M&A STRATEGIST
All the right moves

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M&A Strategist is a collaborative newsletter produced by Bishop, Capitano & Abner and Bishop & Company. Together, these two firms provide financial, legal and marketing strategies for buying, selling & transferring business interests.

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Bishop, Capitano & Abner, P.A. is a business law firm dedicated to providing high quality legal representation that is client-centered, intellectually innovative and solution-oriented. Our transactional team consists of David Bishop, Kenny Abner and Rob Bryan. The transactional practice includes representing buyers and sellers of business, structuring management buyouts and employee stock bonus plans, and serving as corporate counsel for private companies. The firm also has a commercial real estate and civil litigation practice.

For more information, see our website at www.bca-law.com or call David Bishop at 704-716-1215.

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Bishop & Company is an investment banking and advisory firm that helps middle market business owners with ownership transfer strategies. We have helped hundreds of owners value their companies and transfer ownership to employees, family members, financial acquirers and strategic acquirers. We search for and find buyers throughout the United States, and occasionally from a foreign country.

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FINANCIAL, LEGAL & MARKETING STRATEGIES FOR BUYING, SELLING & TRANSFERRING BUSINESS INTERESTS

Spring 2003

A Real World Valuation of Your Business

Have you ever gotten one of those certificates from the jewelry store that says the jewelry you just bought is worth more than you paid? How smart you are to have made such a wise purchase! But don't try to sell it back because the jewelry store won't be buying at that price. The purpose of the certificate is to make you feel good about your purchase or, perhaps, to give you a high value for insurance purposes. Just don't expect that certificate to tell you what you would actually receive if you sold the jewelry.

Business valuations are not altogether different from those jewelry appraisals. Business valuations are prepared for all sorts of reasons – estate and gift planning, domestic disputes, and buy-sells, to name a few – but when it comes to actually selling a business, many of those valuation reports are about as helpful as that jewelry certificate. What an owner really wants to know is what can he or she expect to receive if the business is sold – what I call a "Real World Business Valuation."

In the real world we know that value is in the eye of the beholder. A knowledgeable business buyer values a company based upon expected return on investment, commonly called "ROI." Typically, a buyer of a small to medium-size business expects to get a 20-35% annual return on the equity investment in the business. Whether to require a 20% return or a 35% return depends on the buyer's perception of risk. For example, an investor might demand a 20% return for a company with a long history of growth, stable net income, seasoned management, and loyal customers but a 35% return for a relatively new company with erratic earnings, thin management, and fair-weather customers. Higher rates of return are required for riskier investments.

Adjusting the rate of return for the perceived risk is standard procedure in valuing businesses. In fact, the primary tasks of a business appraiser are determining the appropriate rate of return and estimating the future operating cash flow and balance sheet needs of the business. But a typical business valuation ignores several factors that significantly affect a buyer's ROI – deal structure, financing and tax consequences. Simply put, you can't calculate true cash flow without knowing the structure of the transaction (asset or stock purchase), the financing arrangements, and available tax deductions. And if you don't know your true cash flow, you can't calculate true ROI or the price you can justify for the business.

Let me give you a few specifics on how these factors affect true cash flow and ROI. Purchasing assets rather than stock can significantly improve a buyer's cash flow because depreciation and amortization tax deductions are typically greater in an asset purchase than a stock purchase. And greater tax deductions means lower taxes and

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Who Sets the Price in the Sale of a Business?

How many times have you heard it said that in negotiating the price of anything whoever goes first loses. Thousands, I guess. The idea has been generally accepted in our society and we don't easily forget it. After all, it seems to make sense. Why would you ever set a price if a buyer might come along and pay more than the price you were planning to set?

I must admit, the idea is appealing. Who wants to leave money on the table? If someone values what you are selling more than you do, why should you deprive them of the right to offer

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improved cash flow. Financing can also dramatically alter the buyer's ROI not only because the interest payments are tax deductible but also because ROI is based on the equity contributed to the business, not the total funds committed to the transaction. If the business is successful, the smaller the equity investment, the greater is the return on the equity investment.

Said another way, before you can determine what your business is worth to you, you need to know what it is worth to a buyer. And a buyer cannot determine what a business is worth to him until he knows the structure of the deal. For instance, if we know that the sale is structured as an asset purchase, the relative value of the "hard assets" with a short depreciable life, and the financing arrangement – whether seller financed or asset-based lending from an outside lender – we can then determine true cash flow. Once we determine the appropriate ROI for the particular business, we are ready to put a fair price on the business – a price that reflects true cash flow and true ROI, not hypothetical ROI for a hypothetical buyer.

In a Real World Valuation, deal structure is as important as determining the appropriate rate of return or estimating the future operating cash flow and balance sheet needs of the business. The missing step in most business valuations, which is the real key, is determining the optimal deal structure for a given situation. The optimal deal structure reflects the most appropriate mix of equity and debt that will not only cash flow for the buyer but also produce the required ROI. For a buyer, the less cash or equity invested in a business the higher will be the ROI if the business is successful. Debt is not always the answer though. The more debt taken on by a buyer, the less likely the buyer will be able to cash flow the purchase – unless the financing terms are very favorable.

Standard business valuations have there place and are clearly preferred if you need a valuation for tax purposes, equitable distribution, or some other purpose that requires a conventional valuation. But if you want to know what you should expect to get if you sell your business, a Real World Valuation will give you a much better answer.

For a free illustration of a Real World Valuation, call David Bishop at 704-442-8875 or email dbishop@bishop-company.com

Quick thoughts

S-words are not always bad

If your company has a calendar year-end, you have until March 15 to elect to convert to an S corporation. Now may be the perfect time to convert, particularly if profits are down, because you might be able to justify a lower conversion value than you could a year ago. By converting now, you might save as much as 30 cents in taxes for every dollar of future appreciation in your business value. Call us for more information.

You should see it when it is clean!

When responding to a buyer's request for your financials, send financials that have been adjusted for excessive owner's compensation, discretionary expenses and nonrecurring losses – disclosing, of course, that the statements have been adjusted. Sending financials that have not been "cleaned up" and telling them about the adjustments is like inviting someone to your messy house and telling them that it looks great when it is cleaned up.

Don't sell your business. Sell your buyer.

"The most compelling selling message you can deliver is not that you have something wonderful to sell. It is: 'I understand what you need.' The selling message 'I have' is about you. The message 'I understand is about the only person involved in the sale who really matters: the buyer."

– Harry Beckwith in "Selling the Invisible"

Who needs this deal?

"More bad deals are signed and more sales are lost because of neediness than because of any other single factor. If there's any need in this negotiation it has to be your adversary's, not yours. In order to avoid showing need, you must never feel it. You do not need this deal."

– Jim Camp in "Start with No"

How much is enough?

"Better one handful with tranquility than two handfuls with toil and chasing after the wind." – Ecclesiastes 4:6

"A million dollars doesn't always bring happiness. A man with ten million dollars is no happier than a man with nine million dollars." – Anonymous

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Who Sets the Price in the Sale of a Business?

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a price that reflects the value to them? It all sounds so good, how could anyone question it? Surely, there's some study that supports this well-known proposition.

As far as I can tell it's always anecdotal evidence that backs up this well-known proposition. A story is told – you might even know one yourself – about the seller who got considerably more than he or she ever expected because a buyer was willing to pay more than the normal value for what was being sold. We tend to remember those stories because the seller seemed to get a windfall.

The "don't name a price" philosophy is appealing because it is based on greed. Who doesn't want to get the most they can get for their business? Who, at the very outset of a sale, wants to forfeit the opportunity to get an outlandish price? Who wants to give up on the idea that there may be a competitor, a strategic buyer, a foreign company, or a plain fool who may be willing to pay more than anyone dreamed possible?

It all sounds so good, how could anyone possibly disagree? Well, I disagree. Based on my nearly twenty years of experience in negotiating the sale of businesses, I believe "don't name a price" is bad policy except when negotiating with multiple parties simultaneously, as in an auction. The trouble with making decisions based on anecdotal evidence is that we tend to remember unusual or appealing stories – the seller who got a windfall because he never named a price – but disregard or forget the typical result – the seller who failed to get a fair price or failed altogether in his or her sales effort.

I don't have the statistics to prove it, but my guess is that only one in a hundred business sellers who invite a single buyer to make an offer actually receive an offer that is higher than what they expected (I'm not counting those who have no earthly idea what their business is worth). Without any pricing guidance, a single buyer typically offers a conservative, if not a lowball price, because the risk of being too high is much greater than the risk of being too low. If the buyer is too high, he has just committed himself to paying more than was necessary to acquire the business. If he is too low, he can always increase his offer. Since there are no other buyers to compete against, there is little risk that the seller will accept another offer or cut off him off from further negotiations.

You might be thinking that "don't name a price" still makes sense, even if only one in a hundred ultimately offers a higher price. And you would be correct if there weren't any negative consequences to such a strategy. The negative consequences are significant, however. When you neglect to name a price you pass up a great opportunity to place a value on the business and signal to the buyer your expectations regarding the sales negotiations. Many studies have shown that people are influenced by anchors without even realizing it. In one such study, real estate agents who were asked to appraise residential real estate were much more likely to give a higher estimate of value if they were initially provided with a high listing price. Interestingly enough, those agents claimed that they had valued the property by comparing it to similar properties and had virtually ignored the listing price. In reality, they were strongly influenced by the listing price.

The other major difficulty caused by inviting a single buyer to make an offer is that it is extremely difficult to recover from a low ball offer. If the seller is insulted by the offer, he may lose interest in negotiating further with this buyer. And even if he is prepared to negotiate further, the buyer will be reluctant to significantly increase his offer, if for no reason other than to save face.

James Freund, author of *Smart Negotiating* and renowned attorney with the Skadden Arps law firm believes that a seller should take control of the negotiations by putting a number on the table. According to Freund, sellers must know their value and be realistic in what they ask. Setting the price is clearly the best strategy in single party negotiations. In multi-party competitive bidding, however, setting the price is probably not the best strategy, as we will discuss in our next issue.

Activities and Highlights

David Bishop of Bishop & Company/ Bishop Capitano & Abner and Tom Jackson of Renaissance Executive Forums recently conducted a seminar for Forum members entitled "Retirement Planning Issues for Business Owners." The seminar was the first of a four-part series designed to give business owners a vivid picture of where they are today and what they need to do to realize the full value of their businesses. The second seminar, "How to Determine the Real World Value of Your Business," will be held in the first quarter of 2003. Renaissance Executive Forums is a national organization that organizes and leads Presidential Advisory Boards for owners of small to mid-sized companies, helping owners to improve business performance through the development of enhanced leadership and management skills.

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