easy and expensive is it to be maintained?
- Divisibility – How easy is it to try before you buy?

While many of these attributes refer to physical products, equivalent attributes exist with service offerings. Thus the quality of the experience itself is a dimension of many participant services. Customer service in terms of quality, consistency, friendliness, level of helpfulness, knowledge and so on, can be used to differentiate different types of experiences. Atmosphere, ambience, noise level, security, the type of other participants, duration and mementoes, all alter the feeling during and after an experience. The key to service experiences is to

work out how the customer expects to react and then to offer an exceptional experience along a dimension which the customer values and remembers.

Within any market there will be sets of customers who place different weights on the various attributes of the utility and the buying experience. In the end, you may have to make a choice between different attributes which are mutually exclusive or which compromise each other. Thus, portability may have to be sacrificed for greater productivity.

One dimension may be sufficient for you to create a niche market. Vibrant colors may not appeal to mainstream buyers but a fringe market may exist which appreciates unusual style and color. There may be a niche market in a rugged version of the product for use in difficult environmental situations like building sites or uninhabited regions.

Another dimension of competitive advantage can come from specialist information. Many firms have developed expertise in bidding on government contracts or in consortium tenders. Others have developed deep expertise in a specific application. Some recruitment firms specialize in one type of business or one type of professional executive. Package travel providers often specialize in one region or one type of experience.

Many businesses have grown substantial market presence by solving an especially difficult problem. For example, this could be in servicing jet engines or putting safety systems into mines. The key to this advantage is to solve a complex problem which requires unusual expertise and perhaps specialized equipment. Often these markets are not large enough to attract large corporations. Also, the expertise gained in such environments often cannot be used elsewhere.

There have been many situations in the past where competitors have fought for market share along a single dimension. This has normally been in product specifications, such things as capacity, power consumption, weight, pixels, size, accessories or speed. In their race to be first to market on the next dimension of competition, they often forget that customers have many other attributes of value and that substantial niche markets evolve around those. Thus a product which has average performance but has unbeatable customer service will

gather loyal customers and grow market share providing enough customers value customer service over other product attributes.

Only by finding a strong point of difference along an attribute which the target customer values will your products or services carve out a segment of the market. Clearly the most desirable position to be in is to have a product which not only fully meets the needs of the target customers but has no competitor or near substitute.

Unless the business has a strong cost advantage, growth will only be generated by products or services which are differentiated from the competitors. Typically this differentiation will be based on some level of innovation in product, process or business concept. The innovation itself needs to be difficult to match over a reasonable period of time for the business to gain a leadership position within its target market.

Growth businesses only maintain their position by staying ahead of their competitors. They are very sensitive to what their competitors are doing and how they are positioning themselves within the market. A superior position can be readily lost if a competitor is able to match or exceed your position on the attribute you have chosen to compete on.

The smart business is proactive in delivering increasing value to customers. Within their chosen market sectors, the most successful firms seek out the most demanding customers and work closely with them to provide an on-going stream of added value. These key accounts are often the reference point for other customers within the sector and their purchase decisions will highly influence others in the same market.

By staying close to the key customers and by working with them to establish where products and services need to evolve, the firm has a direct connection to customer value leadership. The market notes the buying preferences of the leaders and thus marketing is more by referral than persuasive marketing. This in turn can lead to greater marketing budget productivity.

Growth businesses carry out continual competitive analysis to ensure their market is not being eroded by developments in other firms. This analysis needs

to be matched with the target segment needs to ensure the firm's products and services continue to provide better value than the competitors. The competitive analysis needs to be able to show very clearly why the firm's products are preferred in some market segments to other offerings and to be able to offer reasonable proof of that assertion.

For a competitive advantage to be meaningful, it needs to be periodically validated by actual or potential customers. The difference must be meaningful and sufficiently important to the target customers that they have a clearly expressed preference for the product or service you are offering. Validation is also needed to ensure that other companies which do have product offerings in the general market in which you are dealing do not have a close alternative.

What we are looking for is a situation where the acquirer has a period of time to exploit the competitive advantage offered by the seller's strategic asset or capability. The strategic value flows directly from the buyer's ability to create much greater revenue than the seller. With the right level of competitive advantage, the buyer can put the seller's product or service into a large distribution channel and with adequate marketing support, the buyer can achieve revenue many times more than the seller would have been capable of. More particularly, the buyer will be able to generate that large revenue gain rapidly because all the other parts of the business concept are already in place. However, this opportunity only exists if the buyer is given enough time to exploit the opportunity and that requires some period of competitive advantage.

A product or capability which can be readily copied, easily assembled or quickly negated by competitor retaliation has little or no strategic value. Thus an essential characteristic of strategic value must be some period of strong competitive advantage.

Registered intellectual property typically provides this as does deep intellectual capital. However, strategic value may still accrue even where competitive advantage does not exist within a wider public market. A large company which can sell a new product or service back into a protected customer base can achieve a large revenue gain. A new product might be added to an already dominant product suite and be swept along in a sales situation. The acquirer may be able to make additional marginal revenue simply by adding

a complementary product to an existing suite of products. The competitive advantage still exists but it is accessed by living in the shadow of other offerings which are winning the business.

Competitive Advantage Check List:

- What patents have been filed or could be filed?
- What trademarks or brands are well established?
- What copyright exists?
- What regulated licenses or rights do you hold?
- What complex problems do you solve?
- What are your strengths and weaknesses vs. the competitors?
- What is the biggest problem your customers have which you could resolve?
- What compliance problem could the firm solve?

Target an identified and accessible niche market

Successful high growth businesses have a very clear definition of their target customer. They know exactly what problem their target customers have and they know how and where to deliver a sales message to the customer in a way which will create a positive situation for closing a sale. Above all else, the sales process is proactive. They go out and touch the target customer; they don't wait for them to find out about the firm and its products or to come and find them to buy the product.

You see businesses all the time which reach out to the general public in the hope they will buy. A retail store, a restaurant and the internet marketing firm are all hoping they can attract customers. But they have little influence over the buying cycle. When I walk down most main shopping streets I am constantly amazed at the number of shops which are closing or opening. I wonder what

happened to the ones which failed? However, it isn't hard to guess what went wrong with most of them. They set up the business using the 'hope' strategy.

They put up a sign or develop a web site and then think:

I hope people bother to stop and read about my products.
I hope they are interested enough to enquire and I hope that they have enough money to buy and are willing to do so.
Then I hope they will tell all their friends.

This does not create a high growth business. The high growth business proactively targets a specific customer who has a problem which they can solve. The customer is either publicly identified by name and address, such as a corporation or a professional service provider, or is available through a mailing list or is a member of a club or association which is willing to support a marketing approach to its members. The size of the market being addressed is sufficient to provide the growth projections of the firm for some years to come.

Alternatively, the customer can be readily reached through an established, or readily built distribution channel. This might be through a subscription magazine, a credit card member directory, a specific specialty store or a web site. The aim of the firm is to gain easy access to the specific customer who has a high likelihood of having the problem which is being addressed by the firm's products or services.

In order to generate the growth rate needed, the firm must be able to project the rate of sales of its product or services. To the extent that it can estimate the number of potential customers it can reach with its sales message, it has a much better chance of estimating its sales closure rate. The marketing program needs to have a very good estimate of the number of potential customers hearing its message in order to be able to estimate interested customers. With a tight customer profile, a readily identified method of reaching them individually and a clear understanding of the sales triggers, a proactive approach can be mounted to generate the level of sales activity the firm can support.

The more successful firms solve a very specific problem which has a compelling need to be resolved. The firm has a much easier marketing task where these problems are experienced by highly targeted and readily identified

customers who are able and willing to pay a reasonable price to satisfy the need. Highly specific problems also normally have readily obvious decision processes with which the firm can work. Thus specific information can be provided to demonstrate how the product or service can readily solve the problem.

A great number of businesses target 16 – 25 year olds, time poor executives, free thinkers or people with a desire to feel young at heart. The problem with this type of approach is that it is difficult to be proactive, to actually reach out and connect directly with the target customer. These businesses are highly dependent on the passing traffic for business. They typically advertise to the general public through newspapers, popular journals and TV. But they can't be sure they are getting to their intended audience. They are reliant on their target customers seeing them in passing. Since most of us are now highly resistant to advertising, much of the marketing spend is wasted.

Alternatively, highly targeted marketing to a named individual or to a tightly defined readership of a specialty journal or to a mailing list of a special interest group, is going to have a higher rate of contact. The marketing spend per contact is likely to be much lower and the conversion rate higher, especially if the problem being addressed has a high compelling need. Thus marketing productivity in high growth firms tends to be much higher.

Often the product or service can be aligned to a problem which is already the focus of attention of an interested group. Thus providing a solution to a new tax compliance issue may find receptive clients through an accountant's journal which has been addressing the need for some time. A plant soil additive which absorbs and slowly releases water which can be spread in a field in climates with erratic rainfall might be of interest to a farmers association or be picked up in a farmer's journal or a specific TV program.

Sometimes a firm can use an existing distribution channel to gain access to a target audience. Thus an existing supplier might be willing to bring a new product to the notice of their own customers if they see it might enhance their own customer relationships. This is often the case with strategic partnerships.

Multiple businesses might agree to work together to promote each other's products to the ultimate benefit of a joint customer. This was often the case

in the computer hardware industry. The marketing challenge of the computer hardware manufacturer was that they did not directly solve business problems. These were solved by software vendors and implementation consultants. In order to sell the hardware, they would identify the problem to be solved, find the right software solution and then present the prospect with a package of products and services from multiple strategic partners. The strategic partners would spend much less on marketing as the hardware vendor was searching out the right prospects for them.

The potential customer needs to be reachable for the firm to proactively impact the sale. A reachable customer is one you can get in front of with your product or service message. Potential customers must be identified with a location or place where you can deliver your message. This also needs to be cost effective, thus a TV advertisement aimed at registered dentists does not make a lot of sense when a trade journal, a dentist conference or direct sales visit to a registered dental surgery, would have a higher conversion rate.

For business to business sales, the sales process also needs to deal with complex multi-tiered decision processes. The person with the problem may not be the person making the buy recommendation or the person with the power to make the purchase. Sales processes need to understand the level of influence, the authority and the politics of the customer environment to close a sale.

An important attribute of the target market must be that they have the willingness and the ability to spend on the product or service. A potential user with no budget or authority may only be able to recommend the product or service, but the criteria for the buy decision may be made on other attributes of the product or vendor. The marketing and sales process needs to take these aspects into account when marketing and selling the product or service.

Clearly a high growth venture also needs to have prospective customers in sufficient numbers in order for the business to achieve enough revenue and profit to be a viable and growing entity. Many businesses limit themselves to one segment, geography or channel. For adequate growth to be achieved, the firm needs to project revenue over a number of years in its selected market segments. If these markets do not generate the necessary transaction volumes

to support a target growth rate, the business needs to look at new geographies, new channels and/or new markets for growth.

Instead of seeking out or developing new products for new customers, the firm should first see if it can find more of the same customers who brought it success. A product which has a clear competitive advantage, solves a compelling need and has a well defined target customer, should be readily accepted in other geographies. Even if the firm is unwilling or unable to establish its own operations in those new territories, it may be able to find distributors with the capacity, knowledge and distribution channels to handle the product or service. This way the firm can continue to benefit from its existing capabilities before it needs to spread its resources across other products.

Target Customer Check List:

- Does the firm have a well defined description of the prospective customer?
- Are there sufficient numbers of the target customers to create a high growth market?
- Is the firm able to obtain names and addresses of target customers in a manner which would allow personal approaches?
- Do the target customers belong to a specific association or well defined entity which would allow targeted marketing?
- Is there a well defined buying process used by the target customers which can be incorporated into the sales process?
- Is the firm able to create a sales proposition which can be put in front of the intended customer which the customer is likely to notice and act upon?
- Are the targeted customers willing and able to buy the product or service at the price offered?
- Is the problem or need being addressed obvious to the intended customer?
- What other businesses are already servicing the target customer which might be interested in working with the firm?

- Are there other products or services which complement those of the firm which can create a better overall solution for the target customer?

Scalability is critical

If the value of any investment is related to the net present value of the free cash flow generated by the investment, it follows that the value of a strategic asset or capability is directly related to the size and growth rate of the gross margins it generates. Thus early revenue generation is more valuable than later generation. Obviously, high growth rates are more valuable than slow growth rates. The value of any acquisition is thus directly related to the speed with which the acquired products or services can generate revenue, the faster the better and the greater the better. In selecting assets and capabilities as part of our strategic sale preparation, we need to look for assets and capabilities which are able to be rapidly scaled or replicated in the hands of the buyer and, obviously, the sooner the better.

In order to make the opportunity able to be exploited by a large corporation within a relatively short period, the selling firm must ensure the buyer has the capability to replicate and scale the strategic asset or capability being acquired. If the seller is unable to create the preconditions to enable the buyer to exploit the asset or capability properly, the corporation may decide not to undertake the acquisition. Few large corporations are willing to take on products or processes which can only be used in a small part of their business.

Part of the sale preparation is to put in place the structure of people and resources which will enable the buyer to scale the asset or capability as quickly as possible. This means the buyer would need to have the ability to rapidly add capacity or be able to use spare capacity, to have knowledge well documented and/or have people available who are able to quickly train a larger number of staff in using the newly acquired products or processes.

We need to concentrate our efforts on products or services which, by their very nature, are capable of driving high growth. We need to ensure that the sales growth which is being generated can be serviced by a highly scalable product or service. Clearly, for this to be effective, you need to start with assets and

capabilities which, because of the way they have been designed and supported, are able to be scaled.

Scalability is the ultimate key to a strategic sale. What the potential buyer needs to see is a high growth market which they can secure through the assets or capabilities of the seller. An acquirer who sees the possibility of a considerable increase in revenue by selling back into their own large customer base or through an existing distribution channel, need not be that concerned about paying a premium for the deal.

Not all products or services can be scaled. There are many situations where scalability is limited or inhibited. This is going to result in a low acquisition price or the deal not being consummated.

Location

A firm located in a region or section of a city which has difficult access or lacks good infrastructure and is unable to be relocated.

Tied to Culture

A product or service which is tightly tied to one limited culture.

Tied to Legislation

A product or service tightly coupled to local, state or national legislation which cannot be ported to another jurisdiction.

Locked in to One Customer

Products or services contracted to one customer or custom designed to suit one customer's specific requirements.

Un-codified Knowledge

Firms which do business out of their heads rather than using a documented, systematic procedure or process which can be readily passed on to new employees are limited in scope.

Highly Dependent on One or Few Individuals

This occurs where a small number of individuals are critical to making a business work and are linked closely to specific customer solutions. This can be difficult for the buyer as they face a risk of losing the capability if the key individuals leave.

Incomplete Solutions

Scalability requires the product or service be complete, tested and stabilized in customer reference sites.

Lack of Standardization

Firms which customize their solutions for every customer often require a high intellectual input. This requires high calibre staff with deep knowledge. The best situations for scalability are where the products are standardized and the level of intellect required to sell, install and support the product is relatively low.

When we seek out a potential buyer, we are looking for a corporation which has the ability to scale the strategic asset or capability rapidly. Clearly this provides the best outcome in terms of creating value on sale. We need to concentrate on those products or services which are able to be scaled rapidly and where we have the ability to put in place the foundations which will enable the buyer to do that.

A New Paradigm

If you decide to prepare the business for a strategic sale, you need to have an evaluation process which helps you identify strategic assets or capabilities. One of the major problems in this process that you may never have previously considered this type of exit and, therefore, have never thought of your products and services in that context. Also, you will normally have developed your business along a conventional growth path, perhaps even struggling to survive and thus you may well be selling products and services which suit your own capability and capacity and these may be very different from the products and services you could offer with the resources of a large corporation behind you.

You might get lucky and have a situation where the strategic assets and capabilities are obvious and are already being developed by the your firm. Then it is simply a case of working out what you have to do to sell to a strategic buyer. At other times, the answers won't be obvious and you will need to do some digging. Remember that what you are interested in is what a large corporation could exploit and this may not be what the your firm is currently developing, selling and supporting. In identifying strategic assets and capabilities, you are often trying to work out what you could do, what problems you could solve and which markets you could offer solutions in.

Usually the key to identifying the strategic assets or capabilities, if there are any, lies in what problems the firm is currently solving or could solve. Usually I start by identifying those problems which represent high compelling needs.

You can start by understanding what problems or needs the business is focused on currently. Too often we see our business in terms of features and functions, products and services, customers and markets but not problems and needs. Once you have identified the problems and needs being addressed, you can rank these in terms of their market growth potential.

- *How quickly do you secure the business?*
- *What level of competition do you face?*
- *How price sensitive is the customer?*
- *What is your competitive advantage?*
- *How scalable is the solution?*

This is a useful starting point but remember that the business will be developed for sale and so some of these issues will be further addressed to improve their outcomes.

Now start to look at potential. That is, what could you do. What you are looking for is a set of problems or needs which you could address with the underlying intellectual property and intellectual capital you have. Remember, it is not necessarily what you are doing now but what problems and needs a large corporation could address with what you have. What additional or different problems could you solve within a short period given access to the resources of a large corporation?

So, if you had the resources and market access:

- *Which problems could you solve with what you have now or could develop in a short period of time?*
- *Which customers have these problems and is the market large?*
- *Would these customers be willing to pay a premium for a solution?*
- *What level of protection can be built into the products or services to provide a reasonable period of high competitive advantage?*
- *Could these products or services be developed and validated in a relatively short period at a reasonable cost?*
- *Can the products or services be put into a form where a large corporation could rapidly scale or replicate them?*

Obviously the key here is whether a large corporation would be willing to acquire the firm to pursue the revenue opportunity, thus the identification of potential acquirers will be critical to the sale preparation task. If you don't have existing products or services to work with or don't have the potential to develop them, you do not have the fundamental building blocks for a strategic sale. Therefore, businesses which do not have existing products or services or do not have the potential to develop highly scalable strategic products or services do not have the potential to be strategic exits.

9

Finding Strategic Buyers

The ultimate strategic buyer is the one which can best utilize the underlying assets and capabilities of the firm. Once the assets and competencies are identified, the search starts for those corporations which can best leverage them.

An investigation of historical strategic sales will show that these businesses were not acquired for their inherent revenue and profits. It was an underlying asset or capability which the acquirer was seeking and they justified the premium on the purchase price by showing they could generate significant future value through the acquisition.

In many acquisition situations, the acquirer is consolidating a number of similar businesses with the aim to build cumulative capacity in terms of revenue. The synergy in the consolidated business comes through economies of scale. In this situation, it is very difficult for a firm to achieve a premium on sale unless they are a key firm in the industry and their acquisition can convince others to join the consolidated entity. Alternatively, they may have some management processes which can take additional costs out of the combined entity. These are not strategic deals. Corporations undertaking consolidation strategies are unlikely strategic buyers.

In seeking out potential strategic buyers, you need to find corporations which can generate large new revenues or resolve serious threats through the acquisition. You should start your search for potential strategic buyers by developing a screening technique to whittle down the list of potential buyers. In the end, you want about 5 – 8 corporations which meet all your selection criteria. If it is not possible to identify that many, then you want those which have the best available fit. I usually start with a wide net and use a series of tests to exclude candidates.

Start with a set of questions which will generate an initial population of corporations which have something in common with your firm.

- *Who makes money when I make money?*
- *Who does not make money when I make money?*
- *Who can make more money than I can from my products?*
- *Who can remove a constraint on my business?*
- *Who has a problem I can fix?*
- *What threat can I reduce or eliminate?*
- *Who sells to the same customers I sell to?*
- *Who uses the same technology I use?*
- *Who needs my customer base?*
- *Who needs my technology or people?*

Who makes money when I make money?

The most common acquisition path is to sell to a partner. Where the firm is jointly selling into a customer, each taking a part of the profit, the larger firm will often want to be in better control of the sales process and the account future. Also a supplier generally makes money when the firm makes a sale and may wish to integrate forward to control the channel and to scale the business. A distributor also makes money when they sell the firm's products. They may wish to integrate backwards to scale the opportunity by increasing capacity, increasing R&D or providing greater coverage.

Who does not make money when I make money?

If one firm wins a contract, it generally means another has lost it. Buying a competitor may provide multiple benefits to the acquirer. It may increase the customer base for existing products, reduce pressure on price, make the sales process more effective by eliminating a competitor and acquire some new product capabilities. The acquirer may wish to upgrade their products, integrate some of the products into theirs, cross sell new products to existing customers, acquire technology or R&D capability or acquire a customer base.

Who can make more money than I can from my products?

The selling firm should look far and wide to find a firm with the capacity to scale their products into larger markets. A buyer which can readily introduce the products into existing customers and/or existing distribution channels is an ideal target. A buyer which has the capacity to rapidly expand the products into a sector they are not currently in, but have the muscle to expand into that sector, is also a good target.

Who can remove a constraint on my business?

If you wished to scale your business by 5 to 10 times – what is the factor constraining your ability to do so? This could be location, distribution channel, export capability, finance and so on. If the constraint could be removed, how much more revenue and profit could be achieved. The strategic buyer is the one which can overcome the constraint.

Who has a problem I can fix?

Often firms lack the capability or capacity in a new area, new technology or new process. Sometimes the quickest way to solve this problem is to acquire it. Alternatively, the firm may be faced with legislative changes, changing market conditions or the loss of key staff. A firm which can solve the problem may be an ideal acquisition.

What threat can I reduce or eliminate?

A threat occurs when a firm is faced with a potential or actual decline in current revenue. This would often come from an existing or new

competitor. The firm may not have the luxury of time to create a competitive product and so acquiring already available products may help to eliminate or reduce the threat. A threat may also occur where the competitors are anticipated to undertake some action. Being first off the block may counter the advantage they otherwise would achieve.

A threat may also come with loss of a key distribution agreement, key account or key capability. Loss of key staff may create a gap in capability in any part of the firm. An acquisition may be used to resolve the problem as well as provide increased capability.

Forward integration is sometimes used to reduce the threat of loss of distribution capability. A key distributor might be acquired by a competitor or a distributor may be financially unstable. Rather than risk loss of the distribution capability, the firm may buy it out.

Alternatively, the firm may be facing a risk with a supplier. The supplier might be acquired by a competitor thus locking out a source of supply or they may be financially unstable. A supplier which is not developing products in line with a firm's strategy may also be acquired in order to own the capability.

Who sells to the same customers I sell to?

Scanning customers to find another company which sells to them will often indicate a potential buyer who can capitalize on knowledge of that customer sector. They may be able to cross sell products or utilize their own distribution channel to move new products.

Who uses the same technology I use?

If a key ingredient to the success of the firm is the use of a specific technology which is expensive or difficult or time consuming to acquire, another firm which uses that technology may wish to acquire the firm to increase capacity or enter new markets. For example, in software technology, many firms which merged used the same underlying language or database technology.

Who needs my customer base?

The customer base can often be a very valuable asset, especially if it provides opportunities for the acquirer to sell additional products or to break into a new sector.

Who needs my technology or people?

A specialized technology, especially if protected with patents, or specialized staff with deep knowledge, can often provide a buyer with scalable opportunities.

Our selection process should have the objective of identifying those corporations which have the capability and capacity to fully and quickly exploit the strategic assets and capabilities of the firm. You want the potential buyer to quickly see the benefits of an acquisition and to recognize they have the capability to exploit its revenue potential.

You should exclude acquisition beginners or corporations wanting to enter a new market (unless that is their core competence). To be really pragmatic, you are seeking a potential buyer who thinks it will be easy to achieve the benefits of the acquisition because they understand it very well, have the capacity and capability to roll out the new product or service and already have experience in the target market.

Reviewing Markets and Products

Ideally, you are seeking a very large corporation which can bring your products to market quickly, has the customer base and/or distribution channels already in place and has the resources to do the job efficiently and quickly. If you can structure your company so that your strategic asset or capability can be rapidly scaled or replicated, which corporation has the best chance of taking it to market and generating the most revenue from it?

Your ideal buyer is a corporation which can take on the strategic asset or capability and quickly generate revenue from it by selling it into an existing marketplace where they already have access.

In order to tease out possibilities, I often take the ideal product/market scenario and look at who will make money out of it if it is hugely successful. This could be the retailer, wholesaler, manufacturer, supplier, installer and so on. This will often help you identify who has the greatest interest in the solution becoming widely available. Another test is to work out who has the best capability of a large rollout. This will often identify the corporation which is best able to undertake the task.

As we have seen from our earlier look at net present value, early revenue is worth a lot more than later revenue. For example, lets say you have two possible buyers, each can generate $10 million in gross margin in the first two years. The better one is the one which can generate the revenue earlier. Using a 50% discount factor we get the following NPV on acquisition.

	Year One Revenue	***Year Two Revenue***	***NPV***
Buyer One	*2*	*8*	*4.8*
Buyer Two	*4*	*6*	*5.3*

In scenario Buyer Two, the acquisition is worth 10% more to the buyer. However, you are more likely to see more dramatic differences. Many potential buyers might need to develop a capability to enter the new market first, delaying the early revenue until year two or three. Other potential buyers will take longer to ramp up the revenue as they retrain staff or undertake trails to become familiar with the product/market.

Many large corporations have an acquisition criteria of achieving a payback in the first two years of the acquisition. Thus the maximum value they are willing to pay is the gross margin achieved in the first two years of the acquisition. Any delay in scaling up revenue will severely punish the seller.

Another consideration for the buyer is the level of uncertainty associated with achieving revenue. Products which can be sold without further development and can be sold to existing customers represent a considerable reduction in risk to the buyer. The buyer will be interested in longer term revenue possibilities

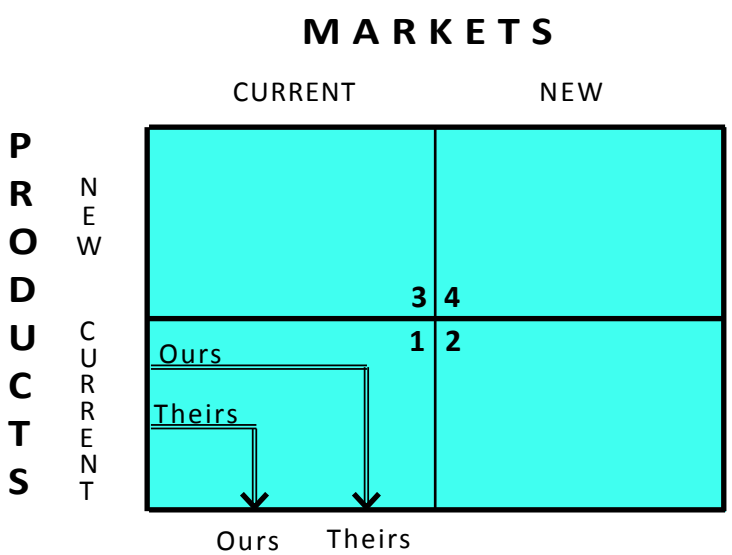
and this will make the acquisition more attractive, but clearly the focus of the seller should be on short term revenue at the least risk to the buyer.

QUADRANT ONE: Existing products into existing markets

Look for situations where the acquired products or services can be sold into a large established customer base or through well established distribution channels. Ideally, what you would like to see is that the buyer already has the distribution channels and the customer relationships in place to quickly sell the products.

Alternatively, look for situations where the acquired firm has a large customer base which can quickly absorb the products of the acquirer. In some cases there are opportunities for a cross selling situation.

In this situation, the buyer faces very low risks as products are already fully developed and markets already exist and are being serviced by the corporation. Early revenue, possibly well within the initial two year target is highly likely.

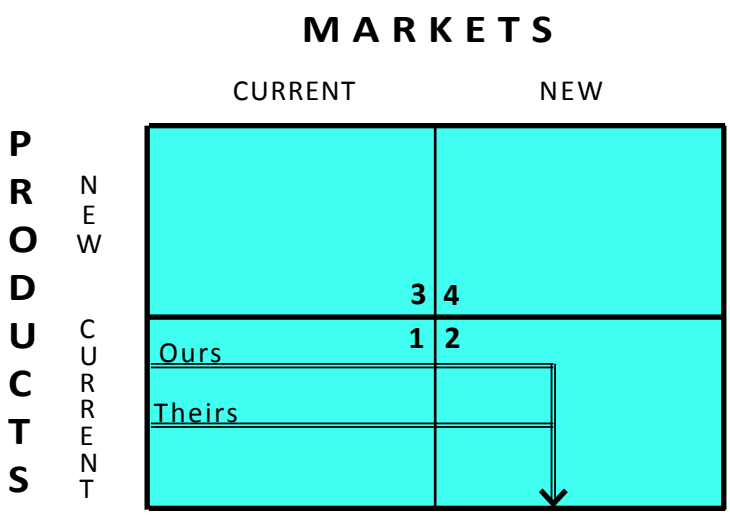


QUADRANT TWO: Existing products into new markets

Most firms know where they would expand their reach if they had the capacity to do so. Thus a company selling into legal offices might expand into auditing firms. A firm selling in the eastern states might expand into the center of the country or open up markets in the western states.

While there is some market risk, the products are already well established, are not being altered and already have a reasonable chance of success in the new markets.

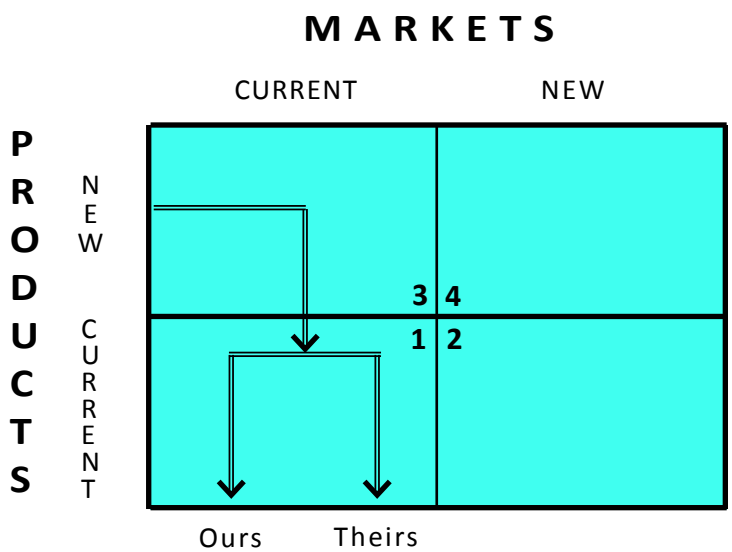
In this scenario, there is a market risk but no product risk. Chances are that an aggressive roll out campaign could secure some new revenue within the two year target window. Longer term revenue is certainly able to be achieved in this quadrant.



QUADRANT THREE: Enhanced products into existing markets

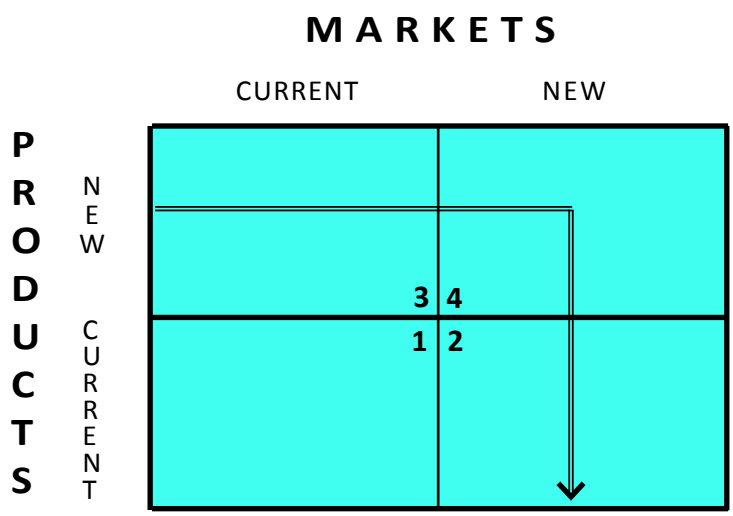
Most firms know where they would enhance or develop their products to provide more functionality or features for their existing customers and hopefully secure more sales or sales at higher price points by doing so.

In this scenario, the corporation is facing some level of product risk but has no market risk. Few product developments happen without delays and cost overruns and so there is some risk, especially in time to market, for this scenario. Even so, there may be some new revenue achieved within the two year window. Longer term revenue will be achieved through this scenario.



QUADRANT FOUR: New products into new markets

The acquiring corporation will have a much longer planning horizon than the selling firm. The buyer will be interested in the long term possibilities of developing the products and services and opening up new markets for penetration. However, it is unlikely that this will occur within the two year window and thus it should not be expected to contribute to the sale value, however, it will make the acquisition more attractive to the buyer.



With this new insight into when revenue will be generated and what risks will be faced by the buyer, you can be much more selective in the choice of potential buyers. Those with large early revenue possibilities should be much more attractive as potential buyers.

The issue of early revenue and low risk is critical in the choice of potential buyers. However, there are still many factors to consider apart from product and market fit, there is also the consideration of how quickly the buyer can ramp up to get product out the door. Some of these issues will be addressed in a later chapter on enabling the buyer but some problems the seller cannot resolve.

Take for instance the problem of putting in place high volume manufacturing or large scale recruitment of service delivery and support personnel. There is only so much which can be done within a limited time period. If process lines need to be re-engineered, if new office accommodation needs to be sourced, if salespeople need to be retrained or specialised equipment acquired, all this takes time and delays the ramp up of revenue generation. What the seller has to do is anticipate these issues and either select potential buyers who don't have these problems or work to find a short term solution which can be implemented while the buyer is putting in place their own capability.

Further Considerations in Selecting the Buyer

There is little point in being acquired if you don't achieve your priority objectives. If harvesting the value in your business is the primary objective, selling out for shares in a privately held business where you are a minority shareholder is not an effective exit. This makes the publicly listed corporation a much more attractive target. Once the listed shares are held past the lock down period, they are normally able to be freely traded, although if some of the former shareholders continue to work for the acquirer, they may be subject to some restrictions.

Your selection criteria for the buyer should also look at their experience in acquisitions, whether they have dedicated staff to handle the negotiations and integration and whether you think they will be a willing rather than a reluctant buyer. You don't want to spend your time educating the buyer on how to do an acquisition nor do you want to be dependent on them making it work where you have some possibility of a claw back or potential litigation if they fail.

Normally you would want to exclude any corporation which does not have a healthy business in terms of potential growth and reasonable profits. You need to be assured they have the capacity to execute on the deal and won't be wavering when something else goes wrong with their existing operations.

While it might look attractive to squeeze the last drop out of your buyer, you should try to avoid the naive buyer. There are some very good reasons why you might want to limit your selection of potential buyers to those companies with a good track record of successful acquisitions.

There is now considerable research available on acquisitions and their impact on the acquiring corporation. A 1999 study by KPMG found that 83% of mergers failed to unlock value. A 2004 study by Bain & Company of 790 deals made by US based companies from 1995 to 2001 confirmed prior research that "70% of all deals fail to create meaningful shareholder value". It would seem that the likelihood of success in a merger or acquisition is against the acquirer. However, a more recent Bain & Company study of seventeen hundred large public companies in six industrialized nations spanning the time period of 1986 to 2001 did uncover corporations which were consistently successful in their M&A activities.

Bain found that the successful corporations had several characteristics in common:

- They were frequent acquirers. That is, they had an M&A program undertook regular acquisitions;
- They typically started with small deals and gradually became more expert at acquisitions and then progressed to larger deals;
- The size of the deals was generally small – often less than 15% of the parent company's capitalized worth;
- A clear return on investment case was made for the acquisition and they were prepared to walk away if their criteria was not met;
- A comprehensive due diligence was undertaken of the potential target with a strong emphasis on the integration effort. This included a serious consideration of the culture match between the two businesses;
- Frequent acquirers set up benchmarks so they know the integration effort is on track and have processes to deal with under-achievement; and
- Successful acquirers have an acquisition strategy which targets potential firms which offer value to their core business and builds relationships with them prior to formal discussions.

Basically you want smart acquirers. They know whether they can make it work and you want a buyer which can. Because they know what they are doing, they won't waste your time and they will quickly recognize the strategic value if it works for them. They know the right questions to ask and will understand how much effort you have put into making it successful for them. Acquirers who overpay, who don't know what they are doing or mess up are your nightmare. They will send their lawyers after you to get their money back.

There are some other good reasons why you might want to look for competent and successful acquirers. Generally they have been there before and understand what to look for, thus their due diligence will be thorough. If they find a serious problem they will request it be fixed, make an allowance to fix it or walk away. That means there are unlikely to be hidden rocks which can catch you out later on.

The last thing you want is for the buyer to sue you over something which could have been discovered and dealt with during the due diligence process. You also want a successful integration of your business into the buyer's and you want them to achieve the benefits of the acquisition. A buyer which is making lots of money from an acquisition is less likely to worry about a few problems they uncover. But always keep in mind that a deal which goes sour will find the buyer going over every inch of the business trying to find how they can litigate to recover their investment.

Clearly successful acquirers rarely overpay for their acquisitions and so it would appear that your chance of generating a premium on the sale of your business would be minimal. However, it is clear that successful acquirers also look for strategic value and are generally prepared to pay above fair market value to gain such a strategic uplift. They are interested in acquiring firms which can clearly add to their core business through extending the scope of their offerings or their ability to scale the size of their business through distribution capacity or customer base. The firm which can show how their products, processes or capabilities can be leveraged by the acquirer should be a good acquisition target.

Your proposition to a potential acquirer should show the buyer how they can exploit the potential of your business. Most private firms are constrained

by limited resources, lack of funding, an inability to recruit the best people due to their size, a limited distribution channel or small customer base. Often these elements are exactly what the larger corporations have in abundance. This presents a great opportunity for the acquirer to release unrealized revenue from the underlying products, processes or capabilities of the smaller firm. The key is to find the right buyer which can do that. If you can show how significant revenue can be generated, then it is certainly possible to extract a premium on sale of the business.

The successful acquirer which pays a premium on the deal is also less likely to terminate your employees. They acquire the business because they see potential in it. It is most likely that the potential needs to be supported by your previous employees, thus you are also taking care of your loyal employees by finding the right buyer. Successful acquirers also understand how to go about the integration effort and are less likely to lose good people through a lack of understanding of the degree of change they are being put through.

Frequent acquirers will almost certainly have a formal process of evaluation, due diligence and integration. They will have learnt from their mistakes and built up an accumulated knowledge of what works and what does not. This should mean they won't waste your time while they figure out how to do the deal. They also might be willing to share some or all of that information with you in a friendly deal so the final outcome is better for both parties.

The experienced acquirer will have a senior member of their executive team who has primary responsibility for assessing potential acquisitions. This also makes your task easier as there is a name for you to contact. Since that person performs only by making acquisitions, they need to have a pipeline of possible acquisitions. Their job includes setting up relationships with potential targets and thus you are helping them achieve their objectives by approaching them with a possible future deal. This makes your task easier as they may assist you in setting up other contacts within their firm so you can better understand where the strategic value might best be utilized.

If they have a formal process, you may be able to review it to see if you fit their acquisition and return on investment (ROI) criteria. Again this helps you weed out potential acquirers where you are not able to meet a critical

requirement. However, where you clearly meet their conditions, this helps you gain more attention during the relationship building phase.

Frequent acquirers know the importance of undertaking friendly acquisitions. Companies which have been through hostile takeovers understand the levels of stress placed on both organizations, the loss of staff during the process and the difficulty of integration. Where they can, acquirers would rather build a mutual case where both parties are comfortable with the acquisition. By undertaking this over a period of time, both parties can sort out the most appropriate integration level and use the time to convince the best people to stay with the merged business.

Culture is seen to be critical in most acquisitions. Only where there is almost no integration can unlike cultures co-exist. The more integrated the planned combined operations will be, the more critical it is that pre-acquisition cultures are compatible. The seller needs to have a good feeling for the match between cultures. Spending some time with the other party pre-acquisition is essential to avoid a disaster. It is in the best interests of the seller for the acquisition to be successful, even several years after the deal is done. Where there is a choice between potential acquirers, the seller should give the culture match serious thought.

If the potential buyer has made prior acquisitions, part of your due diligence on them should be to examine the success or failure of their previous acquisitions. Serious acquirers understand this and should be willing for you to interview the founders and some of the former executives who stayed with the merged business and perhaps some of those who left.

Your objective is always to produce a deal which works for the buyer while allowing you to achieve a premium on sale. By reviewing prior acquisitions, you can see if they have a track record of making deals successful for the sellers as well as for themselves.

- *Were the sellers happy with their deals?*
- *Were any of them sued after the event?*

- *Did any of them stay with the merged company – what was their experience?*
- *How did the earn-out conditions work out?*

Example:

Hampton was equally optimistic about the synergy coming from the acquisition. "Our combined companies are already producing innovative ideas," said Kelley. "During the courting phase, our two R&D teams worked together to develop several new products, including a revolutionary bungee cord with a built-in carabiner style hook. It was introduced at the Automotive Aftermarket Products Expo (AAPEX) in Las Vegas last November and is already generating excitement with the company's key customers." Together, Hampton Automotive Group and Keeper plan to launch over 200 new and proprietary towing, towing security, cargo management products and merchandising concepts "to meet the needs of a changing marketplace," he added.

Source: http:// www.theautochannel.com/news/2006/01/23/208192.html. Accessed 18th February 2006

Many strategic acquisitions occur where there has been a prior relationship between the companies

Example:

In Satyam-Citisofts case, the two firms were introduced through mutual clients of Citisoft and Satyams Financial Services Group, the division into which Citisoft will now be included, and Bear Stearns Asset Management was a mutual client quoted in the release announcing the acquisition.

Source: http://www.a1technology.com/blog/2005/10/satyam-computer-services-limited.htm. Accessed 18th February 2006

Connections between buyer and seller are often related to mutual customers, suppliers and strategic partners.

Do I Have to Sell the Whole Business?

Many business owners only think of selling the whole business without considering whether it could be sold off in parts. In fact, the total sale proceeds may be significantly more if the business is sold in stages, perhaps to different buyers. Not only will selling over time potentially make more money for the shareholders, it can be a very useful way of restructuring or refocusing the business.

Many businesses grow in an unstructured manner. Investments are often made over time to suit the personal interests of the owners or to solve temporary problems. Often those investments end up with a life of their own and develop into significant parts of the business. Many family businesses grow this way and end up spread across a range of activities which are sometimes only loosely integrated. In fact, when it comes to deciding what makes the most sense or the most money, there are often parts of the business which should be sold off.

One harvesting strategy is to prepare one part of the business for sale at a time. Where there are different parts of the business operating in different markets and with different products or services, this should be relatively easy. The objective is to repackage each business unit as a separate stand-alone business and then prepare it for new ownership. This is often easier to resource and certainly easier to manage if there are very different buyers for the different activities. Proceeds from each sale can either be channeled back into the core business or given to the shareholders. Alternatively, the business can be restructured to allow some shareholders to cash out thus providing a way of concentrating the shareholding or providing flexibility to bring in new shareholders.

Often when I investigate a firm to prepare a sale strategy, I uncover a variety of underlying assets and capabilities which will appeal to two or more very different buyers. In order to optimize the overall sale price, I will recommend the firm be split up with each part being specifically targeted for a selected set of potential buyers. This process takes time and money and thus a phased approach is often the most sensible strategy. Of course, it is also true that a complex business is often hard to sell because it may not have an obvious buyer.

I have also seen situations where one part of the business is worth more by itself than the value which was originally assigned to the whole firm. The sum of the parts is often worth more than the whole.

Final Selection

From the information you have gathered and your own understanding of the market, develop a final selection criteria and use this to screen the remaining candidates. I develop a list of ideal buyer attributes and use those to screen potential buyers. This could extend to 12-15 attributes covering size, location, markets, acquisition history, culture and so on. If this list produces 5 – 8 ideal candidates, you would stop there as that is sufficient to develop the sale process.

If there are not sufficient ideal candidates, you do need to source further potential buyers. Almost without exception, not all potential buyers will be able to act on the opportunity at the time you wish to sell thus you need a reasonable number of possible buyers. At the same time, a long list is unworkable. You simply won't have the time and energy to work on the relationships to bring them to the table at the right time.

If you are unsure of the worth of some of the potential buyers, you can simply approach them with details of what you have and ask for an expression of interest. This will help cut down the number as some will exclude themselves.

Once you have the list of potential buyers, you need to work out what you have to do to make a compelling case for each one. A major part of the preparation is to ensure the buyer can quickly exploit the strategic assets or capabilities. I call this 'enabling the opportunity' which I will cover in a later chapter.

Sale Preparation

10

Sustainable Competitive Advantage

Whether it is a financial or strategic exit, the premium on sale is usually delivered through the growth potential of the business being sold. In the case of a financial sale, it is the potential revenue and profit growth from the existing business and in new areas of growth which will drive the premium on sale. Protecting the existing business and enhancing the competitive position of new business is critical to securing the premium on sale. In the case of a strategic sale, the vendor has to ensure the buyer has time to exploit the strategic assets and capabilities being transferred with the sale. In both cases, providing greater protection to future revenue streams enhances the sale proposition but also reduces the risk to the buyer.

Identifying strategic assets and capabilities which can underpin a strategic sale strategy is a key part of preparing the business for a strategic exit. However, unless the buyer has some reasonable time to exploit the high growth potential, the strategic value will be undermined. An important part of our preparation for sale and a critical part of the message to be delivered to the potential buyer must be that the seller can offer a sustainable competitive advantage for the assets or capabilities beyond the sale date to convince the buyer to pay strategic value in the deal.

High growth is most often achieved by seizing a segment of a market and protecting it rather than chasing a large potential market where the venture

has marginal competitive advantages. The business which can gain a strong foothold in part of a market often has the luxury of time to work out how best to grow the business. While many entrepreneurs focus on growth strategies, the smart ones build a wall around their business which can protect them and allow them to exploit the underlying potential in their products and processes. The vendor needs to construct the foundations for such a wall for the buyer to allow them time to exploit their acquisition.

Once the sustainability conditions are established, the entrepreneur then should think about how best to position the asset or capability for growth. Many owners are so focused on the next deal or short term gains that they forget to structure their businesses for growth. This involves packaging and structuring the product or service so that it can be rapidly scaled and /or replicated as well as putting in the other elements to enable the new buyer to exploit its potential. We will be looking at enabling strategies in a later chapter.

Sustainability Characteristics

There are two critical factors in sustaining a growth strategy; getting the business and keeping the business. The size of the market or the growth in the market does not guarantee you will have a share in it and your competitive advantage today may not be a competitive advantage next year. Your major threat may be that your best customers may be purchasing from your competitor next time they buy.

Most entrepreneurs understand the concepts associated with creating a competitive advantage to win the business in the first place, few however, seem to understand what action they should or can take to protect that business from competitors. Protecting the growth potential in the business is critical to generating a high premium on sale. This is especially important in fast paced businesses where product innovation is rapid.

The basic principal behind sustainable competitive advantage is to ensure you have the only viable solution which can solve the critical need of your target customer. You don't necessarily need to have the best solution, only the one which your customer is willing or able to buy. Basically, you need to deny your

competitors access to your customer base by building a wall around the supply chain to the customer.

Competitive advantages are transient. There are numerous forces acting within markets which will undermine competitive positions. These include such factors as;

- Expiration of patents, licenses and copyrights
- New inventions which provide better, cheaper and/or more effective solutions
- New processes which increase productivity or provide new benefits
- New ways of doing business which customers prefer
- Competition arising from more open trade agreements

Thus a strong position at one point in time may be eroded either by the passage of time or by new products and/or new competitors coming into the market. Competing in any market with a constant stream of new products and penetrating new markets is hard work and fighting it out prospect by prospect puts a considerable strain on the business and it's staff. In the absence of some overpowering long term competitive advantage which allows the business some margin for error, you are going to have to battle for each new customer.

Few businesses have the ability to sustain a superior competitive advantage which will ensure a constant stream of new customers. To survive the downturns and competitive attacks you need to build a buffer which will give you time to regroup and come back with new products and/or services. That buffer needs to be built from the existing customer base through recurring revenue, cross selling and account penetration. In order to do that, you need to protect your current customer base from erosion, even in the face of superior products or services from your competition. The task of the entrepreneur is to anticipate new competitors, better products and new business models and to create barriers to these so the current customers either can't move or don't want to move to a competitor.

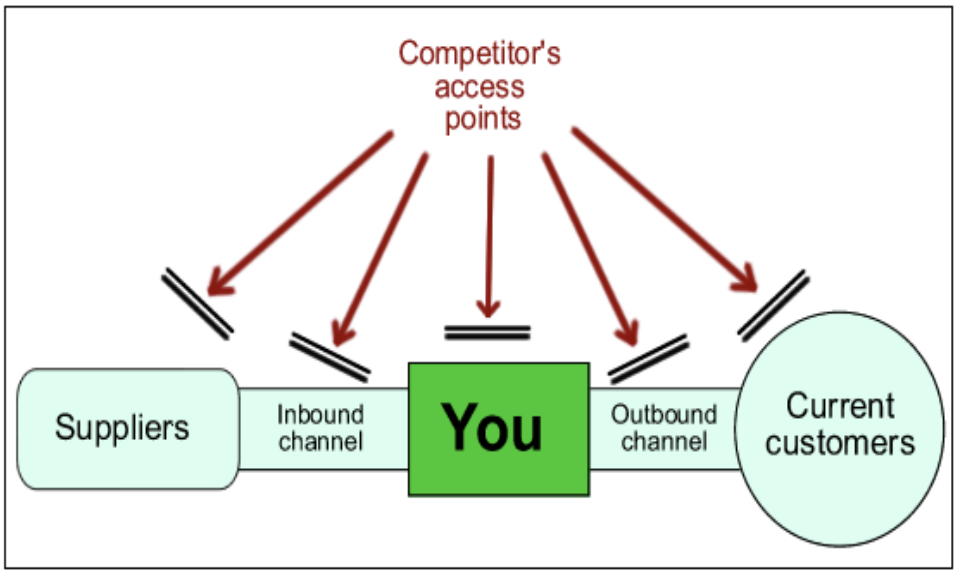
Many entrepreneurs think their business is sufficiently protected by having a superior product or service or by making the product or services offering different in some way from their competitors. This is normally achieved through a combination of features and functions which customers value or it could be

through superior customer service, availability, after sales support and so on. It is highly likely that a winning combination can help secure the initial sale, however, this does not stop the competitor from copying what you do, maybe doing it better and then chipping away at your customer base.

Some entrepreneurs are mesmerized by the size of the potential market. They take comfort in the fact that there will always be new customers to sell to. They seem to think that because there are large numbers of potential customers, they have some divine right to get their share of the potential customers as they pass by. However, the rate of company failures would suggest otherwise. It is not just the competitors you can see that should give you cause for concern; it is new entrants which come into your market with a different business model which can turn an industry on its head. Your hard won competitive advantage goes out the door and your current customer base is under attack. Holding onto your current customers and protecting your recurring revenue is an imperative for survival. The firm which has not bothered to block off the competitors will be the most vulnerable to such changes.

Many entrepreneurs search for the holy grail of 'first mover advantage'. Certainly being first to market can often provide a business with an opportunity to gain premium prices. For example; new markets can sometimes be readily harvested if the new business solves an important problem. Early demand often allows 'cherry picking' – taking those with the highest needs or those who are the most innovative as early customers. First mover advantages are most often associated with new inventions but can also be associated with new ways of doing business. However, there is nothing in this strategy which suggests that you can sustain the initial advantage. Once competitors imitate your product or service, they can attack your customer base.

Whether you have an overpowering competitive advantage or not, you should still implement blocking mechanisms to protect current customer business. The planning question is; "What is going to stop my competitors taking away my customers?"



You need to block competitor's access to your supply chain

Protecting the Business

Blocking out competitors 100% is an ideal. It is unlikely you can develop a business concept which can protect you from competitors over a very long period of time. However, having an understanding of the ultimate or ideal techniques of protection can help you to identify ways in which you can protect your business from competitors. Each link in the supply chain from component to customer provides you with opportunities to block competitors. Any link which is blocked from competitor access may be sufficient to protect the business. Combinations of blocking techniques over several links will increase the probability of success.

The objective of a blocking strategy is to find ways to protect each link in the supply chain so that a competitor is denied access. Where that is not 100%, you want to make it difficult, time consuming or expensive to overcome your blocking factors thus limiting the erosion of current customers. For example, if you have an early warning of an approach to a customer, but the competitor

has to do a lot of work to undermine your position, you have the opportunity of working with the customer to create further impediments.

Customer Blocking Techniques

Most firms have repeat sales to their existing customers. Once the initial sale is made, you need to move immediately to closing the door behind you to your competitors. You need to construct a situation which will ensure future purchases are sent your way and not to your competitors. If you can prevent your competitors from selling to your customers, you have effectively protected that part of your income stream. Your objective is to lock down your customer so they have no choice but to buy from you even when your competitor introduces a better product or service which could more effectively satisfy the customer's needs. I am not suggesting you do anything illegal or unethical to gain the business, only that you undertake sensible and legal blocking techniques.

Clearly the most effective way to lock down the customer is through an exclusive purchase agreement. This need not be to the customer's detriment. There are some very good reasons why the customer may allow or even encourage this arrangement

- Reduction in costs of preparing procurement agreements
- Economies of scale in ordering, freight, receiving and storage
- High learning curve costs in understanding the complexities of each organization, their ordering and fulfilment processes
- Time and resources required in building relationships at multiple layers in each firm
- High start up costs in bringing on a new technology or process. This could involve organisational changes, data conversion and training costs.
- Committed capacity to customer's business

Many companies have implemented single source procurement agreements to provide stability with their suppliers and to show that long term relationships are more important than short term cost savings. It is very common for this structure to be used to implement the exchange of intellectual property, joint design teams and sharing of cost savings.

This arrangement can be sold to the customer if the customer can be convinced that such an exclusive agreement is in their long term interest. The customer has to be presented with a convincing argument of benefits, economies or efficiencies which would accrue to them from locking themselves into such a relationship. This is the ultimate in customer lock-in and the time taken to design products, services and relationships with this end in mind can be the key to long term protection of recurring revenue. The sales process needs to see long term protection of recurring revenue to be as important as the initial sale. Once the relationship is in place, not only will it protect repeat purchases of the same products or service but it can result in lower cost of sales for cross selling products and services.

Some corporate customers are prepared to agree long term procurement agreements in return for discounts, additional customer services or simply to keep life simple. Many corporate buyers believe in building relationships with a smaller number of suppliers in order to gain better attention from the supplier and to ultimately drive costs down and improve quality by working together on procurement programs. You should try to move a preferred supplier agreement to an exclusive arrangement.

Complex products which require considerable up front installation and on-going support are also effective ways of capturing customers over a long period. The 'switching costs', which includes costs, time and stress of moving to another product, can often be very high, thus once sold, customers tend to stay with the initial supplier for a long time. This relationship can be used to leverage cross selling opportunities, especially where additional products can be easily integrated into systems or products already in place. Many software products fit this category.

Some products have a lock in feature due to the conditions under which they are acquired. Life insurance and health insurance, for example, can be prohibitive to change if personal circumstances change and a new policy would be difficult and/or costly to acquire. To retain the benefits, the customer has to stay with their existing policy.

While not 100% perfect, many membership programs create some form of lock in for the customer. Airline frequent flyer programs or store frequent

purchaser programs attempt to create loyalty and to provide the customer with additional benefits which only accrue with frequent or volume purchases.

Example:

Arthur Leontaritis, former part owner of the Basque tapas and wine bar in lower Chapel Street in Melbourne, was highly enthusiastic about his loyalty program. They gave one free coffee for every 6 purchased. "We have been open since September 2003 and introduced the loyalty cards about three months later" said Arthur. "The effect on the business is significant. At the time of introduction we were doing about 9-10 KG of coffee per week, now we do 15 – 20 KG. Our takings are up 4 fold." Arthur was emphatic about the effect of the loyalty cards. "We get about 80% to 90% retention due to the program. There are a lot of good coffee houses in this street. These cards really make a difference"

Outbound Distribution Channel Blocking Techniques

Gaining control over the point of sale to the customer is an effective way of controlling the customer purchase. While the customer may have a range of choices in theory, they may be willing to limit their choice through a preference for a particular method or place of purchase. The corporation which habitually buys office supplies from Office Works or Office Depot chooses only from those products stocked there. When they use a mail order catalogue, they limit their choice to the products listed. A customer who only buys groceries at the local supermarket is restricted to the product range offered. When you choose your mobile phone company you may limit which mobile phones you can use.

Gaining access to a preferred channel, or owning or controlling a preferred channel, gives you effective control over the final purchase. The question which the seller needs to ask is "Where does my customer buy?" Can you then construct a blocking strategy so that you are the product or service of choice? If you are the only product in your category at Office Works or Toys R Us, then you have greater influence over the ultimate customer purchase. Supermarkets understand this and use shelf space as a bargaining chip with their suppliers.

Internet sites which have frequent return rates provide sellers with a greater chance of selling to the loyal user. Internet portals like Yahoo or MSN can be used to offer customers limited choice. While this does not deny customers the right to go elsewhere, the purchase decision is made easier where access is already set up through a favourite portal. If you can be the only product in a category offered by such sites, you have some control over the channel to the customer.

Airline booking systems can act as channel conduits. Some customers will prefer to have all their flights managed through the one system rather than have to deal with multiple carriers themselves. Linkages through such systems to hotels and rental cars can provide the secondary service providers with advantages.

You might be able to use the synergies of an existing preferred channel to reduce costs and gain premium profits or lower your price and undercut competitors. Some firms are able to significantly reduce their costs by using distribution channels which already serve the desired customer. A firm which introduces a new product to an existing distribution channel need only recoup the marginal costs of using that channel. Excess capacity in the channel can be used to cross sell additional products thus achieving deeper account penetration.

Supplier Blocking Techniques

Owning, controlling or being able to influence the availability of a limited, unique or rare input can give you effective control over the entire supply chain. Companies which have integrated backwards to own specialist components or rare commodities have greater influence over the consumer buying decision than competitors who must work with less favourable inputs.

Inputs can be physical, like a commodity or a component, or information or expertise. For example; specialist staff with deep expertise who are in limited supply can be an effective blocking factor if you can develop some form of exclusive supply arrangements. Many situations require an accredited specialist or highly trained or experienced or knowledgeable expert, the firm which has long term access to them through their supplier has a sustainable advantage.

Another form of exclusivity exists where specialist stores and wholesalers have an arrangement with their suppliers where the supplier will not place another store or use another distributor in their immediate vicinity or region. This protects their immediate market and should assure them of limited competition. This is especially effective where the supplier provides brand name products which have high customer loyalty.

In Bound Distribution Channel Blocking Techniques

Another effective way of controlling the supply chain is to limit the access of other competitors to the point of supply. Owning or controlling the inbound delivery channel can provide this level of protection. The most obvious example of this type of control is unique distribution agreements with overseas suppliers. Where the distributor has an exclusive distribution agreement, they have effectively locked out their competitors. This is especially effective where the product solves a unique or difficult problem and has a high customer compelling need to buy.

A good example of this is where Australian firms have been founded on the exclusive importation rights to a new or novel product. Being first to secure the rights to the product or service is a common strategy for a start up firm. They then use this leverage to build their business. I have often said to entrepreneurs. "Go find something overseas which you can sell here and tell them that Australia has only 20 million people and that the market is too small and too far away for them to bother with". The aim is to secure a long term distribution contract which you can use to build a secure revenue stream.

Many companies have grown on the back of such initial contracts. Sometimes they have taken the risk with new brands or products and as their supplier has become more successful, so have they.

Protecting Your Product or Service

The last point of protection is with the business itself. There are two layers of protection, stopping someone coming into the industry and stopping a competitor from copying your product or service. 'Barriers to entry' is the common term used to describe the blocking factors which inhibit new entrants from coming into a market. Many industries have significant industry based

entry barriers but, while they protect you from new competitors, they don't protect you from the competitors which are already there.

Industry barriers are those things which build a wall around the industry to exclude potential new entrants or require considerable cost or time to overcome. The number of ways in which this type of protection can be achieved is extensive but would include such things as:

- Licenses, accreditations, registered rights
- Regulations which limit new entrants
- High cost of set up
- Extensive network of outlets or contact points
- Deep expertise of a situation, process or market
- High economies of scale or high learning curve effects
- Ability and capacity to retaliate
- Protection through subsidies, trade barriers or quotas

If you are already in the industry, you want as many of these as possible. If you are entering a market or trying to grow the business, these can be serious impediments. They can also have negative consequences. For example, high costs of set-up might limit the number of effective competitors in a market but the same high costs may lead to intense price discounting when business levels decline. It may deter others from coming into the market but it may not be sufficient to protect the profits of those which are already there.

Many companies see their relationships with their customers as an important blocking factor to new entrants. Some firms have nothing else going for them other than strong customer loyalty, but this has been sufficient to protect their business over a long period of time. Their level of customer service, customer empathy and willingness to go the extra mile to delight their customers is their strength. You should closely examine how effective your relationships are with your customers and find out how important that is to their willingness to place future business with you.

Employees can themselves be a major competitive strength. In many businesses recruiting and retaining the best people is the key to long term success. Retaining the best people for research and development may give the firm the ability to bring great products to market quicker and cheaper

than competitors. As an example, from 1985 to 1999 I was fortunate enough to have an outstanding team of software developers who moved with me from Northampton in the UK, to San Diego in California and then to Atlanta in Georgia. During that time I was involved in three separate businesses and this team came with me each time. Many people tried to recruit individual members of the team but they stayed together, not because of the salaries, but because I offered an interesting and challenging environment in which they were respected and treated well. I ended up with a real star team which was incredibly knowledgeable and productive.

However, these factors merely deny easy access to the industry by outsiders, they don't normally provide sufficient protection against close competitors. Other blocking techniques are needed to fence off your customers. Such things as:

- Patents, trademarks and copyrights
- Highly prized locations
- Well established brand
- High customer loyalty
- A way of doing business which is highly valued by your customers but is not understood by others
- Secret formulas or processes

A patent which solves a unique problem can be a powerful blocking strategy. The other techniques may be more or less effective but are not guaranteed and they may only work in some circumstances. They are, however, all factors which can impede the effectiveness of a competitor. The greater the time and/or cost to duplicate or overcome, the greater the level of protection.

Few of these barriers are, however, permanent or 100% effective. Many people believe that patents and other registered intellectual property rights provide the ultimate protection. In truth, these rights are only effective if you have the money to defend them. Many patent holders have been worn down by the time, stress and expense of litigation. A large corporation might be willing to take the risk of an infringement suit or be willing to spend a large amount of resources finding a way around the patent.

Integrated Solutions

Few companies can achieve long term sustainability without re-inventing themselves and developing new innovative products or services. In the short to medium term, the best approach is to develop a combination of strategy, protection and employee and customer relationships which can best meet the business needs. Implementing an integrated solution of blocking techniques or factors across the entire supply chain will be the strongest mechanism you can apply to ensure protection of future revenue from existing customers. One hundred percent protection is an ideal but that should not stop you from implementing a range of blocking techniques to give you the strongest position.

Competitive advantage simply gets you into the game. Building sustainable protection to secure your existing customer base can help ensure survival and growth. Each element of the supply chain should be examined for mechanisms which can protect the business. At the same time, the impact of building great relationships with customers, employees and suppliers should not be underestimated as a form of competitor blocking. In the long run, those that have the most effective blocking techniques are more likely to be more successful.

Applying a range of competitor blocking techniques across the supply chain will result in a much higher valuation on exit. For a financial exit it provides a more convincing basis for revenue estimates while at the same time reducing the risks that those revenues will be achieved. This has a direct effect on the discount rate used in the NPV formula. In a strategic exit, the buyer needs to have time to exploit the acquired strategic asset or process. The competitor blocking techniques provide the basis for the competitive advantage the buyer needs to fully exploit the underlying potential of the acquisition.

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Enabling the Opportunity

Creating a sustainable competitive advantage for the buyer to exploit will not, by itself, provide you with the means to maximize the sale value of your business. You also need to structure the business in a way which will assist the buyer to quickly execute on the opportunity or potential in the business.

The value which you will receive for your business is directly related to the level and timing of the revenue and profit which the buyer can extract from the acquisition. The longer it takes for the buyer to exploit that value, the less it is worth to them.

The more distant the expected benefits and the higher the degree of uncertainty that the benefits will be achieved, the less pressure you can create to get the deal signed. Future benefits are discounted back to the present to arrive at the NPV of the opportunity. The higher the NPV, the more you can offer as value you bring to the buyer. The more distant the benefits and the longer it takes the buyer to generate a return on the investment, the lower the NPV and the less the value of your business to potential buyers.

Looking at this from the opposite viewpoint, the quicker the buyer can exploit the benefits, the more certain the projected profits and the sooner the revenue and profits are earned, the higher the NPV and, therefore, the greater

potential value of the business is to the buyer. Given a target rate of return, the buyer is prepared to pay more for earlier revenue and profits. Your objective, therefore, must be to create a set of conditions which enable the rapid transfer of ownership of your business into the buyer's, a smooth integration of business activities where needed and a quick and effective roll out of the program to exploit the opportunity.

The basic questions you should be asking yourself are:

What does my business need to look like at the time of sale?
What can I do to allow the buyer to more easily exploit the opportunity?
What can I do to enable the buyer to generate new revenues earlier?

Reducing Integration Time and Costs

Once you have identified potential buyers, you can start reviewing your own business to identify how your business might be more rapidly integrated into that of the buyer. If the buyer is an individual, how can you prepare your business to enable the new buyer to take control and exploit business opportunities quickly?

One of my workshop attendees put it like this;

"The more I look like the buyer, the easier it will be for them to buy me."

In essence, what he was saying is that, where there are fewer differences in culture, remuneration, entitlements, processes and so on, the easier it is for the buyer to integrate the new subsidiary. While this is an ideal, there may be a number of things which you can do to reduce the time, cost and stress of integration.

Old products

Are there any products or services which you are currently offering which would not be of interest to the buyer or would distract the focus of the potential buyer away from the main opportunity? Old products tend to come with customer obligations, perhaps dedicated staff, equipment,

inventory and so on. Perhaps these could be sold off prior to the sale of the core business.

Parts of the business which are not relevant

Are there parts of the business which are not relevant to the value being acquired? It might be better to carve these off into a separate company and keep this out of the deal or sell it in advance. For example, you might be able to do a management buyout of those parts of the business not relevant to the opportunity for the buyer. This would have the effect of speeding up due diligence, reduce the time to integrate the operations and reduce the cost to the buyer of having to deal with redundant capabilities.

Adherence to standards

Are there standards which you should be using relating to areas such as design, manufacturing, packaging and so on, which the buyer will want to implement prior to rolling out the new products or services? Can these be implemented prior to the sale?

Product interfaces

Are there interfaces or interface capabilities which would need to be incorporated into products or services before they can be rolled out? Are these able to be incorporated prior to the sale or could you make changes to the products or services to ease the work required to implement them?

Customer, supplier and partnership agreements

If you can see that some or all of your agreements will need to be changed to allow you to sell the business and transfer capability to the buyer, these changes should be implemented in advance. If the agreements need to be modified to bring them into line with the buyer's standard agreements, you should investigate how you can assist with these changes by making them prior to the sale or by getting advance agreement with your customers, suppliers and partners to the changes prior to the sale of the business.

Information system interfaces

It is almost certainly the case that your internal financial reporting and other application systems will need to be replaced by those of the buyer or will need to interface with them. You should investigate the capabilities within your own systems to ensure you have as much interface capability as possible. To the extent you can anticipate the requirement and plan for it, the integration and handover task is eased.

Remuneration and entitlement alignment

There are always problems when businesses merge where remuneration packages and entitlements to vacations, public holidays, bonuses and so on, are different. You might want to investigate these arrangements in your potential buyers to see what possible misalignment might occur. It might be worth offering a special bonus on sale to your employees to cancel or alter any existing entitlements so the buyer has the flexibility to implement their own compensation packages.

Succession plan

The buyer will be concerned at the number of people leaving the business at the time of sale or shortly after. They will want to be assured the key people are retained within the business and the management capability to operate the business is in place post sale. It is to be expected that a number of senior executives will wish to leave within a short period after the sale. Most senior executives in small firms prefer to work at a senior level and may be uncomfortable working at a lower level in a large corporation. As well, these individuals, who are most likely cashed up from the sale, will want to use their newly acquired wealth to pursue other interests.

It is important to ensure the knowledge and capabilities within the business is adequately protected. This could be secured by ensuring successors are in place for senior executives, key employees are paid a retention bonus for staying on with the buyer and information within the business is well documented. You need to be able to assure the buyer they will be able to effectively transition the business knowledge to their own employees.

Transition arrangements

The firm should be sensitive to ensuring the buyer is supported throughout the transition period. Thus it may be worth considering retaining senior executives under a consulting arrangement for a limited period of time to assist the buyer to transition the business across to new management. Rather than allow the buyer to imagine risks in the transition, the firm can address these issues in advance and offer solutions. The more that perceived risks can be addressed with acceptable solutions, the more willing the buyer will be to go forward with the deal. This solution also offers greater flexibility for the buyer to encourage senior executives to stay if they need them, but ensures that the risk of them leaving is addressed. It also means they could terminate them earlier if necessary.

Cancellation of external relationships

In some cases the buyer will have a capability which will replace an existing arrangement with an external supplier or distributor and they will wish to terminate the seller's existing arrangements. The buyer may also have their own preferred agreements which they wish to apply after the sale. In anticipation of such a possibility, the firm should have agreements in place which allow for termination. The firm should also have in place arrangements which allow the transfer of any rights under agreements to the buyer. Of course, the opposite might also apply. An arrangement might be cancelled by a supplier on the sale of the business and the firm will need to have alternative arrangements in place.

Exploiting the Opportunity

Many acquired businesses have underlying potential which the buyer is not able to exploit because the knowledge which the business uses to generate revenue is locked up inside the heads of the founders or key employees. For the business to expand other people need to acquire the knowledge or the knowledge needs to be codified and/or de-skilled. When the buyer is reviewing the potential of the business, they are going to want to estimate the time and cost of putting the business on a growth footing. If they have to extract company intelligence first, it may look problematic as there is always a danger of getting it wrong and/or losing the people who have the knowledge.

An essential part of the value proposition to the potential buyer is to show them how they can easily exploit the revenue potential. If the systems are already in place to do this, the risk to the buyer reduces and the time to payback on the investment may well reduce. Both these elements lend themselves to adding more to the price you can extract at time of sale.

Clearly the opportunity is worth more to the buyer if the benefits can be received earlier and the risks of exploiting the opportunity can be reduced. Thus the firm needs to put itself into the position of the buyer and think through the activities which the buyer will have to undertake to rapidly exploit the opportunity. Perhaps this is best understood by making some assumptions about the rollout program.

Assume that the buyer:

- *Wants to launch any projects associated with revenue growth as quickly as possible;*
- *Is willing to provide the necessary funds to undertake the program;*
- *Will allocate the necessary management capability inside the corporation to support the activity;*
- *Will deploy the new capability as widely and as quickly as possible if the costs of doing so can be quickly recovered by new revenue, and*
- *Wants to minimize possible risks.*

A good rule of thumb for any acquisition is to set a target of breakeven or cash flow positive on the investment within two years. Generally speaking, corporations are prepared to fund new projects or programs where they can clearly see recovering their investment inside two years. Therefore, the sooner your proposed expansion program can be cashflow positive, the more positive the buyer's interest.

There are two considerations arising from this approach. For the seller, they must be aware that the size of the gross margin achieved from new revenue in the first two years is probably the limit on what the value of the acquisition is to the buyer. Anything which can be done by the seller to assist in higher and earlier revenue will directly impact on the sale price of their business.

For the buyer, an acquisition which has a quick payback is going to be much more attractive. Whatever they are likely to offer as a purchase price will be strongly influenced by the likely gross margin generated by the new revenue in the first two years. The more they can earn in this period, the more they will be willing to bid to be the successful buyer.

Working out how best to exploit the potential in the business to maximize revenue within two years of the sale is part of the planning which the firm should do in order to articulate the opportunity to the potential buyer. If you think through the activities which will need to be undertaken by the buyer to exploit the potential in the business, you will have a better appreciation of what needs to be done to prepare the business for sale.

What can you do now and over the period before the business is sold to make each activity more effective?

I normally work on a two year preparation program prior to the date of anticipated sale of the firm. That is:

What can I do over the next two years to put in place a platform from which the buyer can launch a program to exploit the opportunity?

Even though this may require an investment by the seller during that two year period, the more revenue the buyer can generate in the two years after the sale, the higher the potential sale value of the firm. Since you don't know when you will need to sell the business or receive an offer to sell the business, you really can't afford to delay this preparation. So assume you will sell the business in two years and then, if you delay the sale, at least you will be well prepared when you do.

Given an objective of rapid deployment, scalability or replication after the sale;

What can you do over the next two years prior to the sale to enable that to happen?

Are you able to go to the potential buyer and say;

"I can make this work for you because we have built a capability and put in place a set of circumstances and activities which will support your rapid rollout of this opportunity".

Put yourself in the position of the buyer and try to work out what problems they would need to solve to enable this opportunity.

To what extent can you resolve these problems in advance?

The key to a premium on sale is to create a platform from which the acquirer can rapidly achieve the benefits they seek in the acquisition. A strategic buyer will be interested in the rate at which the strategic asset or capability can be replicated or scaled. The financial buyer will wish to pursue projects which improve the growth rate and/or productivity of the resources. The anticipated speed of execution of these activities impacts the value of the business to the buyer and greatly influences the price which the seller will receive. There are many things which you can do to make the task of the buyer easier. Some of the examples below should stimulate your thinking about what you could do to enable the buyer to be more successful in exploiting the potential in the acquisition.

Documentation

It is likely that many more people will need to become involved in order to scale up a program. Are you able to provide the necessary documentation of the product, process, systems, implementation activities and so on, to support rapid deployment? Knowledge cannot be in the heads of the current employees if many more people are going to be involved.

Support for a scaled activity

If you were asked to support an activity, 10, 50 or 100 times what you are doing right now:

- *What would the product or service need to look like and what supporting activities would this need?*
- *Are you able to put the underlying support structure in place to enable the buyer to quickly move to those levels?*
- *If you were asked, for example, to train sales staff, product demonstrators, implementation and support staff in large numbers, how would you prepare for such an activity?*
- *What would you need to have in place to quickly move to a much higher level of activity?*

Arranging capacity

Some products and services require additional specialized capacity to support a higher level of activity. This might be a manufacturing capability or a help desk, implementation or support capability. You may need to ensure you have access to adequate supplies of components, ingredients or supplies to support a scaled up operation. While the buyer might have their own plans on how to do this, you might be in a better position to assess the needs. You might screen potential suppliers or identify potential sources of manufacturing capacity or manpower and have an option which the buyer can take up to gain resources. For example, you could secure a letter of intent which the buyer can activate in order to speed up the launch capability.

If the buyer needs to implement new internal systems, processes or capabilities in order to undertake the release of a new product, you might be able to source external capability to allow an earlier launch with a gradual transition to in-house capabilities. Whatever you can do to ensure an earlier generation of revenue you should do.

Building strategic partnerships

Some products or services require complementary skills or resources in order for them to be delivered. If you are able to define these requirements in advance of a scaled up operation, could you also identify, screen and gain agreements for such services.

For example, say you had a business which would be very attractive to a multi-national software corporation. You have an application which could be sold to global end-users but you need a consulting organization to implement it which your potential buyer does not have. Assume that the savings to the global end-user are significant and the earlier they are achieved the more the end-user saves. You could identify a global consulting service which could implement the solution and you could work out an agreement for the deployment of consulting services, a program of staff training and a support desk capability which they would implement to support the program. Your presentation to your potential

buyer can now show how the product could be delivered to end-users with minimal delay.

Creating immediate revenue opportunities

The ultimate opportunity might be enhanced if you were able to deliver to the buyer a large scale customer project. While you might not have the capability of delivering on the project yourself, the buyer might see this as a way of bringing the acquisition into positive cash flow very quickly. It also demonstrates the credibility and capability of the long term potential of the acquisition.

Implementing reference sites

A large scale rollout, especially across multiple geographies, may require a small number of reference sites to demonstrate the key features of the product or service. This might be the case, for example, where the product needs to demonstrate multiple language capability, the ability to handle certain types of transactions or solve specific problems. Reference customers might be arranged for certain types of consumer products by having them associated with high profile personalities. Having the product in the right places, with the right people or being used for the right applications, will assist a more rapid ramp up of sales for the buyer.

Localization

Products which you intend to scale internationally might need to have some localization changes or support. This could be local language, local reference customers, packaging requirements, technical standards and/or support for specialized transactions such as tax or payment methods. While it may be expensive to do every one which will be needed, you might make underlying changes in the product to enable these to be done more quickly and more cost effectively. It would be sensible to implement in your products those changes which would be required for the largest markets in order to speed up time to market in those markets. Where customers are skeptical of the capabilities, you might wish to implement reference sites in those sectors or geographies.

Building market awareness and reputation

In most sales situations, there is a lag between introducing a product into a market and general awareness of the product and acceptance of its benefits. To the extent you can reduce time to market for the buyer by building awareness in the buyer's target markets prior to the sale of the business, you will increase short term market acceptance and build credibility for the acquisition with shareholder's and market analysts. Market awareness might be achieved through trade exhibitions, selective advertising, public relations and by briefing industry market analysts.

Building a prospect pipeline

In a situation where your value on sale is related to the level of revenue generated by the buyer in the first two years of the acquisition, it may help in the sale negotiations to have a database of prospects. These can be handed over for the buyer to act on. The better qualified the prospects are, the more valuable they are to the buyer.

Acquiring licenses, rights, approvals, registrations, etc

Some products and services will require the product or the seller to have certain approvals, registrations, rights or licenses to allow products or services to be sold or the business to operate. To the extent these are already in place, the time to market is reduced. In any situation where these are difficult to obtain, time consuming or costly, resolving this prior to the sale makes the acquisition more valuable.

Put Yourself in the Buyer's Shoes

Few people think beyond the sale of their business to see what the buyer would need to do to fully exploit the business potential. They see that the buyer has the resources or the distribution channel to absorb their product or service but don't' take into account what the buyer would need to do to bring the product to market inside a large corporation across a large geography. They fail to appreciate that the ability of the buyer to rapidly deploy their product or service directly impacts the current value of the revenue opportunity facing the buyer. Clearly, the more it is worth to the buyer, the more the buyer should

be willing to pay to acquire it. Nor do they consider how they could enable the buyer to maximize the opportunity. They fail to consider how much effort, time and cost the buyer will need to expend to scale the business to support a much larger marketplace.

Clearly, the greater the effort required, the more additional resources are needed and the greater the expenditure incurred, the longer it is going to take. The longer it takes, the lower the NPV of the opportunity. Yet, without a great deal of effort or expense, the seller may be able to create a capability which could dramatically reduce the time, cost and resources needed to rapidly exploit the acquisition opportunity. The seller may be able to work with external agencies, suppliers, customers and the media to speed up market penetration through such elements as reference sites, icon users, public relations and so on.

Another critical aspect of the buyer's rollout is that the acquired firm may need to provide resources to the buyer's program while continuing to run their existing business. Few buyers are prepared to undermine an on-going business by stripping out key capabilities to support a large scale rollout. Instead, rollout will be delayed until additional capabilities can be recruited and trained. So a key question a firm needs to ask of itself is:

> *"How can I build a capability which I can release to support a buyer's program while continuing to operate the current business?"*

This additional capability may need to be built and staffed in advance of the sale and then immediately dedicated to the buyer to allow the buyer to launch a large scale program.

You need to build a scenario for how the buyer would exploit your potential. Assuming the funds and internal support are not constraints, how would a buyer best scale a program to maximize the revenue? Now work out what the buyer would need to have in place to launch such a program. Working back from there, build a program of activities which will create as much of the launch platform as you can.

I typically work on a two year program, but if you already have much of the capability in place, you might be able to complete the list earlier.

What you should be aiming to do is build a compelling case for the buyer to move forward with the deal. You want to show them that the resources and activities required to exploit your potential has been thoroughly examined and that you have built a capability and an environment which will allow rapid exploitation at minimal risk and delay. In crude terms – you want them to be able to taste success. You should be able to say to the potential buyer that you have removed as many possible impediments and constraints to scaling the opportunity you could and you are delivering to them a highly probable large scale revenue and profit opportunity which can show benefits quickly.

Creating Additional Potential

Even if you have existing products, services or processes which can be scaled or productivity projects which could be implemented by the potential buyers, there is a good case for using the time available until you sell the business to create new forms of value for the buyer.

One way you can do this is by changing your organisation, products, services and processes so that they become more compatible with those of the potential buyer. For example, can your products be redesigned to better complement the current range of the buyer's product portfolio. Are there new features you could add which would be of benefit to the buyer's customers. Whatever you can do to make yourself or your products and services more attractive to the buyer will improve your value.

You might also look at where your potential buyer can use your current products, services or technology to open new revenue opportunities and to create new products, services or processes which they can exploit. What else could you do to enhance those opportunities? Another possibility is to find ways in which you can increase productivity or reduce expenses in your operations which can be exploited by the buyer across a much larger organization. Firms which sell commodity products can generate value by developing management applications or better business processes which can bring cost savings to a larger organization.

Some businesses can create platforms for revenue generation even though they are not able to exploit it themselves. Thus developing IP and registering new

patents may create potential value. Acquiring new rights though agreements, licenses, registrations, purchase options or outright purchase may also create potential value for an acquirer.

Once you have identified your potential buyer(s) you should consider how you can increase the value of the acquisition to them. You do this in a number of ways; making your business easier to integrate or transition to new ownership; providing products, processes and projects which the buyer can exploit; identifying ways in which you can bring revenue forward in time; and creating new ways in which additional value can be generated. Each of these elements either decreases risk or enhances the profitability of the acquisition. Whatever you can do in these areas will increase the potential exit value of your business.

The Strategic Business Concept

In the case of the strategic buyer, the value which the potential buyer places on your business will relate to what they are going to do with the strategic asset or capability, which may not be the same as what you are currently doing. The value to them will relate to their market and their capability rather than yours. Thus their investment will be set against their projected revenue and profit from the acquisition not your historical or projected revenue and profit. Even if you were to enhance your profitability, it may make no difference to the value of the acquisition to them and may have no effect on the ultimate price they are willing to pay.

In many strategic acquisitions, the asset or capability being acquired will be leveraged through the corporation's existing distribution channel. In these situations, it may be quite irrelevant as to whether the acquired business is making a profit or a loss. In fact, the size of the business itself may be irrelevant to some extent.

The major consideration of the potential buyer will be whether the acquired firm has the underlying capability to support the exploitation of the strategic asset or capability being acquired. Many firms with strategic value make the mistake of putting their effort into growth in revenue and profit when, in fact, this is not the basis on which they will achieve their maximum sale value. In practice, seeking growth may, in some cases, reduce their strategic value

because the acquirer then has to deal with legacy customers and staff they may not want.

The key consideration in a strategic sale strategy is to grow the firm only to the level of revenue and profit necessary to provide the critical size which would allow the acquirer to properly exploit the potential. Once that size is reached, additional surplus funds should be put into enhancing resilience and developing additional strategic value for a potential buyer.

While the pursuit of additional profit may not impact the ultimate sale price, some profit is useful to ensure survival and resilience. The firm must still generate cash to build out its strategic assets and capabilities and needs to have something in reserve to avoid mistakes. Also, it is not possible to predict when the sale might occur, thus the firm needs to plan to stay in business until a sale can be negotiated.

Since strategic value is coupled to an asset or capability, enhancing the underlying assets or capabilities may add more value to the sale price than additional revenue and profit. So instead of pushing the business to achieve higher levels of revenue and profit, you should be investigating how you can enhance the strategic value.

This logic flies in the face of conventional wisdom which says that valuation is based on revenue and profit. But if the maximum sale price is unaffected by revenue at the margin, you are far better to reduce risks in the business and concentrate on building resilience so that you can last long enough to be acquired at a hefty premium.

Instead of funding more growth, the business may be better off selling off parts of the business and concentrating on further developing its strategic assets and capabilities.

IN MY CASE, I sold a 30 person software business which, at the time, was facing insolvency due to a sudden shift in the market and was making a one million dollar loss. The business was sold to Peoplesoft for six times revenue. What was clear was that the value to Peoplesoft was generated by their ability to sell my software products directly into

over 1,000 of their existing customers. At about $500,000 per sale, this represented a very large revenue opportunity. The key to this deal was that our software products were well suited to exploiting this opportunity within their customer base. Furthermore, there were really no other alternatives available to them within the near term. If they didn't step up to acquiring our business, they would walk away from the revenue opportunity and might be allowing a competitor to acquire us.

While profitability, customer base and growth may not be important to a strategic deal, size may matter. In order to deliver a platform from which the opportunity can be launched, the business needs to have the capability and capacity to provide the launch platform.

The asset or capability which is destined to provide the source of the revenue opportunity to the buyer must be in a form or structure which will enable the buyer to achieve the acquisition objectives. If the business is too small, or the asset or capability has not been structured for scalability or replication, the business may not be worth acquiring. Thus size matters to the extent that it allows the buyer to exploit the opportunity. However, beyond that point it may in fact reduce the value of the business. If the buyer has to discard parts of the business or close parts down, there may be costs, delays and risks in doing so.

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Reducing Risks to the Buyer

One objective you need to keep in mind throughout the exit process is to 'make it work for the buyer'. One of the major tasks of the seller is to reduce risks to the buyer. This will include anything which exposes the buyer to potential liabilities as well as situations which cause the buyer to expend funds, time and effort to put the business into an effective and efficient situation.

The buyer will be interested in evaluating three aspects of the business before they decide to go ahead with a purchase:

- *What are the inherent risks in the business being acquired?*
- *What issues will they have to deal with in the change of ownership?*
- *What costs, delays, problems and stresses will they experience in achieving their acquisition objectives.*

The smart seller anticipates these aspects of the buyer's evaluation and puts in place a program to reduce, eliminate or mitigate risks. They set out to ensure the change of ownership process is smooth and set the business up in such a way that it provides the best platform for the buyer to achieve their acquisition objectives.

Most large companies which have undertaken a number of acquisitions will have experienced acquisition disasters. These are often things they knew about going into the deal, but agreed to accept as part of the transaction. More often, however, there are things which are uncovered after the deal has been consummated and turn up progressively over time. The smart ones learn from their mistakes and have a rigorous due diligence process which they undertake prior to finalizing the deal. They also have legal remedies and a project control system following the acquisition to manage surprises.

For the buyer, risks in the deal are anything which will cause delays in exploiting the business potential or opportunity. This includes anything which creates costs, reduces effectiveness or impacts on time to integrate the acquisition or to take advantage of the assets and capabilities acquired. Additional risks for the buyer are those things which require further investigation but were not able to be undertaken prior to the deal closing. Risks are both things which can be seen and things which cannot be seen. For example, an employee intellectual property (IP) agreement may show the firm owns all inventions from its employees. Missing signed IP agreements from past employees may, however, create a potential claim later on.

Observed Risks:

- Non standard customer contracts
- Non standard supplier agreements
- Harsh lease conditions
- Loose IP agreements
- Overly generous reward and remuneration systems
- Generous options schemes
- Generous health or vacations benefits
- Poor reporting systems
- Harsh compliance requirements
- Out of date equipment or poor quality products

Missing information:

- Lack of clear IP ownership
- Lack of documented processes, procedures or instructions
- Unclear customer obligations

- Missing performance information
- Successes and failures not understood
- Information on cost structures or recurring revenue
- Data about sales process, sales cycles, closure rates
- Intentions of key employees

The acquiring firm undertakes the transaction to exploit the business potential, to solve their problem (threat) or to execute on an opportunity. To the extent that uncovered risks reduce their probable outcome or delays their time to execute, the value of the potential acquisition declines. In some cases, the potential or threat will go away or be reduced in potential impact through external events or because they uncover an alternative solution. Opportunities may decline with time or they may find another way of undertaking it. In almost all cases, the expiration of time is at the expense of the selling firm. Either the price will drop or the deal will go away. Therefore, understanding potential risks to the buyer and resolving them prior to an acquisition deal is the best way of preparing a business for sale.

Due Diligence

Once the parties have agreed the business terms of the acquisition, the potential acquirer will proceed to a full analysis of the investment opportunity. At this point, analysts, lawyers and accountants acting on behalf of the acquirer will undertake a due diligence investigation.

The buyer will incur considerable costs in this investigation and will want to ensure the selling firm is acting in good faith during this period. To protect themselves, the buyer may request the seller execute an exclusivity agreement where the seller agrees not to proceed with acquisition discussions with any other party during the due diligence period. A penalty may be agreed for a breach of this condition. Alternatively, in a competitive bidding process, there may be a shortlist of parties which undertake the due diligence assessment concurrently.

One objective of the due diligence process is to investigate the firm to see if the business itself has any major problems which have not been identified in the information already provided to the acquirer. The due diligence process will

undertake a validation of all aspects of the existing business as presented in the documents supplied (information memorandum, business plan, prior financial reports and so on). This investigation would include most of the following (dependent on a share or asset sale):

- Background checks on the key executives and key employees (subject to privacy laws);
- Review of all corporate documents including Board minutes;
- An examination of all shareholder information including share classes, rights, obligations, options, warrants, covenants and minority interests;
- All material agreements with external parties, especially those that impact revenue or expenses or that involve guarantees or restrictions on trade;
- Any employee agreements including management contracts, option schemes, remuneration arrangements, pension arrangements, commission and bonus payments;
- Review of all financial information and additional investigations where necessary to validate key numbers in financial reports and budgets;
- Inspection of all key contracts including leases, mortgages and debentures;
- Review of all compliance requirements;
- Review of all taxation filings and liabilities;
- Review of any current and potential litigation;
- Review of all insurance and any outstanding claims;
- Validation of all intellectual property ownership;
- Examination and verification of all real property ownership;
- Interviews with major customers, suppliers and distributors;
- Verification of costs, expense levels and purchase commitments;
- Assessment of plant and equipment and capital expenditure requirements;
- Review of intellectual property rights, including patents;
- Assessment of key employees;
- Review of inventory holdings including ageing.

This process will check the integrity and honesty of the firm as well as provide a view on how well the business is managed and on the adequacy and accuracy of the information which is being used in the business. It will also uncover how

well the key executives understand their own business and the ease with which they are able to access and provide additional details necessary to the analysis.

A key part of the due diligence process is for the buyer to identify anything which would incur additional costs, create delays or expose the buyer to actual or potential liabilities which are not identified in the information provided to the buyer. This may lead to price adjustment or additional clauses in the sale document. Items which frequently create problems include:

- Non standard customer contracts;
- Non standard supplier agreements;
- Harsh lease conditions;
- Loose IP agreements;
- Overly generous reward and remuneration systems;
- Generous health or vacations benefits;
- Poor reporting systems;
- Out of date equipment or evidence of poor quality outputs;
- Use of company funds or resources for personal use;
- Pre-existing obligations, rights, commitments or restrictions;
- Unusual shareholders rights, legal structures, joint ventures, option schemes or anti-dilution arrangements.
- Punitive rights of existing debt holders;
- Excess inventory;
- Overvalued assets;
- Understated provisions.

A business which is effectively and efficiently run, has good customer, distributor and supplier relationships and has good internal reporting systems which monitor performance, ensure adherence to compliance regulations and protect the business from mistakes should have few problems in satisfying the buyer.

After the firm has satisfied the buyer with regard to its current operations, the buyer will turn their attention to an examination of those aspects of the future potential of the business which are critical to achieving the integration synergy and/or exploitation of opportunities presented by the acquisition.

For example, they may wish to validate the business projections and other planned targets and milestones which underpin the seller's business plan. Or they may wish to validate the size and viability of the opportunity to generate new revenue based on the acquired assets and capabilities of the seller's business. If achieving these targets is critical to meeting the ROI conditions of the investment, this is the area which exposes the buyer to the greatest risks. This investigation will review the following:

- The identification of the prospective customer and the quality of the benefits the customer gains from the product or service;
- The size and growth rate of the prospective market;
- The size, strength and strategies of current and potential competitors;
- The quality of the intellectual property underpinning the projections;
- The quality of the sales, marketing and distribution strategies proposed;
- The likely ability of the management team to be able to execute the plan;
- Availability of executive and specialized staff needed to deliver on the plan;
- A detailed review of the likely cash flow over the expected investment period.

As the business gets older and more complex, the data needed to support a full due diligence becomes more extensive and probably harder to uncover. Few early stage businesses have the filing disciplines to keep adequate records or to file them in a manner which allows ready retrieval many years later. Smaller businesses may not take the trouble to document management or board decisions and then later find they cannot find the authorities which allowed them to make significant decisions which may have affected stakeholder rights. This opens up the door for possible litigation from minority shareholders or other vested interests.

The best path for the potential seller is to undertake a vendor due diligence. This is a due diligence activity which is undertaken by professional advisors on behalf of the seller but from the viewpoint of a potential buyer. The outcome should be an action plan for the seller on what they need to do to bring their business up to date and in a position where they could meet the due diligence requirements of a potential acquirer. So rather than be surprised or penalized

in the acquisition process, the seller who is prepared for due diligence has everything ready for the due diligence investigation.

It is unlikely any firm can submit to the due diligence inspection without there being some issues which need to be resolved. Firms which have not considered due diligence and have let compliance slide, are late with meeting new regulations or have inadequate internal information systems, may have a lot of work to do to bring themselves up to the mark. Thus it could easily take 18 months to 2 years just to put in all the performance and compliance monitoring systems to ensure these aspects of the business will be ready for a due diligence review. Since these systems should be there anyway, this is money well spent and should be done whether the business was being prepared for sale or not.

When you undertake a due diligence review of your business you will inevitably uncover numerous items which need attention. Some activities may simply bring files up to date and make information about company operations available in a more accessible and understandable format. Other items will require the implementation of new compliance reporting and monitoring systems, installation of new financial recording and analysis systems, restructuring of roles and responsibilities and so on. These are aspects of your business which will have immediate payback in the current business but will also produce a more effective and efficient business for the new owner.

The acquisition may be based on some level of integration of the seller's business with the acquirer's existing business. The buyer due diligence process will need to identify where integration needs to occur, the likely priority and timing of such an integration and the capability and willingness of the respective staff to make it happen. Included in that review will be issues such as:

- The need to open or close new offices, warehouses and manufacturing locations;
- The extent to which staff will be relocated, reassigned or have conditions of employment, remuneration, health benefits, entitlements, responsibilities or reporting lines changed;
- The extent to which information systems need to be integrated, merged or interfaced;

- The extent to which the cultures of those units which need to be integrated are alike;
- Whether suppliers, agents and distributors will continue and what costs and disruptions will occur if they are not.

Integration will take time, utilize senior executive time and require funding. These costs and delays need to be factored into the investment evaluation.

To the extent that uncovered risks reduce the probability of achieving the desired outcome or delay the time to execute, the value of the potential investment declines. In some cases, the problems can be overcome by installing additional controls, renegotiating agreements and putting in place alternative strategies. However, these may result in additional costs or delays in executing the plan. To the extent problems cannot be easily resolved or structural changes are difficult to implement, the investment will incur greater risks. At some point the buyer will decide the risks are too great and will decide not to make the investment.

You need to see the integration process as a cost to the acquirer and, whatever the cost, it will be deducted from the potential gain from the acquisition. The more you can reduce the costs, time and stress of integration, the higher the potential value which can be assigned to your business.

Aspects of integration which you can influence in advance of a sale include:

- Moving customers and suppliers over to new relationships and systems, perhaps rewriting contracts, agreements and trading arrangements;
- Shifting business from some distributors and suppliers to those which have pre-existing arrangements with the acquirer;
- Closing down duplicate offices, warehouses and manufacturing facilities. This might include redundancies or relocating staff;
- Shifting financial reporting systems and transaction systems across to a common administrative system;
- Realigning remuneration, health, pension, vacation and other entitlements;
- Replacing staff who have left;
- Changing job descriptions, responsibilities and reporting lines;
- Re-branding products and services and re-designing sales collateral.

Ask yourself how you can help streamline any of these processes with your target acquirers. For example, do you have termination and/or change of ownership clauses in your contracts? Are you using industry standard terms of trade? Are your products based on common industry interface standards and use common industry components?

Take a good hard look at your business and ask yourself if everything you are doing makes sense and if it is contributing to adding value to a potential buyer. It need not generate more revenue or even reduce costs for your business right now but consider the impact on the buyer. Whatever you can do to make the business easier to manage, increase the productivity or allow the buyer to focus on exploiting the potential can increase the value proposition.

Remember that your buyer may have other firms to look at. All other things being equal, the one which is the least effort to exploit is going to be the preferred deal.

If the investigation results in an agreement to proceed with the investment, the buyer will incur the costs of the due diligence plus the legal fees associated with the preparation or review of the investment agreement. These will be factored into the final price paid to the seller. Where more due diligence work needs to be undertaken, this will result in a lower final price to the seller.

The more prepared the seller is for due diligence, the lower the costs of the task, the shorter the time it will take and the more likely the buyer will be to go through with the deal. It is in the seller's best interest to fully understand the due diligence process and undertake as much of the preparation work in advance as possible.

The advantage which accrues to the prepared firm is that this level of preparation indicates to the buyer that the seller understands how to manage its compliance and operating risks. Since these are often where the greatest risks for the buyer lie, this is good news to the buyer and should speed up the acquisition process. Where the buyer has a choice of acquisitions, the better managed one is more likely to also allow the buyer to more quickly execute on the opportunity. It becomes the preferred purchase.

The firm which is better prepared for a due diligence inspection also presents itself as being well managed. Firms which are seen to be efficient will find it easier to secure the support of champions in the purchaser's organization and that will help get the deal done. Also never forget that the task of the seller is to collapse the time to get an agreement. Being efficient and well prepared creates the best chance of getting the deal done quickly and of preserving value for the seller's shareholders.

Creating value is partly psychological. Buyers go into a deal anticipating problems and all their experience suggests they can expect them. They should be delighted when they find a business which operates efficiently and satisfies their due diligence investigation. Don't forget that professional advisors who carry out due diligence projects have to justify their fees and are looking for ways to reduce the price paid by the buyer. If you can create a clean business, the buyer is likely to reduce the scope of the due diligence work. They won't be willing to keep paying professional services fees if the service providers are not finding anything to justify further work.

Always keep in mind the golden rule of selling – the shorter the time it takes to get the due diligence complete, the higher the price you can expect and the more likely you will be to get the deal done.

Confidentiality

If you are talking to potential buyers about selling the firm, this can lead to some unfortunate results if handled incorrectly. Competitors can use this information against you, key employees might decide to leave, staff can be stressed due to uncertainty and become less productive, suppliers might want early payment and so on. How can this be handled with both external and internal parties?

External Parties

Probably there is no one right answer and it may well depend on your own position within an industry. The norms in each industry vary. It may also depend on how good your existing relationships are with customers, suppliers and partners.

Open Intention:

Some industries, such as the software applications and systems market, accept that everyone is for sale. Since they are for sale, discussions are always taking place between parties as to mergers and acquisitions. Generally, acquisitions take place because a larger party can better scale the operations and therefore customers are reasonably well protected.

Strategic Investor:

Many firms are looking for investment to help them develop their business. These can often turn into acquisitions. Providing the firm is open about looking for a partner, it may not be a surprise if that turns into a sale.

Longer Term Objectives:

Many owners are quite open about wanting to retire at some time, or being open to an offer if the offer is a good one. Providing this is not a secret, the firm is reasonably well protected from rumours.

Private Negotiation:

Some customer deals may be quite sensitive to a possible takeover. However, provided this is dealt with confidentially and the reasons are beneficial to the prospective customer, it may be better to declare this privately to the prospect. If they then hear it from another source, at least it was not kept from them.

Partnership Deal:

A discussion of a possible acquisition can be portrayed as a partnership or alliance arrangement. A larger corporation which is looking to distribute your products or enter into a joint venture may wish to carry out extensive due diligence to protect themselves. Another way in which this can be explained is through a licensing arrangement. Again, much of the discussions are similar to those undertaken in an acquisition process but this public declaration allows the firm to proceed without declaring they are going through an acquisition discussion.

If you don't have to do a deal, you can always simply entertain the possibility and portray in that light. That is, "if the right deal comes along – of course we would be foolish not to investigate it". This is something which any reasonable business owner would say and should not convey the impression of a firm in trouble or desperate to do a deal.

If on the other hand, you are desperate to do a deal, the best way to do it is quickly. The longer the market sees you in trouble, the greater the impact on your business. Competitors will be quick to seize the opportunity of undermining your sales efforts.

The only way to execute a deal quickly and yet still come out with a premium price, is to be proactive and prepare for a sale. Providing you know who the potential buyers are and have established the type of relationship which you can leverage to get a deal done quickly, you should prevent any major negative effects on the business.

Consider using a Non Disclosure Agreement to ensure the other party understands the seriousness of the information you are sharing with them.

Internal Parties

Employees are naturally going to be concerned about any possible major change in ownership. They will have heard stories of other firms going through the process and know of redundancies, relocation, changes in work practices, remuneration, benefits and so on. No doubt some of that will happen when your firm is sold. So how can you best deal with that?

Make it strategic for employees:

> When you seek a company which can exploit your potential, scale your operations, overcome your limitations and provide a larger market for your products and services, employees are often better off. You should be conveying the message that you would always be interested in a sale where the employees may have better career prospects.

Involve Managers and key employees:

Some staff are required to make the transaction possible. They will be providing data to the potential buyer as part of the due diligence. They need to be informed about what is going on and be counselled about the implications for their jobs. Where there are potential negative impacts on them, these need to be discussed and a plan put together for mitigating the effect on them personally. This could be a lump sum payout, redundancy payment, a longer notice period and so on.

Provide incentives:

If employees have an incentive to make the transition work, they will tend to support it more. The incentives could be in the form of shares, options, bonuses and so on. There needs to be an alignment of the interests of the shareholders, managers, employees and the new owners.

Employment agreements:

As part of a review of general employment conditions, consider incorporating a bonus at the time of the sale of the business, special termination conditions if the business is sold and/or special retention bonuses for key employees. This change can be incorporated into standard employment conditions along with other updates on health benefits, maternity leave and so on, perhaps based on an external professional review.

Post Sale Scenarios

It is possible to put yourself into the position of the prospective buyer and work out what is likely to happen to the business. If you can anticipate issues, problems or changes which the buyer will experience, can you reduce the impact of these and improve your attractiveness to the buyer? By working through after sale scenarios, the firm can predict where problems might be encountered. As these are likely to cause problems in the negotiation, you may be able to fix these in advance or have solutions which the buyer can implement. By working through how these might be resolved, the firm can take the initiative and reduce potential negotiation problems.

Acquiring firms, especially those which have experience in M&A, assume they will have many issues to deal with after the acquisition. These are generally associated with the integration of the two firms as well as securing the best use of the assets or capabilities they acquire. In projecting the likely situation after the sale, consider the following questions:

- *Where will the merged firm (yours) be located?*
- *What will happen to existing facilities, plants, warehouses, offices which are not required?*
- *Which positions are duplicated and therefore which staff will be made redundant?*
- *Which employees are key to the buyer's benefits being realized? How are those staff to be retained?*
- *What will the new terms of conditions of employment be?*
- *What happens to employee options and any share purchase scheme?*
- *How will health insurance, vacation entitlements and existing bonus systems be translated?*
- *How is the buyer to leverage the new acquisition?*
- *What will happen to existing customers, suppliers and distributors?*
- *Which partnerships, alliances and joint ventures need to be terminated or protected?*
- *What are the owner/managers going to do in the merged company?*
- *What if they don't want some, or all, of the senior management?*
- *What potential litigation will you have outstanding that will need to be resolved?*

The key to a successful negotiation is to have thought through these questions in advance of any detailed discussion with the potential buyer. To the extent these issues can be resolved in advance or options can be presented, the negotiations will proceed more smoothly.

Generally speaking, it is easier to merge a firm which has standard conditions throughout its operations. So industry standard contracts with suppliers, customers, distributors and employees should normally not present a problem.

Overly generous terms of employment (salaries, benefits, bonuses, options, health cover, etc) can seriously damage a potential sale. Since the buyer will most often have to integrate new employees with their own, any marked differences where the new employees are better off, will be a serious impediment. It is always better to have a situation where employees gain through the merger rather than lose. Discretionary bonuses and rewards can be used prior to a sale to provide motivation without any guarantee that these will be continued in the future. Alternatively, terms of employment can be agreed where aspects can be subject to review on a periodic basis. These can then be removed prior to a sale or shortly after.

A firm intending to be sold should also look at the costs of terminating its various agreements. Since the situation after the sale cannot be predicted, having options in agreements which allow termination on change of control, or by putting a formulae or price on termination, allows the firm to estimate the costs of withdrawal. It also prevents a possible legal claim for damages.

The key question here is – how can you make this work for the buyer?

Put yourself in their shoes. What would the ideal scenario be for the buyer? How close can you get to that scenario? The closer you can get, the easier the negotiation will be. The buyer will be pleasantly surprised with the homework you have done and will see that you understand what they have to do to make the deal work. The fact you have resolved many of the problems, allows them to see you are flexible and will do what you can to resolve potential problems during the process of negotiation.

Install a Board of Directors

In preparing the business for sale, you should give serious consideration to installing a Board of Directors as part of your sale preparation process.

You may feel you alone know enough to adequately manage the business and that the costs and time involved in supporting a Board of Directors is a waste. You would not be alone in that opinion as most small, medium and family business owners feel the same way. But running your business is not the same as positioning it for a sale. In setting a business up for sale, we need to consider the viewpoint of the buyer and what the buyer would find attractive

in the business. Our objective is to take away from the buyer any hesitations about the operation of the business as well as reducing the anticipated costs and delays of changing the ownership of the business.

The buyer will be concerned about inherent risks in the business. If the selling business has systems and processes for reporting to an independent board, it will indicate to the buyer that the owner is prepared to be accountable for performance and is prepared to review the business operations with external parties. If the process is done properly, the buyer can be confident that the underlying systems and reporting processes will enable an easier transition to new ownership. If the Board reporting pack includes operational as well as financial performance measures, the buyer will have more confidence in the quality of the business being acquired.

One of the biggest concerns of any buyer is the fear that the business rests on the personal knowledge and contacts of the owner. To the extent this exists, the buyer takes the risk that the goodwill and corporate intelligence will be lost with the departure of the owner. To the extent the business has a knowledgeable and independent Board of Directors, the buyer can have some confidence that the underlying systems are in place to monitor business operations and that some of the corporate intelligence is shared among the Board. Thus the buyer has the option of keeping some of the Board members for a period of time after the purchase to ensure knowledge is transitioned to new management.

Perhaps the greatest benefit of having a Board in place prior to the sale is that it indicates to the buyer that governance is seen to be important in the business. It also shows there are disciplines in place for longer term planning, risk assessment and accountability, all very good signs of a well run business. This will all help to give comfort to the buyer and hopefully speed up the sale process as well as increase the sales value.

Prevent the Loss of Key Employees

In the pressure to sell a business, the entrepreneur often forgets that it is a team sport. While the business owner might be overjoyed to see keen buyers banging at the door, the rest of the employees may not be so excited. Not only do they face a change of boss but they will be rightly concerned about their

future employment, their job responsibilities and even whether their desk will continue to have a window view. If the entrepreneur is to realize the full value of the business, he or she needs to have the full support of the key employees throughout the sale process and beyond into the new ownership.

As a business owner or investor, you need to put aside traditional views of valuation based on EBIT multiples which reflect what you achieved in the business and embrace a more realistic view that the value of the business is what it can achieve for the new owner. Everything we buy, including a business, only has value for what we anticipate we can harvest from it, whether that be an experience or a good return on our investment. Thus preparing a business for sale is simply about anticipating how we can maximize the future value for the new owner. Much of that value may be tied up in the active and positive participation of the current employees in the business under new owners. So what can we do to ensure that the new owner has the full support of those key employees who will help maximize that future productivity?

We need to examine three areas of concern for the new owner; what problems, risks and liabilities are inherent in the existing business; how easy will it be to transfer ownership and, lastly, how confident will the new owner be that he or she will be able to exploit the potential of the business post-sale. Firstly, our current employees can help put the business onto a low risk, profitable and resilient basis. For that to occur, we will need their active co-operation. What we don't want is for them to be antagonistic or hostile to the new owners, or to be disruptive or to undermine the sale process. Certainly we don't want them to leave because they are concerned about their future with the business. What we need to do is to involve them in the sale preparation and due diligence process and give them an incentive to work towards a common goal of selling the business successfully.

The next stage involves the transition to new ownership. We need to be confident the key employees will transition the core knowledge in the business. To do this successfully, there should be incentives involved to encourage them to stay around in order for the transition to occur.

Lastly, we want the new owner to have the highest chance of successfully running the business and, possibly, developing it to generate greater revenue

and profit. We need to consider how we can structure the business to provide the best platform for that to occur. Again, this may mean some incentives for the key employees to stay with the new business to give it time to settle down under new ownership.

The buyer needs to have time to transition the inherent business knowledge to employees who are likely to be employed longer term with the acquirer. Since most resignations of newly acquired staff are likely to occur during the first year of the acquisition, putting in place incentives for key acquired employees to stay during the transition period can significantly reduce buyer concerns. Where the vendor has arranged this prior to the sale discussions, the buyer has some assurance that a major risk can be averted. This not only places the vendor in a more positive light but can positively influence the value of the business being sold.

To do this right, it will require you to allocate some of the sale proceeds to encourage and compensate key employees. By preparing the business properly for the new owner, you are going to significantly increase the price you achieve for your business. Your investment in your employees will be more than compensated by the higher sale price.

Within the sale preparation process, senior managers will play a key role. The major stages are preparation, negotiation, due diligence, integration and on-going post acquisition operations. Within most of these stages, the current management are actively involved and they can either help make it work or scuttle it. Getting their support is, therefore, absolutely necessary.

Many entrepreneurs incorrectly believe they can carry this process off by themselves and continue to manage the business under new ownership. However, entrepreneurs typically make poor employees and most smart buyers know this and so they look to the management team to provide the transition to new ownership. This view from acquirers is not unreasonable. Entrepreneurs are used to being in charge, making decisions without justifying them, taking shortcuts and accepting risks. They often don't fit well into a bureaucratic structure where they have to report to a boss and take orders. In addition, they are most likely cashed up, want to take it easy or want to move onto their next big idea.

Similar logic can be applied to many in the senior management team. The CFO is unlikely to want to step down to being a branch accountant, the Sales Director to a Sales Manager or the Marketing Director to a Product Manager. If they are all used to being part of the strategic decision making process, they are likely to want to perform that role again. Furthermore, they may have done well out of the deal and want to move onto another venture. The bottom line – few of the senior managers will go with the deal or stay long after the deal is completed. Smart buyers know this and therefore look to the second level management and key employees to make the transition successful.

The entrepreneur who wants the deal to be successful must find a way of gaining the support of second level management and key employees in both the preparation for sale and in the transition of knowledge across to new ownership. If the people who have to make the deal work are uncertain of their future or resent the business being sold, they may leave or work to undermine the process. The entrepreneur, therefore, needs to bring them into the process in such a way that they will actively support the sale preparation and will be willing to transition to the new ownership in order to provide the continuity needed by the buyer.

Incentives need to be provided to management and key employees to encourage them to work towards a sale. This means ensuring they have sufficient incentives in the form of shares, options or bonuses to do so. Those who will be made redundant need to be provided with a bonus in order to stay until the sale is completed and provide them with a buffer to allow them to be retrained or look for new employment. Those key employees who need to be retained need to be provided with significant incentives to willingly stay on for, say, a year to transition the business to the new owners.

Business owners who fail to put these incentives in place risk buyers walking away from the deal or facing a significant drop in sale price.

Do It Quickly

The best scenario for all concerned is to have the deal done quickly. This then leaves little time for staff to become stressed by the whole affair. You need to prepare a contingency plan for the sale of the business so that it can be executed within a short period of time. The deal negotiation and closure process can be dramatically reduced through this preparation process which results in the business being less exposed and less disrupted than if the sale process was continued over a long period of time.

13

The Acquisition Process

To be successful at closing a sale of the firm, you have to know how the various buyers will approach the acquisition. There are a range of potential buyers; individuals, trust funds, private equity firms, superannuation funds and private and public corporations. Each of these will have their own preferred process and specific objectives. Some will undertake the investigation and negotiation themselves while most will work through professional advisors. Usually, small acquirers and individuals seeking to buy a small firm will work with a business broker. Larger acquisitions and larger buyers will typically involve the merger and acquisition services (M&A) of a accounting or legal practice or the use of a boutique investment bank or corporate advisory firm.

All Business Brokers typically approach the sale of a business in a similar manner. Since they often act for both buyers and sellers, the process they use for one is simply the mirror of the other. More sophisticated buyers, such as Investment Funds, Private Equity Funds and Corporations will normally have internal M&A departments which have systematic processes for evaluating and executing the acquisition. Understanding how these entities go about their processes can provide a very useful insight into how you should position your firm and the key criteria you have to meet to be seriously considered.

Business Brokers typically sell businesses which have a value of $3 million or less. Larger deals will typically go to established Corporate Finance Houses

or Investment Banks or the Corporate Finance divisions of large professional accounting or legal firms. Larger businesses tend to be more complex to prepare for sale, require a larger due diligence activity and often involve overseas buyers. The contracts tend to be longer and more complex and often several experts are involved to assess specialised aspects of the seller's business.

Business Brokers

Business broking has its roots in the real estate market. Thus brokers might one day be selling a commercial property and the next a small business. Their approach to one is not dissimilar to the other. They work with the vendor to prepare a description of the business, advertise the business for sale, deal with enquiries and then help the parties with the necessary formalities of transferring ownership. Few of them understand how to develop a business for sale or how to price a business which has growth potential. Since they work mostly on commission, their motivation is to proceed to a sale as quickly as possible.

The process normally includes a selling memorandum, basically an information pack about the company with sufficient detail to enable a prospective buyer to assess its worth and potential. Interested parties indicate an expression of interest followed by a letter of intent. The potential buyers would then conduct due diligence on the business. Finally, a deal would be negotiated and a sale and purchase agreement signed by both parties.

More sophisticated broking firms are prepared to work with the vendor to structure the business for sale. These firms often act as business advisors to assist the business to prepare itself for sale. This type of work would normally be undertaken on a consulting basis.

Some broking firms specialise in a specific industry and are more likely to have knowledgeable potential buyers on their books. Also experience within an industry can be very useful as it can provide the vendor with very useful tips on how to clean up the business before the sale. Such brokers are also likely to have a database of both buyers and sellers within an industry and can use their contacts with both to seek out potential buyers. For example, if they have just sold a comparable business they may have a list of potential buyers which were not successful with that deal but would consider looking at another

opportunity. Alternatively, they may have a register of frequent buyers who will seriously consider any selling firm which meets their investment criteria.

Example:

By taking these steps, you can not only increase the perception of value to your buyer, but also convert into cash and improved figures, many items which would otherwise be handed over at “no value” to the buyer on settlement:

Tidy up your stock. Sell off obsolete, or slow moving stock items. This will improve both your sales and your Gross Profit. Your buyer will be impressed that you are not holding any unsaleable stock. And it will eliminate any possible arguments over the valuation of such stock during the sale.

Tidy up your Plant & Equipment. Make your workplace into an efficient working environment. Add a little paint here and there to make things look well maintained. Ensure that you eliminate oil leaks. Anticipate Health Dept. requirements, and sell off and convert into cash any scrap, redundant or obsolete machinery and parts that are cluttering up the place.

Tidy up your staff. Where possible, get your staff to take up their leave and other entitlements prior to sale. Get them to wear uniforms, and make sure they wear safety gear when required.

Tidy up your premises. Have a look around with the eyes of a prospective purchaser. What would it look like to a critical new observer? The condition of your premises can say a lot about your profitability.

Tidy up your Debtors. An area of great concern to a prospective purchaser is the state of your Debtors. Based on your figures, the buyer will have to do his cash flow and working capital forecasting to justify the purchase, and may be very nervous about taking on customers who look as though they take forever to pay their accounts. Now is a good time to bring them into line. You can use the improved cashflow to :

Tidy up your creditors and even take those early-settlement discounts. This will create a positive impression of the inherent strength of your business.

Tidy up your Balance Sheet. It would also help if you could remove from your Balance Sheet any items which are unrelated to the business being sold, and include, possibly through an Asset Revaluation Reserve or similar, any assets which are not currently listed at their proper value.

Source: http://www.lloydsbus.com.au/bestprice.html Accessed Sept. 2005

Brokers often provide check lists to their clients to assist them to prepare their businesses for sale. This type of checklist is a useful guide to elements of your business which you should be examining as part of the sale process.

Choosing a broker to assist you is not that easy. There are numerous to choose from and their methods can differ markedly. Some advertise in 'Business for Sale" magazines, others in the financial newspapers, some have extensive websites and others have extensive databases of prospective buyers. You need to undertake your own due diligence on the Broker.

- Do they have experience with your industry?
- Are they willing to provide references of similar sized businesses they have sold?
- Can they provide you with references to both buyers and sellers in the same deals?
- Do they have staff with commercial experience in your industry?
- How long have they been in business and how many businesses of your size have they successfully sold or purchased?
- Are they able to provide you with access to creditable legal and accounting professional services firms to assist you if you need that help?
- Do they have national, international or regional coverage? What do you need?
- How do their fees compare to other Brokers?
- Are they competent to offer business advisory services?

You might shortlist Brokers and have them provide you with a proposal for selling your business. Conduct references checks and decide for yourself

whether you feel you can work with them. Make sure they are able to up sell a business with growth potential – don't be talked out of growth potential as part of the sales value. If they are not convinced of the case, find another broker who has experience selling more than real estate.

Most business brokers would be well out of their depth selling a small business to a large corporation. If you believe your most obvious buyer is a large corporation and the anticipated sale price can justify a more sophisticated and knowledgeable advisor, you will be much better off working with a large professional services firm.

A deal which involves very significant strategic value where the expected sale price bears little relationship to the current financial performance of the vendor is unlikely to involve a business broker as few would have the knowledge and experience even to suggest this as a possible outcome.

Corporate Buyers

Very few corporations buy firms for their revenue and balance sheet if there are no other synergies in the deal. They are typically looking at how they might generate a strategic benefit from the deal. Even a financial acquisition will typically involve some level of cost saving synergies. However, most corporate acquisitions are made for strategic value. The strategic value will arise through the acquisition solving a problem or need which they have or presenting them with a compelling opportunity within their strategic objectives. However, they will try to close the deal around conventional valuation models which focus on net assets, cash flows and profits. Only by understanding how the buyer could leverage the potential of your firm can you move them to a premium acquisition price.

The key to an acquisition premium is to discover how they would exploit the acquisition. This may happen if your firm is approached directly, but if you have to take the initiative, then you need to spend time with the potential buyer to establish whether there are synergies in the relationship. If time is on their side and not yours, the power in the negotiation is left with them. Only by having time and choice can you avoid a fire sale.

Many companies are prepared to discuss a potential acquisition, especially if they are not put under pressure. Scheduling a meeting with their M&A Director is certainly possible if you make it easy for them. Going to their office (especially if you have to make a considerable commitment to do so is impressive), meeting them at a trade show, seminar or conference are common techniques to get in front of the potential buyer. What do you want to find out?

- Are they interested in doing acquisitions?
- What areas are they interested in?
- Do they have any criteria they use to rate possible acquisitions?
- What characteristics rule out an acquisition?
- Do they have location, age, size, industry preferences?
- Are they looking in any specific area?
- What is their process – how do they go about the evaluation?
- What typical information are they seeking in the evaluation?
- What things would make you more attractive?
- What are they not interested in?
- Who should you stay in touch with?
- Can they give you some references to CEO's or CFO's of past acquisitions?

The Venture Capital industry has created a myth that success in an exit is about building an 'A team', creating revenue and profits and rapid growth. While this may be appropriate for financial acquisitions, this usually does not apply to strategic acquisitions. Many acquisitions are made to acquire specific intellectual property (IP) or assets, specific key people or access to a strategic market or customer. Most often senior management is made redundant in the process (there goes the A team) and/or the customer base is abandoned as they are not beneficial to the new owner.

If you think of the acquisition from the buyer's perspective, you can start to see where the fit is, but, more particularly, you can see what is not going to fit. What doesn't fit becomes a problem in the acquisition. If the firm is being acquired to fix a problem, then your employees, customers and even products may be a liability going forward. If the acquisition is being done to acquire products which can be sold back into the buyer's customer base alongside existing products and your customers are not targets for the rest of the product portfolio, you have customers they probably don't want.

You may have spent years building up revenue through a network of distributors to find your best potential buyer only sells direct. You now have a problem of closing down the distribution network in order to get the deal done.

The key to the sale might be your IP or some key people. The buyer may be able to leverage that across a large existing customer base or to open new markets. Regrettably the rest of your company is a liability.

Many firms are wary of opening up their books and IP to a potential buyer, worried that their competitive advantage may be copied or their secrets stolen. While this is a reasonable concern, the advantage of time to market and cost to create is on the firm's side. A corporation which is under threat may not be able to wait to build their own solution. A corporation faced with an opportunity may be prepared to pay a premium to access it early. Another approach is to use an independent auditor to verify product capabilities or simply refuse detailed access until there is solid evidence of intention.

What is the key message? Know what the potential buyer(s) want and what they don't want. Only by spending the time meeting and talking with potential buyers will you find out which are the best fit and what you should do to present a compelling acquisition proposal.

Building Relationships

It is much easier to set up a deal where existing relationships exist, especially if you have taken the trouble to meet the key players. Within most sectors, the number of key executives is quite small and they can often be met at seminars or conferences. This applies even to competitor's executives. Also, in most industries there are people who have worked for several companies, thus the network is often well connected across companies.

In building your network you are not selling your company, you are simply getting to know people who might help you when it comes to getting the deal done. It may be that, when you are ready, there are people who will help you identify the best targets and help with introductions.

You can often position your company well in advance of making an approach or being approached. You can use your time at conferences positioning your firm in the market. Often competitors and other industry providers will be in the audience. You are simply letting people know what you do well. Take your core strengths and produce an interesting case study around it. This can then be presented to industry participants in the trade press or at a conference.

You should get to know the trade journalists and the market analysts in your sector or from the sector in which you expect the buyer to come. Getting publicity in the trade press may help open the door when you want to meet executives from potential buyers. Take advantage of industry functions in your own country and in the major markets to meet with M&A Managers and your equivalent in the potential buyer's business. You might even use the situation to discuss the future sale of your company and start building the connections for more detailed discussions. You might invite the most likely prospects to visit your firm to meet your management team. Providing there is no time pressure, this is a good way to build trust and present a story about how any synergy might work.

More formal relationships can also be useful in building bridges. There are a variety of ways in which formal relationships can be set up. These could include:

Management and/or shareholder roles:

- Member of a Board of Advisors
- Member of the Board of Directors
- Minority shareholder
- Venture capital provider

Formal trading relationships:

- Distributor
- Alliance partner
- Joint venture partner
- Customer
- Supplier

Formal relationships have a high conversion rate to acquisition. It is a 'try before you buy' transaction. The buyer has more of an inside view of products and management and has a better understanding of the fit of the two businesses and of the potential benefit of the acquisition.

Example:

April 30, 1997

Charlotte-based Metaysys Inc., a developer of transportation management software, and Costa Mesa, Calif.-based OPTUM Software, a provider of warehouse management systems software, have formed a strategic alliance. The partnership will coordinate implementation, use and support of the Metasys Enterprise Transportation Management and OPTUM Software's MOVE WMS solutions.

Source: http://www.bizjournals.com/charlotte/stories/1997/04/28/daily9.html Accessed 18th Feb. 2006

August 3, 1998

White Plains, N.Y.-based Optum Software and Charlotte-based Metasys Inc. have completed their merger. The companies announced their execution of a definitive merger agreement on March 31. Optum, Inc. provides the first supply chain execution software suite for manufacturers, distributors, retailers and third party logistics providers.

Source: http://triad.bizjournals.com/site_map/charlotte_sitemap_19.html Accessed 18th February 2006

What the firm has to avoid, however, is creating a situation where there is only one potential buyer or where a sale can be blocked or hindered due to an existing relationship. At the same time, a formal relationship is often quite easy to convert into a sale and so the firm does not have the stress of looking for a buyer. If the benefits to the buyer are sufficient, then a premium can still be achieved in passing control to the new owner.

Some formal relationships can be set up with a acquisition in mind. The formula for the deal can be worked out in advance so that the negotiation takes place before the formal trading relationship is entered into rather than be at the whim of the buyer later. The relationship can also be entered into with an option to terminate if there is a change of ownership. Alternatively, the firm could build in an option to buy out the trading partner in order to seek out a buyer. The strategy here is to have thought through the implications of a sale to both the trading partner and to a non-trading partner before entering into the initial relationship.

Example: *(Author's italics)*

Agere Systems announced Monday the acquisition of an Irish semi-conductor-maker that designs broadband network chips that are 10 times faster than current technology. The move is Agere's first expansion after two years of contraction and plant closures, including the end of manufacturing in the Lehigh Valley.

The Dublin company is a startup venture founded in 1996 that began as a provider of engineering services. ***It has collaborated with Agere for the last year on developing gigabit Ethernet chips used in high-speed broadband networks.*** *Agere produces chips for slower speed Ethernet connections.*

Source: http://www.mcall.com/business/ accessed 7th September 2003

Example: *(Author's italics)*

Thursday September 4, 9:22 am ET , 2003

ATLANTA (Dow Jones)--Chinadotcom Corp.'s CDC Software unit signed a definitive agreement to acquire Ross Systems Inc. (NasdaqNM:ROSS - NEWS) for $5 in cash and $14 worth of chinadot-com common shares.

In addition, ***CDC Software has been a master distributor of Ross Systems' enterprise business solution,*** *iRenaissance suite, in the Greater China region.*

Source: http://www.rosssystems.com/ Accessed 6th September 2003

Example: *(Author's italics)*

ATLANTA — Home Depot said Friday it has agreed to buy IPUSA, a national roofing installation company ***that has served as a contractor to Home Depot for the past six years****.*

Privately held IPUSA, which is comprised of Tampa-based Installed Products USA and Installed Products of California, is one of the country's largest installers of residential replacement roofing.

The transaction is expected to close within 30 days. Terms of the acquisition were not disclosed.

Home Depot, the largest retailer of roofing materials, said the acquisition will provide it with a stronger platform for the company's expansion into roofing installation and other installation services.

Home Depot is working to increase its share of the $32 billion installation services market.

Source: http://www.dailybulletin.com/Stories/ Accessed 7th September 2003

When the owners need to sell, when they get an attractive offer or when they wish to sell, these prior relationships will help ensure the right potential buyers are brought into the sales process.

Creating Competitive Tension

In order to create the right conditions for a sale, the firm needs to satisfy two conditions; have time on their side and have more than one potential buyer.

The classic 'fire sale' occurs when the firm is under pressure to sell. This often occurs when they are under pressure to find cash to satisfy creditors. It does not, of itself, mean the firm is unprofitable. A firm can have a healthy profit position and a healthy revenue position and yet still find itself short of cash to meet contractual obligations. Under pressure, the firm may not have a choice and thus be forced to sell to a buyer which can satisfy its obligations. When time is short and little preparation has been undertaken, the likely outcome is a sale at a hefty discount to the buyer.

To create the right conditions for a sale, the firm has to have time to negotiate and to pull back from a deal. The best conditions are created when the potential buyer urgently needs to fix a problem (threat) and the firm has no need to sell. This can often result in a very high premium on the deal. Pre-sales situations can often be quite disruptive to continuing business thus the firm must manage the revenue and costs very carefully so as to not weaken their ability to delay the sale if that can create more tension in the buyer.

The best situation for the firm to be in when entering a sale negotiation is to have alternative buyers. Each potential buyer may have quite different reasons for doing a deal, however, by having more choice, the firm can create competitive tension and push the price up. Any firm entering into negotiations will want an exclusive right to enter into due diligence and detailed negotiations. This is a reasonable position to take due to the expenses which the potential buyer will incur. However, that does not preclude the firm from negotiating the business terms prior to agreeing an exclusive arrangement. The firm can also sometimes negotiate costs if the buyer decides to withdraw.

Competitive tension can only be really effective if the alternatives are real and not just illusionary. Thus a stable of potential buyers needs to be created well in advance. Where the firm has personal contacts at the right level, this is more effective. When entering into a potential deal, the firm simply contacts the other parties and informs them that negotiations have commenced and that it

is likely a sale will occur. If they wish to participate as a potential buyer, they are then put on notice that time is of the essence. This situation can occur either proactively or reactively. The firm might be approached by a potential buyer and see that initial negotiations will take them to a reasonable sale position. Having committed to the process, other potential buyers should be notified that the sale process has started. Providing that relationships have been built in advance and the acquisition potential of the firm is well understood, other parties should be able to put their own acquisition process into action.

Example: *(Author's italics)*

DAYTON, Ohio (AP) - Board members of Elder-Beerman Stores Corp. said the retailer will accept an $82 million offer from Bon-Ton Stores Inc. ***unless rival suitor Wright Holdings Inc. raises its offer by early next week.***

The Elder-Beerman board met Thursday after receiving the offer to merge the Dayton-based retailer with the York-based Bon-Ton for $7 per share.

Elder-Beerman and Bon-Ton entered merger talks in late July, about a month after the Elder-Beerman board agreed to sell the company to Wright Holdings, a subsidiary of Goldner Hawn Johnson & Morrison of Minneapolis, for $6 a share.

Under terms of the agreement with Elder-Beerman, Wright Holdings has three business days to raise its bid.

Goldner Hawn's managing director, Michael Sweeney, has said his company remains committed to acquiring Elder-Beerman and keeping its current management and operations intact.

Source: http://www.observer-reporter.com/ *accessed 7th September 2003*

In a strategic sale valuation is problematic. You will no doubt want to have some idea of what the business is worth going into a discussion and your

shareholders may want to have this information before they agree to a serious negotiation. However, when the value is based on what the buyer can achieve rather than what the net worth or the profitability of the firm is, this presents the entrepreneur with quite a dilemma. You actually have very little idea of where the final price will settle because it depends on the competitive bidding and the size of the opportunities for the potential buyers. There are, however, some strategies that you can use to assist you.

First, you need to uncover how your business will create value for the buyer. In your discussions with each potential buyer, you should be finding out how they will leverage your strategic value. While they might be reluctant to disclose this, you will no doubt be discussing issues around key staff, product roll-out, scalability of the opportunity and the role you and others might play in that activity. Thus there is a good case for an open discussion. How can you best help them exploit the potential? What more could you do to make it effective for them? What role would they like you to play and how can you make it work for them as well as you? Teasing out some of these issues will help extract information on the size of their opportunity.

Next you need to establish the impact on them of not being successful with the acquisition. What happens if some other corporation is successful in acquiring you? Does this damage them in the market place? Will one of their competitors gain an advantage on them? They need to understand the opportunity which they will lose as well as the competitive impact on their corporation if they are not the successful bidder.

No doubt they will be reluctant to provide this type of information but it is essential for your positioning that you establish as much of this as possible, then you can keep reminding them what they are losing by not being the winning bidder.

It will still be near impossible to establish the final price but at least you will have some parameters around which to work. You might wish to set a minimum price which is acceptable to all shareholders. As long as the minimum is at least where you would be willing to undertake the sale, anything beyond that is a gain. Remember also that if you walk away from the deal, the same opportunity may not come again. Sometimes it is better to take the money and

start a new venture and do it all over again than to not sell and then find that the opportunity does not present itself again or the firm gets into trouble and you are not able to create the same competitive tension next time around.

This is a negotiation game and certainly experience helps. Get the best people on your side you can and give it your best effort. You can always walk away from the negotiating table if you cannot achieve a good result but always remember that you may not have the same opportunity next time round. Too many entrepreneurs set their sights too high and then later regret not taking the money when it was offered. If you have put in the time to prepare the ground, have connected with the right potential buyers and have uncovered the opportunity for them, you should be in a very good position to do well in the negotiation. In the end it is all about preparation.

14

Deal Structure

Good deals occur where parties are reasonably flexible, understand that no one wins if no deal is made and that everyone needs to walk away feeling they have won. Good deals usually can be done quickly where both parties see a good result being achieved for both parties. A buyer who feels they have acquired a firm which can provide a good return on the purchase price, is a deal which can later absorb some problems. A seller who knows they achieved a sale which was worth more than the conventional financial value of the firm can also feel rightly proud of the deal. The key is to make everyone happy with the result.

Whether you are approached with an offer or you stimulate an offer by establishing the relationships as described in this process, you will end up negotiating a deal with many dimensions. Generally in this type of process it is important to meet somewhere on the same page and in the same book. If you are on another planet with respect to price and conditions, the time will be entirely wasted and both parties will end up frustrated.

In most cases, most elements of a deal are negotiable. Whatever constraints you have and whatever constraints they have in negotiating a deal should be uncovered as soon as possible. For example, you might decide you wish to retire and staying on for any period other than a short handover is not what you want.

There may be pressing family or personal reasons for your decision but it may be sufficiently important for you not to wish to compromise that part of the deal. It may be important for you to have some guarantees of further employment for some of the staff. The buyer may wish to have a guarantee that certain key staff stay on for some minimum period. Whatever these issues are, they should be set out before the serious process of negotiation begins because they help to determine whether they can be met.

I like to think of a deal as representing a certain target value to the buyer. That value represents their view of the balance between the risks in the deal and what they are prepared to pay for the opportunities it represents to them. They will have perceptions of risks based on industry and personal experience.

Part of the entrepreneur's negotiating objective is to show how the risks have been minimized or removed and how the buyer can fully exploit the potential. Imagine the target value as a point on a continuum which moves down with higher risk and up with greater opportunity actualization. The initial task is to move the point up as high as possible by reducing risk and showing greater potential realization.

Once the best price which can reasonably be expected is offered, you can start to break that value, the 'deal value', up into deal elements. The deal value can then be carved up in any number of ways but, at this point, the pie does not get any bigger. With this approach, both parties can start to set out where they want the value to be spent.

The deal value may be achieved by the seller at some period in the future based on certain conditions being met. To the extent those conditions can be met, the buyer is normally willing to make available the whole deal value. However, to the extent it cannot be met or is not met, the deal value is reduced by some amount representing the cost of correcting the shortfall or the opportunity cost of not having that advantage.

Some minimum level of performance may not be negotiable. So, for example, if the deal depends on certain key employees staying on after the acquisition, additional incentives may be offered to them to gain such assurance. You should consider this additional incentive as a deduction from the deal value,

but perhaps essential to satisfy the buyer. Some period of non-compete may also be required to prevent the key managers and shareholders from joining the competition or setting up a new company in competition. If three years was the desirable period but the sellers want only two, the deal value should be reduced by some amount representing the additional risk faced by the buyer.

This framework can provide a workable method of negotiating elements of the deal. Any reduction in risk moves the final deal value up, although this may appear as an increase in the purchase price to the seller. Any increase in risk or reduction in the ability to exploit the opportunity simply reduces the deal value.

In order to fully achieve the value from the deal, the buyer may wish the seller to complete R&D projects, sign up key customer contracts, cancel or negotiate specific obligations, negotiate redundancies or relocate staff. These could be framed as staged payments, earnout or fixed payments on achievements. In other words, the final acquisition price can be made up of many elements, each of which has a fixed or calculated value, which can be paid out in stages or accumulated to an end point and then paid out in some mixture of shares and cash. The period can be relatively short if it is expected that key objectives can be determined quickly, or it could be over a number of years if it requires a considerable period for the objectives to be achieved.

Elements which may be included in the final deal may include the following:

Base Price:

This should represent the minimum that will be paid for the firm. It may be subject to adjustments through a balance sheet audit which will verify valuations and liabilities. It also may be subject to adjustment through warranties and representations for some specified period of time. The base price may be offered in the form of shares in the acquiring corporation, or cash or some combination of both.

Escrow:

An escrow sets aside some portion of the purchase price against adjustments and warranty claims. Generally this will be held by an escrow agent and may be claimed against by providing specific evidence of claims. Usually it

is limited in time, such as one year. At the end of the escrow period, the remaining shares are returned to the selling shareholders.

Options:

Options of selling employees may be converted to ordinary shares prior to the sale being consummated or may be carried over into options of the acquiring corporation. Options carried forward provide incentives for employees to stay with the buyer. Additional options may be offered to key employees to retain them.

Stage Payments:

Stage payments are normally aligned to the achievement of objectives. So, for example, they could be aligned to the delivery of certain key R&D milestones, or completion of certain contracts, or the signing of certain key contracts.

Earn Out:

An earnout aligns the purchase price with the achievement of specified revenue targets or other milestones. This may be set at specified increases in the purchase price or a percentage of the purchase price based on specified targets. The additional earnout would normally be for a set period and may or may not be capped. The earnout may be for all shareholders or limited to key shareholders who stay with the buyer.

Continued Employment:

Continued employment of former owner/managers and/or key employees may be sought by either or both of the parties depending on how important those staff are to achieving future objectives. Specific jobs could be negotiated. Specific management agreements and remuneration and incentives may be included in the deal. Some staff may prefer a short term consulting agreement.

Director Position:

Either or both parties may want former key executives to continue on a Board of Directors for some period.

Warranties and Representations:

The acquirer will not be able to verify everything in the deal. To overcome this limitation, they would normally require the Directors and/or shareholders, or some subset of them, to provide warranties and representations about key elements of the firm. This might be asset valuations, contingent liabilities, incomplete litigation, prior balance sheet and revenue statement assurances and so on. Any claims in this area might be taken against an escrow account if that is set up, adjust the final purchase price if some balance is still to be paid, or might be subject to a recall of value through arbitration or litigation.

Non-Compete:

Generally the buyer wants to protect themselves from competition from former key shareholders and executives of the selling firm. This is usually set for a limited period like 2 to 3 years. It would normally exclude the individual from working with a competitor or from undertaking a start-up which would compete.

Holding Period:

Where publicly listed shares are being taken as part of the purchase price, these may be subject to registration. That process may take some months. During this period the selling shareholders will not be able to sell their shares. There also may be further restrictions on the sale of shares which the buyer requires in order to not flood the market or not to show a lack of faith in the future of the corporation. Shareholders continuing on as key executives may also be subject to non-trading or blackout periods or sale restrictions due to insider trading restrictions.

Specific Liabilities:

The selling shareholder may be asked to take over specific liabilities or contingent liabilities. This may happen where key shareholders have personal loans to the firm. The buyer may regard their repayment as an obligation of the sellers and not theirs. They may also decide the risks inherent in specific contingent liabilities are too difficult to assess and ask the sellers absorb whatever is the eventual outcome. Since contingent liabilities are often deal killers, this is something which sellers need to give special consideration to.

If the alternatives are no deal or a deal with some possible downside, the latter may still be worth doing. At other times, the contingent liabilities may be capped on either side or may be handled through the escrow.

Costs:

Legal and Accounting professional fees incurred by each party are normally borne by the respective parties. However, these costs may be assigned in some proportion to one or both of the parties depending on the deal structure.

Use of Intellectual Property:

Normally full rights to any IP passes to the new owner, but this need not necessarily exclude use by the seller. It may be possible to negotiate the use of IP for personal or non-competing purposes post sale.

In negotiating the deal, both sides have issues which need to be addressed and both sides usually have some flexibility to trade. A higher risk taken by one side should result in a change in the purchase price. If the sellers absorb some contingent liability risk, this should result in some other advantage to them, such as a higher price or more options etc.

Earnout

Owners of the selling firm often agree an earn-out as a way of securing additional compensation for the business they are selling. This frequently occurs where the price the buyer is willing to offer is seen by the selling shareholders as inadequate compensation for the potential of the business. Circumstances where this might occur are;

- Significant expenses have been incurred in recent research and development which has been written off but has not yet translated into revenue;
- The owners have taken either very low salaries or excessive salaries or benefits which are not able to be easily calculated;

- Large contracts have been secured, or are about to be secured, where the benefits have not flowed back into the accounts;
- The sector is experiencing significant growth and the firm is well poised to take advantage of that; and
- The potential acquirer is able to remove an impediment to growth which will return premium profits to the acquirer.

The selling shareholders argue for a higher valuation on the basis of potential. The acquirer may be reluctant to agree the higher value arguing that the benefits may not be realized. The compromise is often negotiated as an earnout based on the future performance of the acquired firm or the combined entity.

Another reason for an earnout arrangement is a performance based purchase price where other activities or achievements other than revenue or profits may be the basis for such payments. This might include;

- Completion of development milestones
- Acceptance of products by named customers
- Completion of key contracts
- Signing of key agreements by customers, suppliers, partners or distributors
- Approval of products by licensing authorities
- Granting of rights under patents, trade marks, or licenses
- Achievement of various quality targets

Earnouts should be used where there is a reasonable level of uncertainty of some future event or future performance which can have a material impact on the value of the acquisition. There should also exist the possibility that none of the earnout will be earned if the anticipated events or targets are not met in a material manner.

Where events are more certain, such as the outcome of a litigation settlement, lease payout, warranty claim and so on, these are better handled through escrow arrangements and under warranties and representations. In these situations, the valuation is set on a positive note where all outstanding items are worth zero. A portion of the purchase price is then set aside, generally in escrow and claims are made against that portion as each item is finalized or

settled. These items are generally discrete in nature, often able to be calculated in advance and not overly subject to effort by either party and will normally be limited in time.

The earnout approach is best used when the parties are not able to agree on a purchase price because future events, which could materially affect the value acquired, cannot be determined with any certainty. Alternatively, the buyer is willing to pay more but only if the seller can achieve certain predetermined performance or event objectives.

As a general rule, a good earnout formula is one where the buyer is very willing to pay the earnout if objectives are achieved and the seller has a reasonable degree of influence over the events which contribute to that level of achievement. A good earnout formula is also easily defined, measured and objective and not capable of manipulation by either party at the expense of the other.

Earnouts are however not as common as may be expected.

Example:

In an article in CFO magazine titled 'Caution: Earnouts Ahead', the author Roy Harris notes that contingency terms were found in 4 percent of all announced U.S. M&A deals, with over 10 percent of all deals valued at or below $250 million, encompassing such terms. More than two hundred acquisitions in the U.S. have contained earnout agreements in each of the five years to 2000, with a total value of such transactions peaking at $27.9 billion in the year 2000.

Source:http://www.indiainfoline.com/nevi/earn.html Accessed 9th May 2004

Term of the earnout

There is considerable disagreement among practitioners about the most workable term of an earnout. On the one hand, shorter terms have higher

degrees of likely achievement while longer terms allow for too many influencing events to occur. Also longer earnouts reflect lower present day values due to the discounted cash flow impact of distant payments. Thus the further out the potential payout, the less value it has for the sellers and the more likely it is to be disputed or not achieved.

Example:

Baltimore-based Sylvan Learning Systems Inc. certainly found it so. The company, a prolific acquirer of educational companies in recent years, started out by setting up one-year earnouts. For the managers Sylvan retained, "the natural response was to go gangbusters in terms of revenues and not spend for future growth," says senior vice president and CFO Sean Creamer. Sylvan now designs earnouts for three years or more and monitors the deals carefully, sometimes using special audits to make sure the managers aren't "gaming the system."

Source: http://www.cfo.com/article/1,5309,7261|0|C|2|,00.html
Accessed 9th May 2004

To a certain extent, it depends on which party has the greatest influence over the target achievements. The longer the buyer is in effective control, the more influence, positively or negatively, they can impact on performance.

How large should the earnout be?

Conventional wisdom suggests that earnouts should be limited to 10-25% of the ultimate purchase price. One of the issues which both parties should be aware of is that earnouts are really only appropriate where there is some degree of uncertainty in achieving defined potential targets. If the events or targets were guaranteed, these can be factored into the base price. Where probable outcomes may in fact not be achieved, both parties need to think through the consequences if the earnout is not achieved or substantially not achieved.

An earnout element based on specific large events may be quite reasonable if the final determination cannot be readily influenced by either party. This could be, for example, FDA approval which is awaiting final determination. This might significantly change the valuation and both parties may agree a significant earnout on the conclusion. However, if the earnout requires active co-operation of all parties and is based on many contingencies, it simply opens the gates to a claim of lack of effort on the part of the buyer.

How should the earnout be calculated?

There is no magic formula for earnout calculations especially those that are performance based. Should they be based on a cumulative achievement or on stage targets? The problem is one of uncertainty for both parties. The seller will want to ensure that payments, once achieved, are not subject to clawback while protecting against events outside their influence, while the buyer wants to reach certain long term objectives.

The biggest problem in all earnout calculations is finding an objective formula that is not subject to manipulation or re-interpretation by either party.

Revenue

May be boosted by promotions, discounts, poor contracts, early shipments, false invoicing, manipulated stage payments, etc. Revenue may also be negatively impacted by cutbacks in allowable marketing expenses, promotion of competing products, interference or delays in completing contracts through approval cycles or newly imposed conditions.

Expenses

Can be reduced by reducing staff, delaying staff replacements, delaying purchases, cutting back on R&D, delaying performance bonuses, buying lower quality stock or components, fighting warranty claims and so on. Additional costs may be imposed for redundancies, implementation of new systems, additional reporting and budgeting requirements and so on.

Net Profit

Calculations can be influenced by changing depreciation methods, how

goodwill is expensed, reclassifying expenses as capital items, excluding some payments as extraordinary items and so on.

Even where the manner of calculation has been specified, there can be alternative calculations. The words 'According to GAAP' (Generally Accepted Accounting Principles) need not ensure that a particular method is used if the auditors recommend a change due to legislation or a new accounting standard. Even 'as applied at the time of the agreement' will not necessarily cater for an event not foreseen. The terms 'consistently applied' are often used to overcome changes. Setting out the method of calculation during the earnout discussions may help bring out any differences in treatment. The measurement issues become increasingly complex as operations are merged with those of the buyer or central services are undertaken by the parent which results in disputes over transfer prices between entities.

Where competing products are being offered, the earnout may be calculated on both product lines in order to avoid any issue of deliberate bias.

Targets should be kept simple, easily and unambiguously calculated and subject to objective measurement by an independent auditor if necessary. Revenue, for example, is easier to calculate than profits. Specific milestones are easier to determine than profits. Earnouts can be based across a range of events or targets, some financial and others based on specific events.

Example:

SAL's former shareholders and creditors have an *earnout* that is contingent upon three events in 2002: 1) an *earnout* note, due in twenty-four months, for $500,000 will be issued if the SAL Model 5 stepper's performance satisfies stated stepper throughput and mechanical performance criteria by no later than March 31, 2002; 2) a second *earnout* note, due in twenty-four months, for $500,000 will be issued if the combined Model 5 stepper and JMAR X-ray source demonstrates X-ray lithography exposures which satisfy stated performance criteria by September 30, 2002; and 3) a total of 354,736 JMAR shares and an *earnout* note, due in twenty-four months,

for $1.2 million will be issued if an order from a commercial semiconductor manufacturer is received by December 31, 2002 (with pro rated reduction of the payment to zero if the order is received between December 31, 2002 and March 31, 2003).

Source: http://www.bristoldirect.com/adobe/JMAR_Research_1-22-02.pdf. Accessed 9th May 2004

How should the earnout be paid ?

The parties need to agree how the additional valuation created through the earnout will be paid out. Sometimes this is done in cash, other times in cash and shares, or just in additional shares. When shares are used for the earnout, both parties need to agree a formula for how the number of shares is to be determined. This might be at the same market price as for the base compensation, or it might be the price on the day of the payout. Sometimes it is hard to judge where the sellers might be better off. What would happen, for example, if there was a major change in the share price?

Example:

The last round of Nasdaq listings was triggered by the success of Chinadotcom's listing, which having both 'China' and 'dotcom' in its name ensured it had a very hot reception. Who could have guessed at the time that it would trade down from a peak value of $73.43 to a 39th of that ($1.86) at its low?

Source: http://www.financeasia.com/Articles/18395183-969A-41CD-A63F80D95A44D208.cfm Accessed 9th May 2004

How much freedom to operate should the seller have?

This is an area of much dispute between buyer and seller. If the earnout is based on operating the business as a continuing concern to achieve the performance targets, this may not sit comfortably with the buyer. The buyer is exposed to expense blowouts, capital project commitments and agreement

obligations. Also the buyer will want the business run so that it reduces risk exposure while putting the business on a good footing for the time it takes over effective control.

This potential conflict in interests often results in the acquired business being subject to numerous reporting requirements, expenditure approvals and restrictions on borrowings, capital commitments and so on. Working out the operating conditions and then recalculating the earnout on the new basis can help. It may be appropriate to work out various critical factors such as headcount, expense budgets, capital expenditure allowance, marketing spend and so on.

Example:

Autonomy Corporation plc , a leading provider of infrastructure software for the enterprise, today announced it has entered into a definitive agreement to acquire etalk Corporation, a leading provider of enterprise-class contact centre products, for a purchase price of US$70 million payable in a combination of cash and Autonomy ordinary shares, with an opportunity to earn additional consideration payable in Autonomy ordinary shares upon meeting and exceeding certain future performance-related targets.

Source: http://www.cambridgenetwork.co.uk/pooled/articles/DF_NEWSART/view.asp?Q=BF_NEWSART_156736 Accessed 18th February 2006

A more serious issue is conflict of interest over where the efforts of the newly acquired business should be directed. With an earnout in place, acquired management will have a focus on maximizing their earnout. At the same time, the reason for the acquisition may be to integrate the businesses or to leverage the assets or capabilities across a wider corporate entity. It is difficult to do both at the same time. The most capable people and those with the most knowledge in the acquired business will want to focus on the earnout. However, it is these same people who need to be involved in assisting the roll-out of the newly acquired assets or capabilities.

The new owners have to decide one way or the other. Either they leave the business alone during the earnout or they compensate the prior owners for the time required to work with the new larger entity. This may ultimately result in the new owners paying out all, or most, of the anticipated earnout in advance.

Earnout or employment compensation?

Where the selling shareholders argue the business being acquired has unrealized potential and they wish to be compensated for that – the earnout is correctly paid out to all shareholders. However, where the new owners wish to motivate the newly employed managers to achieve certain objectives or targets, the additional value should be included within employment agreements as additional bonuses or compensation.

The difficulty here is to separate that which rightly belongs to the shareholders as a group and that which is reasonably held to be personal effort. Shareholders may well object to one of their number being offered an overly generous package where they think the compensation should go to them all for creating the foundation on which the near term benefits are being achieved. Where business deals or significant milestones are clearly in progress, the shareholders could argue that the benefits should accrue to all shareholders even if some additional compensation was paid to an individual to see it through to completion.

As a general rule, the more certain the target is to being achieved, the more the compensation should be directed to the selling shareholders as a group. Alternatively, where significant effort is still required, compensation should be directed to the individuals who can best deliver the results.

Whatever is agreed, it is best if all the selling shareholders, or at least the larger non continuing owner/managers, sign off on the deal as this should avoid future litigation.

Example:

Billabong International Ltd., Australia's largest publicly traded surfwear manufacturer, has acquired the Honolua

Surf Co. apparel brand and its 19-store retail network. Depending on the eventual payout, the acquisition will cost Billabong between $10 million and $15 million.

The acquisition will be funded by debt and paid in two installments, according to Billabong. The initial payment to Honolua is 75 percent of the agreed purchase price. After three years, Honolua will receive 25 percent of the initial purchase price plus an incentive-based payment calculated on the increase in retail profits over the period. In addition, Honolua's co-founders, Tom Knapp and Randy Blumer, receive an annual earnout over three years based upon continued employment.

Source: http://www.insider.com.au/inside/html/modules.php?name=News&file=article&sid=1724 Accessed 9th May 2004

Renegotiation or payout

Not all events can be forecast and there will be occasions when the earnout is frustrated by events outside one or both partys' influence. Some of these may be anticipated, such as the resale of the acquired firm and an agreement entered into about the resulting impact on the earnout.

What happens, for example, if the prior management is unable to continue due to ill health or if actions of the buyer cause the acquired business to be severely disrupted?

Earnouts are frequently renegotiated as events unfold. This, however, requires goodwill on both sides.

Example:

"In July we indicated that 100% of the Group's total potential earnout liabilities had been realized, renegotiated or capped. Further progress has been made in renegotiating Parsec's earnout due to some major changes in that business.

Agreement has therefore been reached with the vendors of Parsec to settle their outstanding earnout (maximum total of £6.8m payable in Anite's financial year 2005/6) for £873,000, to be paid in guaranteed loan notes, repayable after one year.

This, together with other minor adjustments, has reduced the total future cash earnout liability from £25.4m to £19.5m, whilst bringing forward all remaining 2005/6 financial year liabilities, thus ensuring that all outstanding earnouts will have been paid out by the year ended 30 April 2005, subject to performance."

Source:http://www.pressi.com/int/release/74044.html Accessed 8th May 2004

Example:

Brooktrout Inc., a provider of telecommunications hardware and software, tried earnouts in an acquisition in the early 1990s and discovered that a demotivated workforce can destroy all the supposed benefits of the approach. In its case, says CEO Eric Giler, Brooktrout agreed to assume the liabilities of a Texas company and to make contingency payments to the selling executives if they hit certain sales goals they set for themselves.

"Entrepreneurs are their own worst enemies," often setting targets that are too ambitious, says Giler. And they did that here, falling far short of the earnout goals. While conventional wisdom may say that this would be good because Brooktrout wouldn't have to pay the earnout amounts, Giler soon learned otherwise. "As you start to miss your targets, the incentive goes way down and you have to fix that" so the employees will stay committed, he says. In Brooktrout's case, that meant "resweetening the deal" with a whole new set of stock options

and cash bonuses for the very employees who had failed to achieve their original goals.

Source:http://www.cfo.com/article/1,5309,7261%7C10%7CC%7C2%7C,00.html Accessed 9th may 2004

"Best efforts"

Where the owner/managers are not employed by the new owner, they are very dependent on the buyer following through with agreed programs of promoting the product or services to achieve potential revenue and profit targets. However, many times the buyer has other priorities and the potential may not be realized. This is a recipe for litigation.

Example:

Even if the seller is successful in getting the buyer to accept sales revenue as the appropriate target, problems can persist. For example, in J. Bloor v. Falstaff Brewing Company, 601 F.2d 609 (2d Cir. 1979), Falstaff acquired Ballantine's brewing business and agreed to pay the Ballantine sellers a royalty of $0.50 per barrel for 6 years after closing. Post-closing, Falstaff slashed the annual advertising budget from $1,000,000 to $115,000 and reduced distribution centers. Profits rose dramatically, but sales dropped 29% in one year and 45% in the next year. Nevertheless, the seller was successful in its breach suit against the buyer since the contract required the buyer to "use its best efforts to promote and maintain a high volume of sales."

Source: http://www.imakenews.com/techyvent/e_article000100532.cfm Accessed 8th May 2004

Example:

Melbourne, Australia, 5 May 2004

Biota Holdings Limited (ASX:BTA) announced today that it had issued a writ in the Victorian Supreme Court, claiming breaches of contract and fiduciary duties by the worldwide GlaxoSmithKline (GSK) group for failing to promote and support RelenzaTM. The writ seeks unspecified damages for lost royalty revenues to date, as well as future losses through the life of the product's patents.

"Relenza was a breakthrough influenza drug that had great potential, but it was effectively abandoned at birth," said Biota's CEO, Peter Molloy. Biota claims that the product failed not because of any inherent disadvantages or deficiencies, but principally because support for the product was withdrawn immediately after the launch year."

Source: http://www.biota.com.au/announcements/2004/press120.html Accessed 6th May 2004

Taxation implications

The payment of cash or shares after the closing date of the acquisition may be treated as income or capital gains depending on the way in which the compensation is worded, calculated and timed. Different rulings may apply in different states and countries. Before any earnout is agreed, both parties should take professional advice on the matter. With some change in structure, the same end result may be achieved with different tax consequences.

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Selecting Professional Advisors

While every entrepreneur knows how to properly package a product or service to achieve a profitable sale, few would claim they have the same competence when it comes to selling a business. The fact of the matter is that selling a business is a specialist activity with its own set of legal and accounting issues and this is one area where experience does count. That being said, the entrepreneur knows his business and should understand better than anyone where it has growth potential, the basis for a higher sale price.

The same may be said of the inexperienced Investor. VC firms and experienced Investors who have participated in a number of investments should have some experience working with professional advisors and probably have some existing relationships which they can use. However, selling a business to a large global corporation based on strategic value is not something many investors have experience with and, to be frank, few advisors have either.

In my experience, there are few professional advisors who understand how to position a sale around the business potential whether that be financial or strategic value. Most often they tend to push the deal back into a conventional framework based in an EBIT multiple and in doing so miss the whole point of the exercise. They are not only a waste of time but tend to get in the way of the deal being done properly. The choice of advisors is critical.

Apart from the support you will need from professional legal and accounting firms, should you use a business broker or investment banker to help sell your business? The answer really depends on how well you understand the process of selling a business, whether you already have willing buyers in your sights and whether you have prepared the business for sale. If you are unsure about how you should prepare your business in order to achieve the best offer, or if you are uncertain how to attract the right buyers, then getting help from professionals who undertake those tasks on a regular basis makes sense. Even an experienced entrepreneur who has sold several businesses may like to have an advisor in the team to assist in the negotiations. There is considerable benefit in having an objective, knowledgeable person on your team to provide feedback, suggestions and to keep the negotiation process moving forward.

The key to the use of such professionals is, however, to use them to assist the Investors and internal management team in the process, not to take control. Too often business owners have allowed professionals to control the process and the negotiations not recognizing that the advisors primary motivation is the commission on a quick sale. The entrepreneur who understands his or her business well and spends time identifying and connecting to the best potential buyers, will generally achieve a much better price for the business. The best buyers will be those corporations who can best exploit the potential in the business. Positioning the business with these potential buyers and preparing the business so that it can support such potential is best undertaken by the entrepreneur. It also takes time and cannot be undertaken properly if the business is rushed into a sale.

At the same time the entrepreneur is preparing the business for sale and positioning it with potential buyers, professional legal and accounting firms need to be appointed to assist with both preparation and sale transaction support. Better sale prices are achieved where business risk for the buyer is minimized. This process often requires the business to undergo a vendor due diligence as part of the preparation process. By proactively undertaking their own due diligence review, the entrepreneur can discover risks in their business which can be addressed long before a potential buyer emerges. Not only does such an activity improve the current business but it significantly reduces buyer due diligence costs and time during contract negotiations. A business which is well prepared for buyer handover will attract better buyers and a better price.

The smart entrepreneur needs good advice and smart people to support the sale process. The result usually is a much better price.

The Professional Accounting and Advisory Firm

The type of advice and help which a professional advisor can provide includes assistance in the following areas:

Valuation

If the firm has already prepared a valuation of the current business and projected valuation of the business opportunities to potential acquirers, this will contribute considerably to the discussion with the potential buyer. The advisor can review the financial projections, provide conventional valuations and brief the entrepreneur on how best to present their case. Understanding how an acquirer undertakes a valuation will ensure the firm has prepared the proper information, presents it properly and is able to validate the underlying assumptions and values.

Preparing an Information Memorandum

The Information Memorandum (IM) is the document which most firms use to solicit interest in their business. It describes the business, sets out the historical and projected financials and provides background information on the industry, the competitors and the acquisition opportunity to allow a potential buyer to decide if they wish to proceed to a more detailed examination of the business. It is the foundation document which will be used by the potential buyer to evaluate the acquisition. It is important that the IM be prepared thoroughly, be properly explained and contain the information needed by the potential buyer to undertake their initial due diligence on the opportunity. The advisor can prepare the IM to ensure it is readable and persuasive and provides an appropriate level and type of information.

Reviewing financial Information

Current financial information needs to be prepared according to generally accepted accounting principles and presented in a conventional format which allows easy analysis. Your advisor can ensure the statements are prepared correctly and that the accompanying data fully supports a detailed

investigation. This information is normally reviewed by your advisor to ensure that financial information is presented on a consistent basis from year to year and that any extraordinary or abnormal items are fully explored.

Helping with introductions and referrals

Well established accounting firms and investment banks participate regularly in transactions involving buyers. They are, therefore, in a good position to know most local large corporations on a personal basis and certainly by reputation. If they consider you have a good business proposition they can help short list potential buyers you should approach and then can help with introductions or referrals. They may also be able to assist with the search for prior acquisitions and with uncovering news items which relate to them. They may have connections to assist you to contact prior sellers so you can gain an independent view of the potential buyer.

Since many professional firms have national and international offices and affiliate networks, this can be used to uncover other possible buyers and generate introductions. Having the right potential buyers in the final bid process can make a huge difference to the ultimate sale price.

Reviewing purchase terms and conditions

While purchase agreements are often set out in a conventional format, the vendor is not normally in a position to know what terms would be reasonable for their business. The advisor should be able to recommend where terms should be renegotiated, however, always obtain proper legal advice on contract terms.

Assisting in negotiations

The firm which is represented by a well established and respected advisor is likely to be better prepared for the negotiation. At the same time, the buyer knows that the terms are going to reviewed by a knowledgeable party. This should result in more productive discussions and the result is likely to be better for the firm. The buyer may prefer to deal with a business represented by a professional advisor as they know the entrepreneur will not need to be educated about conventional terms and conditions or the warranties and representations required under a normal deal.

Advice on preparation

Preparation for an acquisition is much more than preparing a business plan. The advisor reviews the likely buyer's investment criteria and investment process in advance with the management team to ensure the vendor has prepared itself for both the negotiation and the due diligence processes.

Due diligence

Due diligence will be carried out by the buyer as part of their initial evaluation of the acquisition opportunity. This is mostly a product/market evaluation to see if the merged business can support the opportunity claims of the firm. After the business terms of the acquisition are agreed, the buyer will carry out an extensive review to further ensure it has a thorough understanding of the business and the management and has uncovered any data discrepancies and investment risks. Your advisor can undertake a trial due diligence process to ensure the firm is fully prepared and help to correct any deficiencies.

Advice on pensions, option schemes and remuneration

Once the buyer is involved, the firm will have little opportunity to change the remuneration and benefits of its staff. A professional accounting firm can review these before an approach is made to a buyer to ensure the current remuneration and benefits are fair and reasonable and provide the most positive basis for the planned sale.

Tax advice

Few firms are structured from the outset to be optimal for a sale. Over time the tax regime will most likely have changed, especially with regard to retirement strategies, trusts, capital gains and options. The corporate structure of the business may not be suitable for an outright sale or be optimal if there is an earnout portion. A professional accounting firm can also review the current business processes for compliance, tax collection and reporting. At the same time, personal tax planning for the major shareholders should be undertaken to establish the right basis for the planned sale. This will include the best format for the sale (eg. sale of shares or sale of assets).

Exit strategy assistance

From their knowledge of prior acquisitions, your advisor can help define business potential, strategic value, identify integration issues and/or show how the firm can best position itself for a sale.

The Professional Legal Firm

The type of advice and assistance which a professional legal firm can provide includes help in the following areas:

Review purchase agreement

The purchase agreement would often be prepared by the vendor's lawyers, however, this protocol varies in different countries. In addition, some buyers insist on having their lawyers prepare the contract. This is a complex legal document which few entrepreneurs will have ever seen and certainly few would understand in any depth. The professional legal firm can draft the documents for you or construct the terms and conditions and identify any harsh or unusual conditions which the buyer has requested and assist in the renegotiation of those where the buyer prepares the document.

Review warranties and indemnities

The vendor would normally be expected to provide warranties and representations and indemnities to the buyer. These can often be renegotiated to be less harsh. The professional legal firm will know what is reasonable and what is not. This is one area where proper preparation, good reporting and compliance systems and good governance can significantly reduce the exposure of the vendor.

Review employment or non-compete agreements

The buyer will expect the key executives and major shareholders to enter into employment agreements and/or non-compete or restraint of trade agreements. The professional legal firm can ensure the terms and conditions associated with these agreements are reasonable.

Preparation of disclosure letter

The vendor should be prepared to disclose any issues which may effect the decision of the buyer to purchase. They should also identify any potential liabilities of the business. The professional legal firm can advise on the types of disclosures and how the letter should be worded to best protect the sellers and to ensure there is no avenue for redress on the part of the buyer if events do not go to plan.

Review corporate documents

As part of the preparation for the sale, the professional legal firm will review the corporate documents which authorize the firm to undertake business to ensure it meets the requirements of the buyer. This review would normally extend to board minutes, shareholder agreements, option schemes and any material contracts the firm has entered into.

Depending upon the size of the transaction, the vendor should plan for approximately 5 - 10% of the sale price to be spent on their professional services fees noting that smaller transactions are likely to have a higher percentage associated with advisors fees.

Not all professional services firms have the necessary experience to undertake this type of work effectively. The entrepreneur should not assume that their current professional services provider has the expertise to properly advise them in this area. They should seek independent advice as to which professional services firms are best equipped to handle the transaction they wish to enter into. Before they start to incur costs for this service, they should undertake some due diligence and investigate the extent to which the referred firm has a track record of success in working with clients on sales and acquisitions of similar sized businesses or to similar sized acquirers.

Asking for references would not be unreasonable and they also should ask for a list of transactions which the professional services firm has participated in and some details of the work performed for the clients involved. People move between professional firms and so the firm should ensure that the expertise is still with the professional services firms. They should ask to be allocated an advisor with personal experience in these types of transactions.

Some advisors, whether they be accounting, legal or corporate finance executives, are so locked into a traditional model of firm value that they simply 'don't get it'. They will want you to undertake a conventional valuation based on historical earnings, a conventional information memorandum and won't grasp the impact of the opportunity which the buyer can extract from the potential and/or strategic value in your business. Certainly you and they will have difficulty trying to put a value on the business if it is based on the buyer's potential rather than your net worth or profitability and your advisors may be uncomfortable going forward on that basis. However, if you have clearly identified potential buyers which have expressed interest in an acquisition, this should provide a good base from which they can assist you to prepare the business for sale.

If your initial discussions with a professional advisor show you that they want to take you down the conventional path, you should move on and find one that you feel can best represent the potential in your business. Ask them to provide you with references to similar sale transactions they have advised on.

Entrepreneurs and Investors who have not participated in large transactions are often concerned about entering into relationships with Investment banks, larger accounting and legal firms and often hesitate because they feel the larger firms carry considerable overhead and this gets passed back down to the client in higher fees. It is certainly true that the larger firms typically have higher charge out rates but they also need to compete for services of the smaller clients and so it is not unreasonable to ask for a smaller charge out fee given the size of the firm.

The larger firms do have an advantage of being national and international organizations and having specialists in most areas and this can be to the benefit of the smaller firm involved in complex trading transactions. When it comes to contracts and agreements which can materially effect value dilution, a little more up front may better protect the value of the firm on ultimate sale. This would certainly apply to IP agreements, option schemes, shareholder agreements and any acquisitions which the firm enters into.

The larger professional advisors have a decided advantage in M&A transactions. They see them often, they regularly advise on both acquisitions and sales. Larger accounting and legal firms are often asked to undertake due

diligence work on behalf of larger corporations and thus are very familiar with the entire process. Larger firms are taken seriously when it comes to negotiations and thus can better protect the entrepreneur who has never experienced these types of deals.

In the end, it may come down to spending a little more over a longer period to be better prepared than spending a lot near the end closer to the transaction.

The business is likely to be better managed and be less risky as a result of more professional preparation. At the same time, the impact of a large professional firm in the deal process can enhance the reputation of the seller and may result in a better price being negotiated. Certainly it should speed up the due diligence process which in itself can have a significant positive effect on deal price. It should also speed up negotiations as the buyer knows it does not have to educate the seller about normal terms and conditions of a sale.

I have often been asked why I used a big four auditing firm with my last venture given that the business when it started only had a dozen staff and, when sold, had only grown to 30 employees. My answer has always been to show the impact on the final due diligence and deal discussions and to ask whether the person asking the question thought I received value for money.

My last business went into free fall after several large software corporations decided to enter my market with similar products. All my prospects were their customers as our supply chain optimization software sat alongside a large ERP system such as those sold by SAP, Oracle or Peoplesoft. When these corporations announced that they were going to develop their own supply chain optimization solutions, their customers decided to wait for the integrated solution from their main software vendor. Thus I found myself in a situation where I had 30 staff and no prospects. Naturally we decided to sell the business before we were forced to close the doors.

This was my fourth software business and I had the experience of working through the sales process for the earlier ones. I also had been through the due diligence process for raising venture capital twice and

taking on a large corporate loan. I knew from those experiences that being prepared for due diligence was a critical part of getting a quick decision. I also knew that the quickest way to get through the due diligence process was to ensure that the professional advisors I used had high credibility. Basically, I wanted to have all my source documents accepted without question. The only effective way to achieve this is to have the biggest and the best.

When you are selling a business to a large, perhaps, global corporation they are going to undertake a very extensive and sophisticated due diligence. They will almost certainly use a large auditing firm and a highly respected legal firm. In order to uncover the risks and problems in your business, these advisors are going to review everything. The only way you can speed up this process is to demonstrate to them they don't need to audit most of the historical information because they will be able to rely on the documents produced by your own advisors. My approach was to push back hard and state that any additional audit was wasting my time and the buyer's money but that I was willing to provide warranties for the quality of the information presented. In any case, if there was a subsequent problem, they could always go back and litigate against my advisors who would normally have much deeper pockets than me.

This last business of mine was sold for six times revenue to Peoplesoft in a period of just over two weeks. Given that it was losing over $1 million at the time, whatever additional fees I paid to my advisors was well and truly worth it. When you are dealing with large corporate buyers, it is best to have good quality advisors in order to be very well prepared for the due diligence and the negotiations.

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Other Considerations

Selling a business is more than a process of preparing the business for sale, negotiating the deal and then allowing the buyer to take control. It is a psychological process for the entrepreneur. The entrepreneur has to move from a growth plan to an exit plan, a huge shift in attitude.

Most entrepreneurs see selling their business as either something which will happen in the distant future or as a sign of failure. Few see selling the business as an objective in its own right or as something which is near term. They are usually so consumed with immediate issues or with development projects that consideration of selling is the last thing they think of. Even when they understand the possible value on sale, they generally feel they can get more if they only hang on a little longer and push the revenue and profit up further.

Much of the advice they receive is from people who have little experience of selling a business or have a negative experience in their past. Professional advisors are often little better. They are trapped into conventional models of valuation which do little to guide the high growth potential entrepreneur and therefore, their advice is often misleading. It is only by understanding how high growth potential can be leveraged into the sale value, that the entrepreneur can really consider the alternatives of staying with the business or selling. If the business has greater value in the hands of the buyer, selling can be a very attractive strategy.

Why Plan to Sell

Few entrepreneurs set out to start a new venture with the objective of building a company to sell. Most set out to build a business around an opportunity and along the way comes the better salary and benefits. As it grows and develops, they are consumed with the next deal, next year's plan, the need for external funding and the task of simply generating sales to make payroll. Sometimes they think of their eventual retirement but it seems a long way off and rarely do they think that they may be forced to sell or that someone may come along and make them an offer they can't refuse.

Few entrepreneurs consider whether they might actually be better off by selling. Take a moment to work out what you are getting in terms of remuneration, benefits and dividends. Then consider what you could earn if you sold the business and went to work for someone else or stayed on to work for the new owner. How much worse off would you be on a month to month basis? In fact, many people end up earning more from their new job. Now work out what you would receive after tax if you sold the business. Divide that value by the expected life of the business (remember that few businesses last more than 10 years). Would your new salary plus a share of the sale proceeds make you better off over a ten or twenty year period?

When I sold my first business for US$9.6 million, my new salary was higher and I was no longer responsible for meeting the payroll of 160 staff every month. My share of the sale proceeds was around US$4.6 million. I put US$1 million into a trust fund for the education of my three children and left the rest in shares of the acquiring corporation. I could not possibly have made that amount of money in a lifetime of working on a salary.

Very few firms last forever, most are lucky to survive for 10 years. On the basis of probability, I was certainly better off taking the money. Certainly, for the rest of my life, I could expect to live well. In any case, like a lot of entrepreneurs, I went on and started other businesses which I subsequently sold at a premium.

Some entrepreneurs do set out with the intention of selling their business; this was what I did with my last company. Others build a company to undertake an initial public offering (IPO) and find they don't have the right type of enterprise

which lends itself to an IPO and decide to sell instead. Many companies are approached to sell and some take up the offer.

Then there are those who find that their best option for retiring or of liquidating their investment in the business is by selling, but they are under no pressure to do so. They can take their time and wait for the right moment. Sometimes they will put out the word through their professional advisors or maybe use a business broker. Other situations which might encourage them to sell are:

- There is no successor in a family business (about 50% of all family firms)
- The owner/manager wants to spend more time with their family
- The fun of the venture has faded and the owners have lost interest
- A better opportunity presents itself

People who have the time to plan the sale of their business will often involve their professional advisors to help them develop up to date information on the company. They will prepare an information memorandum, maybe even a business plan. They will seek advice on a valuation and typically be told how their industry calculates a sales price or how a net present value (NPV) or similar valuation can be calculated.

Selling the firm without taking the time to fully investigate its growth potential and to provide a convincing case for the buyer is, however, not a proactive strategy for getting the maximum value for the business when you do sell.

Firms which sell based on a historical earnings formula are simply giving the firm away based on what they have achieved (or not) rather than selling on what the business is capable of in the future.

A common situation which confronts many business owners is that they have been forced to sell. He or she does not really want to sell but circumstances force it on them. This can occur through a variety of circumstances, many of which are outside their influence:

- Internal changes at a major customer leads to a loss of business
- A major customer goes bankrupt and puts the firm into a cash crisis
- The market collapses and the firm is no longer viable

- A key supplier goes out of business or is acquired by a competitor and is no longer willing to supply components
- New legislation requires a major upgrade of the plant and equipment which is beyond the resources of the owners
- A key employee leaves
- A partner wants to retire and the remaining shareholders are unable to buy him out
- The CEO owner/shareholder has to cut back on work due to ill health
- Litigation exhausts the firm of cash and incurs massive debt
- The market temporarily declines due to terrorism or natural disaster and the firm does not have the resilience to survive it.

When this happens, the worst situation to be in is to be unprepared. Planning the sale of the firm is akin to disaster planning. Simply by going through the process of developing a plan to sell the business, a lot can be learned and the firm better prepared for a such an event.

> *When a business gets into trouble, the net worth tends to dissipate quickly. There is often a shortage of cash and debt finance is hard to find. This situation often forces the business into a fire sale. In these circumstances time works against the seller leaving them with inadequate time to set up a sale which enables the owner to extract the maximum value for their business.*

In the case of having to sell the business, the difference between the valuation which can be achieved by being fully prepared and ready can be many times the average industry sale price. The return on the resources devoted to undertaking a systematic process of preparation can have a very significant impact on what the shareholders will realize for their investment.

Finding the right buyer and being well prepared for the negotiation can often result in a price to the seller considerably more than what could be achieved through more traditional methods. The return on investment from the cost incurred in professional advice used to groom the firm for a well prepared sale is very high. Since you can never know when you might want to sell, or need to sell, being prepared can make a significant difference to the sale price.

When to Sell

There are very few entrepreneurs who would say they sold a business at the right time. Many will tell you they sold the business and then discovered the market improved and they would have received more if they had hung on longer. Others will tell you they sold the business after the market peaked and received less than they would have earlier. So when is the right time to sell your business?

Economic cycles are somewhat predictable, although few economists would be willing to state exactly when the downturns will occur. Layered on top of general economic cycles are industry trends which can confuse the picture. This is further complicated when you try to predict the possible future performance of the individual firm. There are numerous internal and external pressures which can influence both short term and long term profitability of any business. For most businesses, the future cannot be predicted with any degree of certainty. You only have to read the daily financial press to see how often public corporations miss or exceed their forecasts.

You might argue that you run a very effective, growing and profitable business and that you should hang in there for a higher valuation, however, you would be overlooking factors beyond your control. Recall the impact the terrorist events of September 11th 2001 and the Bali bombings had on various national economies. Natural disasters are unpredictable but can devastate sectors of our economy. There seem to be regular natural disasters such as tornadoes, cyclones, droughts, floods and earthquakes. While your business may not be in the geographical location of the disaster, it can affect your customers and suppliers, thus disrupting your business. Few of us would have predicted the fall out from the collapses of WorldCom, Ansett, HIH, BICC, Enron and Arthur Andersen. Basically, no matter how well you manage your business, you can still be seriously impacted by bad luck and events outside your control.

Your business can also be seriously affected by new competition, the loss of key employees, government or industry regulation, a major cost imposed by changes in regulations or by a major customer being acquired and switching to a competitor. Business is about risk. You can sit there and take the risk of the business increasing in value or you can sell and take whatever value has been

achieved to date and then think about taking it easy or putting some of the money back into a new venture.

The bottom line – you probably have an equal chance over the next several years of growing the business or suffering some form of setback. Predicting the state of the business in the next few years should not be the major determinant of when to sell the business.

Example: (Author's italics)

Select Travel International and Select Line Holidays of Leith have ceased trading, leaving debts of more than £700,000, after Aim-quoted World Travel Holdings said the companies "did not perform to expectations."

In a statement, the company said it had decided to shut the Scottish businesses "given the poor financial state of Select Line revealed following completion." The chairman of World Travel, John Biles, admitted the decision to pull the plug so soon after buying the group may appear unusual but he declined to comment further on what had gone wrong in such a short time.

"The wording in the statement was carefully chosen," he said. When asked if the liquidation of the companies was the end of the matter as far as World Travel was concerned, Biles said he expected so.

The liquidation move came just eight months after the companies were acquired in the all-shares deal. Liquidators are now trying to sell on domain names owned by the companies containing the '241' brand name in a bid to repay creditors who are owed a total of £738,000.

Debbie Harvey, of Reading-based insolvency practitioners Harrisons, said the failure of the companies had been blamed on the ***effects of September 11 and foot-and-mouth on tourism***. "World Travel was faced with a choice of having to invest large sums of money into the businesses which they didn't have or walking away."

Source: http://www.business.scotsman.com/ *accessed 7th September 2003*

Think back over the last few years of the household names which are no longer in existence. Large companies have more resilience than small companies but they still fail. Small companies generally have a much higher probability of failure.

If you sell to a listed corporation, the state of their share price and price earnings multiple (PE) can certainly influence their willingness to undertake an acquisition. If the public markets are receptive and the PE is relatively high, an acquisition by a public company can have an additive effect on the valuation of the acquiring corporation. For example, an acquisition which is done on an EBIT multiple of, say, 6 into a corporation which has a PE of 14 will add the additional multiple of 8 to the benefit of their own shareholders. So a public corporation trading at a PE of 20, they may be willing to pay a higher EBIT multiple. This may be a good time to sell.

Many business owners are concerned about whether they will have enough funds to finance their retirement and how they will spend their time when they do. Imagine how sad it must be to reach retirement and find you left it too late and you ended up with a fire sale. Sometimes it is better to take what you can and have the comfort of having the money in the bank or other low risk investments. You can always work for someone else or spend your time working in the not for profit sector as a volunteer.

You might consider what your next best alternative is if you were to seek paid employment. If you currently take $150,000 in benefits from the business, what could you earn if you became an employee? Let's say, $90,000. After tax you are worse off by about $30,000. If you could sell the business and pick up $300,000 net, it would take you 10 years to equal that. If the net proceeds were greater, this may mean a good standard of living for the rest of your life. Take the money!!

Alternatively, you might be bored or the business may have outgrown your ability to manage it effectively and the business may be suffering as a result. Not everyone is suited or has the desire to manage a larger business. Your skills may be more effectively employed by selling this business and starting again. Many entrepreneurs are best at business creation where their passion and

energy are best utilized. They are often not good at the detail or the day to day management. If you are not having fun any more, then sell and start again.

Even where the business has considerable potential, you may not be the right person to manage the business or you might not be able to capture the potential. Every business has to change dramatically as it grows in order to cope with the increasing complexity of the operations. You may not want to manage a more formal and more bureaucratic business. At the same time, the potential of the business might be limited by your ability to manage or to finance the growth. Sometimes it is better for the business and for its employees to sell to a corporation which can better exploit the potential and perhaps offer the current employees better career prospects.

Growth businesses go through considerable changes as they grow. I discovered large transition points in my own businesses at 12, 50 and 100 staff. One business went through a huge organizational crisis when it undertook an acquisition 12,000 kilometers away.

There have been several well-accepted theories defining the organizational changes which occur with different stages of growth in a new business. Larry Greiner published an article in the Harvard Business Review in 1972 entitled *Evolution And Revolution As Organizations Grow*. Neil Churchill and Virginia Lewis developed this further in a 1983 article entitled *The Five Stages Of Small Business Growth*, also published in the Harvard Business Review. Mel Scott and Richard Bruce looked at growth crisis points in their article *The Five Stages Of Growth In Small Business*, published in Long Range Planning in June 1987.

These models all show that important changes will occur within the business as growth occurs. The main factors creating complexity are the number of staff, the number of customers, the number of products and the number of locations. To achieve five times the level of business you have now, most of these parameters will have to change. What is not so obvious to most entrepreneurs is that the business will need to be managed differently with each additional level of complexity.

In the early days, the entrepreneur is able to run the business with sheer energy, passion and vision. They know everyone and staff are motivated because they are part of the grand adventure. As the company adds staff, however, new

people come into the business who were not part of the grand vision. Their motivations and needs are likely to be different. They may see it more as a job than a mission. They will have different needs and management styles will have to change. At the same time, the growth brings with it specialization of tasks and more formal organizational structures. Reporting lines become clearer, job descriptions become the norm rather than the exception and performance targets and monitoring are introduced. Soon there is a new layer of management between the chief executive and the operations. What began as a project has now turned into a business.

As the business grows further, communication becomes more formalized as communication lines become longer. The left hand no longer knows what the right hand is doing. Customer service quality often falls because new customers do not have the advantage of personal links with the founders.

Problems tend to increase with a second location as daily face-to-face communication becomes physically impossible. External shareholders and/or external directors force more transparent decision-making, which means the entrepreneur can no longer make decisions on the fly. Many more staff, customers and other interested parties, depend on the business for their livelihood.

There are important strategic insights which can be gained from predicting what your business might look like and how it should be organized as it goes through these transition stages. Almost certainly you will discover you have the wrong organizational structure and the wrong information technology systems to support a larger business. What can be more surprising is that you will also discover that some of your best staff are unlikely to make the transition. They may lack the skills, personality, work ethic or experience to work effectively in a more complex situation.

Many entrepreneurs simply are not able to make the transition, or they do not want to. This is very confronting, but it is better to recognize it and plan to delegate more responsibility or to sell the business and move on to something for which you are better suited. With time on your side, you can restructure the business so that the business is no longer dependent on you, you can bring the business up to a state of sale readiness and then you can find the right buyer to take over.

Often business owners find they have reached a point in the size of the business where they need to make a substantial investment in order to move to the next stage of growth. This may be an expansion of capacity, investment in another location, re-equipping a manufacturing or warehousing facility, installing a new accounting system or taking on full time specialist staff. The cost of doing so may be beyond the ability of the firm to finance and, therefore, the entrepreneur has to incur sizable new debt and/or dip into life savings. This new investment may be somewhat risky as the anticipated revenue may not be assured. What might have been a very comfortable business might suddenly turn into a high stress activity. Maybe this next stage is not for you. Maybe it would be better for you to sell to a corporation which is able to take it to the next level and exploit the future opportunities better than you.

You might have another opportunity you wish to pursue. It may be more exciting, more fulfilling or simply more financially attractive. However, in order to undertake it, you might need to release funds from your current business. This would be a very good reason for selling.

Selling the business is not always about failure. In fact, in most of these scenarios, they are about understanding what you are good at, where you wish to spend your time and how you want to manage your life. However, you do need to be able to answer the question 'Why do you want to sell? There is nothing wrong with wanting a better life or simply being exhausted with keeping a business going or just losing interest. Owners sell for lots of reasons including divorce, ill health, family problems, lack of capital to expand the business and so on. If the business is in trouble, you wont be able to hide it – you will lose more by covering up a problem which will certainly be found out during the investigation phase. The key here is to be prepared to sell the business and to know what value the buyer can extract from the business and to ensure you have multiple potential buyers.

Exit Fear

It is widely acknowledged that a significant portion of private firms will be coming onto the market over the next ten years as the baby boomer generation nears retirement. While some have family members to pass the business onto and others will reach an arrangement with employees to buy out their interests, most will be seeking to sell their businesses. With this background, it is hard to understand why so many fail to confront the issue and fail to undertake business and personal planning to provide the best outcome from such an event.

Some founders simply don't want to let go of their baby. They have often put the best years of their life into building a robust business and the thought that someone else will take control is impossible for them to accept. While they know that a sale is inevitable, they are simply unwilling to spend any time planning for it because it means they are acknowledging they will be selling their business.

Exit fear is not just a characteristic of retiring founders; even younger entrepreneurs who have raised venture capital on the basis of a likely trade sale of their business seem reluctant to put the effort into preparing the business for sale. Most of them anticipate they will not have a job with the acquiring firm and this creates a good deal of uncertainty around their future – even though they have a reasonable assurance that they will take away a good deal of money with the sale.

I found the same reaction many times in my workshops on selling a business. Entrepreneurs attend the workshop in order to better understand how to sell their business but often express concerns about life after the sale. As one executive put it to me "I just can't face the thought of doing another start-up – imagine having to go back to not having any support staff, no infrastructure, to have to watch every cent and go through the slow grind of building it up again. Why would I do that to myself when I have such a good life right now?"

On the other hand, there are those entrepreneurs who are only too eager to sell their current business because they have another one going on the side or they are keen to invest in their next great idea. Others have a strong desire

to take time out to recharge their batteries before they jump back into a new venture.

A normal condition of sale of a business is for the prior owners to agree a 'non-compete' clause as part of the consideration. The buyer does not want the prior owners using their money to set up in competition. This can be challenging for the prior owners as it effectively denies them an occupation in the area they know best. However, this would not normally prevent the sellers working or investing in complementary businesses, working under contract for the new owners or taking an extended break. The important consideration here is that the sellers have considered the impact of this restriction on what they will do once the business is sold.

Once you start to put some effort into preparing your business for sale and begin to consider what else you might do, possibilities start to open up. You begin to see just how much the business could be worth if you put the extra effort into the preparation and you begin to appreciate just how well off you could be later on. At this point, most owners lose their "fear of exit" and their motivation is replaced by the entrepreneur's "instinct for winning". Preparing for a personal exit is an essential part of the preparation process.

When I have worked with entrepreneurs on this issue, their fears were nearly always dispelled when I was able to show them how to create a number of interesting and viable options. What few appreciate is that, in many cases, they don't have to sell 100% of the firm at once. Often a business can be split into several components, each of which might be suitable for sale to different buyers. One strategy is to split off a portion of the business, prepare it for sale and then use the sale to take some value out of the business. This way the entrepreneur is realizing part of their wealth. The sale proceeds can be used to invest in new ventures or to establish a retirement fund. This strategy can be followed over a number of years with different parts of the business.

Another alternative is to work with a Private Equity (PE) firm to sell down part of the business. This way you get to take some of your wealth out of the business up front. The PE firm will work with you to inject new management into the business where this is required, fund acquisitions where this will increase the returns to the shareholders, arrange for debt financing to improve equipment,

develop new products and markets and bring on a more experienced Board of Directors to prepare the business for an Initial Public Offering or a trade sale.

Many entrepreneurs use the current business as a platform to launch a new venture. Once the new business is a reasonable size, they can let go of the old one. Others develop an active interest in not-for-profit activities after the sale. Some become angel investors and have an involvement in several ventures. All it takes is a little creative thinking!

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Conclusion

Selling a business is often a life changing event and if you are going to do it, make sure you walk away with as much as you can. Why spend years building a business to falter at the last hurdle and fail to properly prepare the business so you generate the highest exit value for your time, risk and effort. For most entrepreneurs, deciding to sell their business is probably the most important decision they will make in their commercial careers. If done successfully, it is the one event which will push them into the cashed up, multi-million dollar, lifestyle class. It will change their lives forever. However, few bother to undertake the same rigorous planning of the harvest which they would devote to purchasing a major piece of equipment or entering a new market. While they feel comfortable planning an expansion of their business, they shy away from taking the hard decisions about how to extract themselves from their business.

For many, it is a difficult decision to face because they have inadequately planned for life after the business. Their business is their life and their life is their business. However, when you talk with cashed up entrepreneurs, you see a very different picture from what you would expect. They are active, involved with numerous activities and still thinking of new ventures. Most start another business or buy out a smaller business. Some spend their time with charities while others become angel investors.

Preparing for the sale and for life after the exit, are really two parts of the same problem. Without seriously planning for what to do when the business is sold, the entrepreneur really doesn't do a very good job of the preparation for the sale.

Few of us ever get to plan exactly when the business will be sold and thus preparation for the event needs to take place without delay. The vast majority of entrepreneurs don't plan on selling their business in the near term, however, a business which gets into trouble through external or internal changes or events is often sold to get the entrepreneur out of trouble. A business which is approached by an attractive buyer is usually not for sale, but if the price is right, the sale may well happen. In neither of those circumstances can we say the event was anticipated. However, extracting the best price at the time of sale will not happen unless the business has been prepared for sale.

As you can see from this book, there are considerable benefits from developing a strategy to prepare the business for sale. Tidying up the business and sorting out the dead wood and stripping the business back to the productive parts will, of itself, make the business more efficient and put some energy into the business. Staff feel good when everything is being done well.

Cleaning up the business and getting it ready for a systematic investigation by a buyer is an essential step in the preparation process. A business ready for due diligence is generally one which is being run effectively and efficiently. The process of getting ready for sale will uncover numerous things which need to be cleaned up or fixed. This will greatly assist the business to operate better. It is also the most important step in preparing the business for sale.

If you are anticipating a ***financial sale***, start a program of continual improvement. Whether this is done through benchmarking, quality improvement or continuous process improvement, the activity of systematically examining the business looking for improvement and involving staff in the activity, will generate numerous ideas for productivity gains.

Then give serious consideration to how the business might start to grow without putting undue pressure on management or the resources of the business. Maybe this is working more with your best customers or taking on

minor additions to personnel. Adding a growth component to the business will lift the spirits of those who work for the business as well as provide some incentives for management to look for creative ways to use business resources to expand.

Then it is time to get creative. What can you do to provide a major boost in growth over a short period of time which could be enacted by the buyer shortly after they take control? This is what I have termed the 'Platform for Growth' and is a major contribution of this book. It is not just anticipated real growth which impacts valuation; it is also the potential growth which the business is able to generate in the short term after the sale which can seriously lift the valuation. However, that potential business has to be locked down and strongly validated with evidence.

If you have identified ***strategic value*** in your business, it will be worth the time and effort to prepare the business for a strategic buyer. This means spending time working out how a potential buyer could effectively exploit the potential within the firm. Once this connection is made, the process of preparing the business, positioning it for sale with prospective buyers and negotiating the sale agreement becomes quite straight forward.

Then give serious consideration to how the strategic value within the business might be enhanced. This might require additional investment in developing assets or competencies further. At the same time, serious consideration needs to be given to what process the buyer will use to replicate and scale the asset or competency being acquired. Key to securing a high value for the firm is to ensure the buyer is able to rapidly exploit the potential acquired with the business, therefore, having a fully documented and reliable process in place for the buyer to rapidly scale the acquired asset or capability is going to be an essential part of positioning the business for sale.

The processes which I have outlined in this book really do work. Apart from my own experience, I have assisted numerous entrepreneurs to sell at a premium. As an example, I recently worked with an entrepreneur to sell a relatively small business which was making a small profit. Over a year, he cleaned up the internal systems, put a succession plan in place for himself and introduced bonuses for staff to stay after the sale. He then identified how the

business could be developed through some additional investment by the right buyer. The business was sold at the end of the year's preparation for 40 times EBIT. We were able to increase the business broker valuation by a factor of ten.

There is no question that significant improvement in sale value can be achieved if the right approach is taken and you are willing to invest in the preparation process. Don't be passive and let a conventional valuation be imposed on you. Take the initiative to understand how you can influence the valuation and then look for a buyer who understands the value of the work you have undertaken to improve the business and the business prospects.

The difference between selling out with little notice and preparation and putting the time and effort into planning a financial sale can be 2 to 9 times the conventional valuation. In the case of a strategic sale, sale values of 20 to 40 times a conventional valuation are possible. During the preparation process, some owners will discover opportunities which will greatly improve the sales value. There is no question that a substantial difference can be made with a systematic approach to the problem. Going through the exercise is highly beneficial to the firm as it should uncover numerous ways in which the basic operations of the firm can be made more effective, that alone justifies the effort. But the most important outcome is the amount of cash which the entrepreneur will walk away with and, with the right approach, that can be greatly increased.

Don't delay - an attractive harvest is well within your reach.

Ultimate Exits Workbook

Download a copy of the workbook for Ultimate Exits from:

www.ultimateexits.com/workbook.html

The workbook will assist you to prepare a detailed strategy for selling your business. It provides you with a methodology for identifying where you are today on exit preparedness and then shows you what you need to do to bring your business up to an exit readiness state which will give you the best possible chance of achieving a significant premium for your business on sale.