HAMILTON RICH

# SELLING YOUR BUSINESS?
# A PRACTICAL GUIDE

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HAMILTON RICH PTY LTD

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# Contents

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# Introduction

Some years ago someone asked a friend of mine if he had read a certain business book. Our friend's response was *"No, I run businesses, I don't read books about running them"*. That friend was typical of most of our clients at Hamilton Rich. He is very good at running businesses and didn't' need any "help" from a business book.

Recently that same friend decided he wanted to consider selling his business. He acknowledged that, although he was an expert at running businesses, he was a novice when it came to selling a business.

That friend turned to us at Hamilton Rich to help him decide whether he really should sell, how he would sell, and what his business was worth. Once he had worked through those important decisions with us he asked Hamilton Rich to help him achieve the sale and to do so in a manner that did not disrupt his business, ensured he received full value and had limited risk of any subsequent warranty claim from the purchaser.

This book is written with that friend in mind and aims to help business owners who acknowledge that selling their business is one of the most important things they will ever do.

Please feel free to visit our website or call Tony Holley or Michael Mahoney to have a no obligation discussion about your business.

We know that many of you will only read the first few pages of this e-book, that is why we start with the Five Mistakes Business Owners Make when Selling Their Small or Medium Sized Business, hopefully those examples will encourage you to read on or give us a call.

# Five Mistakes Business Owners Make when Selling Their Small or Medium Sized Business

There are five common mistakes that we see business owners make when selling their small or medium enterprises (SME) / business.

## 1 Not making your SME business "Sale Ready"?

Abraham Lincoln said, "I will prepare and someday my chance will come"

## 2 Not understanding who might want to buy your SME business.

You understand your customers, so why not understand who might want to buy your business

## 3 Not understanding how much your SME business is worth.

When selling anything it's handy to know what it is worth, but do you know what your business is worth?

## 4 Not running a professional sale process for your SME business.

You manage your business well, make sure you sell it in a professional manner

## 5 Leaving it too late to sell.

How many of us wish we had sold all our mining shares back in 2013?

# Mistake #1

## Not making your SME business "Sale Ready"?

In an ideal world everyone starting a business would build it with an eventual sale in mind. They would build it to last, not take shortcuts and develop it so that it can be sold for as much as possible. Every major decision would be taken with that final sale in mind.

In the real world, inhabited by us and most people we know, it is never that simple and therefore you, the owner, need to prepare your business for sale, it must be "Sale Ready".

A business that is Sale Ready is likely to gain an excellent price and substantially reduce the risk of disappointment.

Most business sale processes that don't achieve their objectives are rushed and this lack of preparation becomes a real problem during the sale process leading to a weakened negotiating position and undesired compromises.

How can you avoid this fate? Start early; before you want to, before you have all the answers, before it is comfortable. Crucially before circumstances force you to sell at a time other than that of your choosing.

Preparing your business for sale means addressing the areas that will either suffer if you weren't there tomorrow or that would require substantial work for a new party to understand and execute, or both.

People buying businesses, and we have bought many so we have a fair idea of what they look for, tend to highly value; growth, sustainability, free cash flow and attractiveness of the industry.

Typically a buyer will value your business on a multiple of pre-tax, pre-interest profits.

The size of the multiple will depend on many considerations but the higher the confidence the buyer has in the growth, sustainability, free cash flow and attractiveness of the industry the higher the multiple will be.

What can you do pre-sale to maximise the value? We believe that as part of a plan to make your business Sale Ready the following should be focussed on:

- Make sure you can demonstrate recent sales and profit growth. Buyers don't tend to believe (well most don't) stories of a Lazarus or J Curve turnaround in profitability. They like to see recent growth and the actions already taken to make sure that growth continues. This ties in with not leaving a sale too late and making sure you sell your business while it is still growing.
- You will need to demonstrate that the business is not over reliant on any small group of customers, suppliers, products/ services, or people. Most particularly the business must not be reliant on you the owner. A general test is "can you go for 3 months holiday away from the business?" You need to demonstrate that there is a management team in place who can run the business.

Similarly, if a major customer, supplier, product ceases then the business must be able to continue to prosper and grow without it.

Buyers seek businesses with reliable, recurring income and a reasonable portion of the costs being variable rather than fixed. They seek businesses that are resilient and can withstand downturns in sales.

All of these matters can be developed so that, by the time you sell, the buyer will view your earnings as sustainable and pay you accordingly.

- Accounting profits are wonderful but we all pay for our mortgage, school fees, holidays etc. in cash. A buyer will want to see that your business (using an awful 1980's term) "spits out a lot of cash". This has the benefit of enabling the new owner to use this cash to pay dividends/ reduce debt and it will mean that growth can be funded largely from cash profits. Make sure that you manage your working capital effectively and consider cash return when considering expansion opportunities.
- People rarely want to buy a business in a contracting industry where margins are being squeezed and sales declining and where costs are mainly fixed. You know the attractiveness of the industry you are in and you know which parts are the growth areas where you should focus.

In the words of Abraham Lincoln "I will prepare and someday my chance will come."

Who knows, you may be approached by an over eager buyer, they be your Alan Bond. As Kerry Packer once allegedly said ""You only get one Alan Bond in your lifetime, and I've had mine".

Likewise, you may receive an approach from someone doing "an industry roll-up" or from an industry player for whom your business is a wonderful "fit".

Make sure that your business is Sale Ready to take advantage of opportunities and maximise your sale price.

# Mistake #2

## Not understanding who might want to buy your SME business

Do you understand your customers? Of course you do. You know their likes, their dislikes and why they buy your products.

You need to do the same with buyers of your business otherwise you may fail to achieve the true value.

There will be various types of potential buyers for your business and they will be looking for the attributes we mention in our earlier topic about making your business "Sale Ready"?"

More explicitly your buyers will put additional focus in specific areas depending on the type of buyer they are:

- Financial buyer
- Industry player

### Financial buyer

A financial buyer may be a wealthy individual, family, Private Equity firm, or even a listed company looking to grow their portfolio of investments. They will assess your business mainly on its merits as a stand-alone business.

Typically, this category of investor is not expecting any synergies but does expect your business to be able to grow and prosper without your day to day involvement and with minimal input from them. It is absolutely critical that if you are to sell to a financial investor that you have a strong management team in place and preferably have a CEO in place who is actually running the business.

### Industry player

If someone in your, or an adjacent, industry is to buy your business they will typically be most focussed on how your business and their business could collectively sell more product/ services than either do as stand-alone businesses. Put another way, can your products be sold to their customers and vice versa?

They will be looking for synergies through gaining better buying and reducing back office costs and may be prepared to pay a premium for these strategic benefits.

An industry buyer will logically value your business more highly than a financial buyer as they should receive a larger increase in profit and should better understand the opportunity and risk of your business.

To better understand the needs of those two categories of buyer your Advisor should break each down into various sub groups e.g. for industry players; same industry, adjacent industry, private company, listed company, growth focussed, risk focussed, local, multinational etc.

Your Advisor would then research and understand who are the ideal buyers of your business and then target your sale process towards them.

Failure to understand your likely buyers can lead to failure to identify the best buyers, achieve competitive tension and achieve the right price or even the sale of your business at all.

# Mistake #3

## Not understanding how much your SME business is worth?

Would anyone disagree with the basic concept that when selling something it might be handy to know what it is worth, but how do you know what your business is worth?

We could just trot out the usual bland statement that “your business is worth what a willing buyer will pay to you when you are a willing but not forced seller”. But that is not really much help. Let’s look at a few of the major value drivers.

The first question to ask is do you actually have a business? We once saw a business sitting on $5m worth of property and $6m worth of inventory turning over $12m and earning an EBIT (Earnings before interest and tax) of $500k. It got worse, the earnings were declining!

To our mind that was not a business, the owner became much richer through selling the property and stock, collecting the debtors and then going on holiday.

Saleable businesses earn a commercial return on all the assets used in the business after charging market rate for the owner’s work. We are not going to over complicate matters by talking about the “capital asset pricing model” but suffice to say that the riskier the business is perceived to be, e.g. the less secure the customer and supplier relationships, the higher the return on assets must be and so the lower the price to you.

Timing affects the alternate options available for buyers, the hurdle rate of return a prospective buyer needs to achieve, their appetite and funding capacity at that time and what risk premium they apply.

The inverse of their required rate of return becomes the maximum earnings multiple they will pay. So if they require a 20% return, then they will not pay more than 5 times your EBIT or if a 33% return is required they will pay up to 3 times your EBIT.

## The overriding value driver

Businesses tend to be valued on a multiple of pre-tax, pre-interest (EBIT) profits. The size of the multiple will depend on many considerations but fundamentally the multiple, and hence what you get paid, is generally higher when:

- Sales are growing.
- The industry is growing.
- Net profit margin is high.
- High level of annuity style reliable sales.
- Low fixed costs.
- Assets required to earn the profits are low.
- Low dependency on the owner.
- Dominant position in a niche market.

When thinking of those characteristics Mr (Meat) Loaf comes to mind, "too much is never enough".

Outside of boom times, only an exceptional SME private business (one that gets all the ticks above) will achieve greater than 5 times.

## Some key valuation concepts

There are a few key concepts to consider when valuing a business.

**Concept 1.** You are not James Bond; you can only get paid once. If you are being paid based on a multiple of the earnings stream your business generates, then you cannot also get paid for the assets required to generate this level of earnings. We call this the box approach.

Whatever needs to be in the box to generate the earnings has to be in the box you exchange for cash with a business buyer. The box typically includes your stock, debtors, prepayments, fixed assets, goodwill and also your creditors and accruals.

If the box is full beyond what is required to generate the EBIT, then you can either get paid extra for surplus cash or inventory or else sell it off prior to business sale completion.

Very small businesses are often sold on the basis of an amount for the business goodwill plus stock at valuation (SAV). The adverts might say "$500k plus SAV", that approach is fine for selling a hot dog stall (awkward SAValoy pun intended) but is not the usual approach for selling more substantial businesses.

**Concept 2.** The second key concept is that there are industry buyers (they may gain strategic and synergistic benefits) and financial buyers. If you prepare your business so both an industry buyer and a financial buyer can buy it, you will increase your chances of a successful sale. As Woody Allen allegedly said “bisexuality does double your chances for a date on Saturday night.".

An industry buyer will often pay more, than a financial buyer, as they are looking beyond the economics the business currently presents. They typically operate in your industry or an adjacent market already, but sometimes not in Australia or in your niche. These buyers may gain substantial synergies through acquiring your business.

A financial buyer is evaluating the business purely on the financial and risk characteristics of the business and without a detailed understanding of the industry so they will probably apply a higher risk premium on their required return. The higher the perceived risk, the lower the multiple they will pay.

High business sale prices are often industry purchases based on ‘synergy value’ or as part of a ‘roll-up’. In roll ups a listed group often buys a number of smaller businesses at significant multiples and seeks to benefit from the higher public company multiple.  We and you  would know if a roll up play is happening is your industry.

**Concept 3.** The third key concept is objective value. The objective value is set by financial buyers. Financial buyers are looking at various investment alternatives, be it your business, another business or other assets classes entirely. They look at the multiples they would need to pay for other investments and will value your business by reference to those benchmarks after taking into account the growth and risk profiles of their alternatives.

**Concept 4.** The fourth key concept is the business value to you. You know the business, its strengths, weaknesses and idiosyncrasies. You also know the advantages it gives you in terms of tax, family employment and so on. A buyer does not know the positives with the certainty you do and has to assume the worst. The less you have fortified the business, the lower the likely price. If the value of the business to you is higher than the objective value, then you should strongly consider not running a sales process. Any sales process involves risks with key customers, suppliers and staff.

A good Advisor will be able to understand how your business makes money, what are its risks, who are the likely buyers and what it is worth. Before you start any sale process you should ensure that you also properly understand this. Make sure the advisor talks with you about the various valuation concepts and the overriding value drivers.

# Mistake #4

## Not running a professional sale process for your SME business

Do you use random people off the street to devise your marketing strategy, negotiate your most important deals, manage your legal, tax and affairs and look after your investments?

Of course not. You manage all of that in a professional manner and you will want to manage the sale of your business in a similar manner.

We have come across people who say "I can manage my business sale myself, I am an astute business person and know my business better than anyone else". Maybe they are largely correct but what could go wrong, here are a few things to consider:

- **Opportunity cost**. A buyer wants to see a business that is absolutely humming, and that is your responsibility. Even under ideal circumstances where you have a smart Advisor running the sale process there is risk that you will become distracted away from your business. Part of the Advisor's role is to make sure this does not happen. If you become diverted into running the sales process, your focus on your business will decrease. If profit goes backwards by only $100k it could cost you $0.5m in sale proceeds.
- **Expertise and experience.** A quality Advisor has seen all the tricks before and knows how to commercially deal with them. Do you know how to identify the traps in earn outs, deferred consideration, part scrip deals, warranties, restraint of trade and the many other unpleasantries involved in a business sale? Even if you have previously sold a business, you will still benefit from expert external Advisors. The Advisor knows how to challenge, extend and manage the other professionals. We recently came across a tax Advisor that had not highlighted that a sale price of $6.5m could actually give a substantially lower after tax proceeds than a $6m sale price.
- **Benefits of a third party negotiator**. Hamilton Rich negotiation skill yielded a client $2.5m (40% more) during a single meeting. It is an advantage to be able to put forward "if, then" positions as an advisor, whereas coming from an owner they can instantly become concessions.
- **Pure economics.** US statistics suggest greater than 50% of small to medium enterprises do not sell. Outsourcing the task to a professional and motivated advisor increases probability of success.
- **Targets.** While an owner may well nominate more strategic buyers, a high calibre advisor will identify lateral strategic buyers including offshore players as well as a host of financial buyers that an owner would never locate. It is a numbers game, some numbers are better than others, but a good target list starts with 30 names.

# Mistake #5

## Leaving it too late to sell

One of our friends recently told the story of how he wished he had sold his mining shares back in 2013. His delay cost him many hundreds of thousand dollars. Leaving it too late to sell your business could cost you a lot more.

For some owners it may be best to never sell. Maybe profits will continue to rapidly grow, risks remain minimal and management succession is guaranteed. For most business owners it is not so simple.

If you sell your business at the right time it should be attractive to buyers, be an easy low risk transaction for you, and should attain top value.

Successful business sales usually occur when the business owners plan the sale and sell for a variety of non-pressing personal and business/financial reasons. They make sure that their business is "Sale Ready" and then pick the opportune time, of their choice, to sell.

If you wait until your energy and passion are diminished, growth has stalled, and risks abound it could cost you a lot.

It may be that your business is exposed to risks that either you do not have the energy to tackle or ones that are unlikely to be perceived by potential purchasers, if so you may need to consider a sale sooner rather than later.

Hopefully you will never be in the position where ill health, other family reasons or deteriorating business performance make you a forced seller.

Many business owners realise they have spent most of their lives building a great business, but that there has been a cost along the way. Typically, those long interruption free overseas holidays, extended time with family and improving the golf swing have been pleasures deferred.

One business owner recently said to us "I don't want to stop working, but I can't have so much of our family money tied up in this business, I need to sell and be involved with smaller investments". He was lucky, he had made sure that his business was "Sale Ready" and was selling at a time of his choosing.

We often come across business owners who just "know" that it is time to sell. It is often for a combination of the reasons above and it can be a very emotional decision with ramifications to their whole way of life.

The lesson learned from our experience is to sell when it is right for you but to always make sure you make sure your business is "Sale Ready" so that when you do decide to sell you can receive full value.

# What is involved in Selling my Business?

A lot of work. Some you will be able to do, but a lot that you will have to pay expert advisors for. Rather like your child's sporting teams if they start becoming half decent, there will be many side-line experts. If their day job does not involve selling businesses, apply your filters.

Rod Macqueen, a client of ours, had great success deploying highly capable experience within his area of expertise while coaching the Wallabies. For example, he had John Muggleton to coach defence and Steve Nance to train fitness from league and video analysis expertise from AFL. What he did not do was say to Steve Nance you also be the attack coach or run the whole team for me.

At Hamilton Rich, we have substantial expertise running the sale process. This comes from vast experience of buying, selling and running businesses. We have been buyers, so we understand the purchasing mind-set. We understand what is involved in targeting a pool of appropriate buyers and how to run a sale process. We understand the factors that will increase or decrease sale prices and we understand the potential remedies and how to implement them, including recruiting the appropriate expertise.

Our experience with Lawyers means we will manage them and keep them focused on commercially realistic outcomes. Our experience with Accountants means we will be directing them as to what will be required and the level of detail, as well as often sourcing specific tax advice around areas like the Small Business Capital Gains Tax exemption if it is not within their usual operation. While Michael is a Chartered Accountant, he will not replace the role of the Accountant in the process and you should be careful of an Accountant or Lawyer who think they can play all the roles in the team. Rod Macqueen was successful because he brought all the best expertise to bear, not because he thought he could fulfil all roles. We suggest you choose an Advisor who can bring all the desired expertise to bear, not one who thinks they are the repository of all knowledge and skills.

Getting a purchaser to part with $5m, $10m or $20m is not easy. That is why a lot of detail is required both before and during the due diligence process. There is naturally a high attrition with even a well sourced purchaser target list. Sometimes it is because you do not answer questions or areas of concerns for them well enough, sometimes it is because your answers are comprehensive and highlight things they prefer to avoid.

With industry players it is further complicated in that you do not want to give a competitor key information if you are not confident they will complete the purchase at the agreed price. Negotiating how and when to reveal detail is as much art as science and our experience helps.

The following is an overview checklist of the sort of things you will need to consider and where applicable get in place and document for a successful sale process. A sale process is a full time job and many business sales have fallen over because the results of the business have deteriorated during the sale process.

That is why appropriate outside expertise is key as the owner and key staff cannot be too diverted from the core business operation. The elapsed duration from the commencement of a sale process (remember there is a research stage where an Information Memorandum is prepared before going to market) to completion is virtually never less than 6 months, with an average closer to 9 months.

## Pre-sale preparation checklist

This is a good generic starting point to illustrate the scope of work that is likely to be required. It is imperative that you and your Advisor fully understand and agree upfront what needs to done, who will do it, and how much it will cost. Lack of clarity on this could cost you money and jeopardise the likely sale of your business.

### Legal considerations

- Clear structure with direct ownership of assets.
- Long-term, transferable supplier agreements (if applicable).
- Long term, transferable customer agreements (if possible).
- Transferable leases, ideally with future options (so they offer long term possibility, but not locked in if non-retail business).
- No significant pending legal issues, be it workplace relations, OH&S, customer or competitor or IP lawsuits.
- Up-to-date licenses, registrations and any other requirements to legally do business.

### Financial considerations

- Consistent and increasing revenues.
- Increasing profits or clear investment in the future growth of the business.
- Positive cash flow.
- Superannuation paid on time
- All GST, PAYG, FBT and other taxes paid.
- Good banking relationships, debt within covenants and not overdue (if applicable).
- Not excessive working capital; showing reasonable relationship of current receivables to payables, moderate inventory levels with limited dead and slow moving stock appropriately written down (if product based business). It may be that your definition of dead and slow moving will not be the same as the purchaser's, again we can help with this both at the planning and negotiation stages.
- Financial statements properly prepared, any add backs clearly detailed and justified as to why they are not part of the ongoing required cost structure.

## Business Reputation and Marketing

- Clear ownership of all key marketing material, website, company trading name, registered IP if any, trademarks and brands.
- Strong reputation with customers and within industry, seen as desirable place to work.
- Clear, well designed and modern website that is a successful business generation mechanism.
- Clear business generation mechanism that can be cranked up or clear understanding of how the company adds value and why it wins work if work is won through customer intimacy strategies.
- If retail, highly visible and convenient location with strong signage and appropriate parking.
- If wholesale or service business, premises that are fit for purpose with identifiable expansion strategies or capacity.

## Business Operational, Management and Staff considerations

- Appropriate Management team in place, evidence owner has been able to take extended holidays.
- Capable and experienced staff in key roles.
- Equipment in reasonable condition, not at end-of life (so as to artificially inflate earnings).
- Well-documented operations and systems to perform key company functions.
- Clear understanding of the company's competitive advantage, differentiation, how and why it wins business and why it will continue to be profitable going forward.

## Customers and Suppliers

- Ideally long term customers with long term supply agreements in place.
- Well distributed customer profile is preferable; any one customer making up >10% and top 10 greater than 50% will have a negative effect on valuation. Unless we can explain to the purchaser why it is a positive.
- Long term, exclusive supply agreements in place and most likely with strong long term relationships. If supplier dependent, will need to target buyers that are positive to the supplier.
- Contract relationships for services; clear demonstration that they are commercial relationships at commercial rates that will logically continue post sale.
- If not a full sale process, then what?
- There are a number of options to a full business sale process. These include:
- Targeted approaches to a key supplier or customer, likely merger partners or financial buyers.
- Succession to a family member or external CEO.
- A full or partial Management Buy-out (MBO).

## Targeted approaches to a key supplier or customer, likely merger partners or financial buyers

Some businesses will have a logical buyer, someone for whom the value is greater than for any other prospective purchaser. For them a large risk (such as the loss of the key customer or supplier relationship) does not exist as they are the large customer or supplier. While the business logic can be compelling, it does not mean achieving a high price is guaranteed. The purchaser will want to retain most or all of the special benefit they will accrue.

There could be a party in the industry that is in the process of industry consolidation, often called performing a ‘roll-up’. They often pay a premium price with overpriced stock, rationalising deals based on ‘synergies’ to come. Like the Loch Ness Monster, these synergies are often talked about and rarely seen, so they often implode within a few years. Those business sellers who have believed the promised and taken overpriced stock with lock-in periods then wish they had received good advice.

## The Family or external succession option

We often come across successful business owners who hope that one of their children should take over from them and run the business. Sometimes this works, we recently had a Melbourne based client where the son is doing a magnificent job as CEO.

Unfortunately, we know of many inter-generational transitions where the daughters or sons have proven incapable of running their parents’ business.

The cost of a son or daughter failing in their role as CEO of the family business is much more than just financial. It can lead to lifelong feelings of failure and worthlessness for the son or daughter, rancour from other family members combined with guilt and sadness for the parents.

We acknowledge that nepotism has its place but realise that you also need to protect and grow your business for the benefit of your whole family and the staff that have served you.

The rather offensive term “Idiot Son” is often bandied around when the next generation fails.

We dislike this term; it ignores the fact that it is the business owners’ responsibility to ensure that he or she does not pass management to an ill equipped son or daughter. Succession failure is typically not the fault of an “Idiot Son” it is the fault of an over optimistic and unrealistic parent.

How do you avoid such a failure? We recommend the following:

- Structure your business so that a CEO from outside could come in and run the business
- Work out the necessary characteristics for a CEO to replace you
- If a family member wants to be next CEO then train them
- Rigorously assess the capabilities and adequacy of your son or daughter
- Allow the new CEO, a family member or outsider, to really be the CEO

Let’s now look at each of those goals and how you can achieve them.

## Structure your business so that a CEO from outside could come in and run the business

Put simply, if you structure your business so that an outsider can come in and run it you will be putting in place the systems and processes necessary to protect the business from being over reliant on you. This will have the benefit of not only making successful succession more likely but it will also make your business more resilient and capable of being sold should that ever become your goal.

Practically you will ensure that you have the right people reporting to the CEO. These will be competent, reliable and enthusiastic people that run their area of authority with very limited assistance from you. Such roles might include; sales manager, stock and inventory manager, accountant and the appropriate technology and innovation drivers.

We recently spoke to a potential client who wanted to sell his business but because the business was so reliant on him he was unable to sell. Potential buyers were effectively telling him that it was too risky for them to replace him with a new CEO because the support structures were not in place. It would be unfair to appoint your daughter or son without first properly structuring your business.

## Work out the necessary characteristics for a CEO to replace you

If you were writing a job description for a 3rd party employee, what would be the key skills, knowledge and experience you would be seeking. You would look at what attributes had made you successful in the role. You would assess how the future requirements and scale may vary. You would look at the support team and their associated skillsets and see what the key gaps were likely to be.

## Rigorously assess the capabilities and adequacy of your son or daughter

An external advisor or Board Member that can speak truth to power is useful here. Someone that can do everything is often not truly great at anything and that is where the thought process of identification of must have characteristics versus nice to haves naturally heads. Supplementation is possible, but not if they are not able to develop core skills required for the role.

If given the role prematurely, without caveats and upfront performance criteria, then either the business or family relationships are likely to suffer. We have all heard stories of 3rd generations stuffing up family businesses, unfortunately 2nd generations similarly do not have an unblemished record.

## Family member CEO training

The starting point is a gap analysis between a realistic assessment of your child and the criteria of the CEO role. Then there is the question of whether they are coachable – ego is the enemy in that respect. Just as with an external candidate, external training, shadowing and mentoring would be mechanisms you would use to try to bridge these gaps.

## Allow the new CEO, a family member or outsider, to really be the CEO

Once you have ascertained with sufficient confidence that they have the required skills and experience to be CEO, you need to let them be CEO. Operational matters then become their sole jurisdiction, your role if now Chairman is strategy only. There is a reason it is regarded as poor governance to go from CEO to Chairman in Public Companies – our egos become attached to being right and our reasoning generally leads us to believe we are right. The new CEO is not you, they will do it differently, they will make mistakes where you would have got it right and vice versa.

## The Full or Partial MBO Option

A Management Buy Out (MBO) occurs when existing management buyout the existing shareholder(s). They may buy all or part, they may buy personally or with external help but whatever the specifics **the MBO may secure an excellent outcome for the vendors and for themselves.**

In a recent transaction, we helped a Sydney based company that had a co-founder and major shareholder looking to exit. We concurrently ran a targeted trade sale and an MBO process. The MBO price matched the external bid for the whole business and won the day. It also gave the vendor a sense of satisfaction through selling to the 'natural' and best owners of the business.

A common fallacy around MBOs is that current management will not pay as much as a 3rd party. Our vendor above achieved a great price selling to the management team. The MBO team understood the business, knew opportunities and were best positioned to handle normal business risks. They saw the real value of the business and happily made the purchase.

Other benefits of selling to your management team include avoiding the normal confidentiality risks attendant in a 3rd party sale process.

Some of the key ingredients for a successful MBO are:

- A capable Management Team of at least 2 with entrepreneurial spirit, a credible plan and skillset to grow the business, and a desire for long term wealth creation.
- An owner open to exploring the idea of a sale to key staff.
- An owner who would like a quick transaction or one without warranties or

deferred consideration or where they are happy to keep a small stake. Providing the process is supported by a capable Lead Advisor an MBO can proceed more quickly than a traditional sale process.

- What are the obstacles to an MBO?
- Agreement on price and how it should be calculated is one problem.
- Funding can be a challenge but there are nowadays several specialist financiers who are keen to fund management buyouts.
- Is your business sustainable without you or without a key staff member? Sometimes without the owner or one or two key staff there is no business, as all the goodwill resides with them. If all the goodwill resides in a key staff member, it is difficult to sell for a high price what they could easily replicate if they left.
- Some common mistakes in the MBO process include:
- Taking your eye off the core business while focusing on the MBO transaction.
- Confusion between equity ownership and employment (some think it guarantees their job, it does not).
- Understanding the characteristics, pro's and con's of various funders.
- Not paying for specialized tax advice can be an expensive economy.
- Learning painful lessons rather than paying for expert advice to guide you through the process (but we would say that, wouldn't we).

# Warranties – Don't put your money at risk

Picture this, as Debbie Harry sang in 1977, you have:

- Sold your business
- Received a great price
- Been enjoying your retirement

But, the phone rings:

- It is your lawyer calling
- He tells you that the purchaser of your business is making a substantial warranty claim
- You say "Oh dear" (or something rather more colourful)

You realise that:

- You might have to pay back a substantial portion of what you received for your business
- You will be tied up with lawyers for, at best, months
- Your lifestyle is under attack

It is the job or your advisor, and lawyers, to help you make sure this never happens.

Your Advisor will use many techniques to protect you including:

- Managing the due diligence process so that risky issues are fully disclosed at the appropriate times without jeopardising the deal
- Working with your lawyer on the warranties
- Ensuring you have a legally effective Disclosure Letter/ Documents to limit the hazardous effects of the warranties

This is not an esoteric discussion, it is absolutely essential that risks associated with warranties are managed, mitigated and minimised. You are relying on the proceeds from the sale being for you, these must not be taken back by the purchaser.

# What Should I Pay To Sell My SME Business?

At its most simplistic level you should pay a rate commensurate with the likely sale proceeds, the degree of difficulty in achieving the right sale price, and the necessary skills and time commitment the Advisor will need to achieve that result.

There can be false economy in nailing an Advisor down too much, knowing what a fair rate is will help you negotiate an appropriate fee.

So what should you pay if you are selling a business valued between $3m and $100m? The following graph provides broad guidance, but fees are not standard; some Advisors charge $400k (4%) for a $10M sale, others may charge $600k (6%).

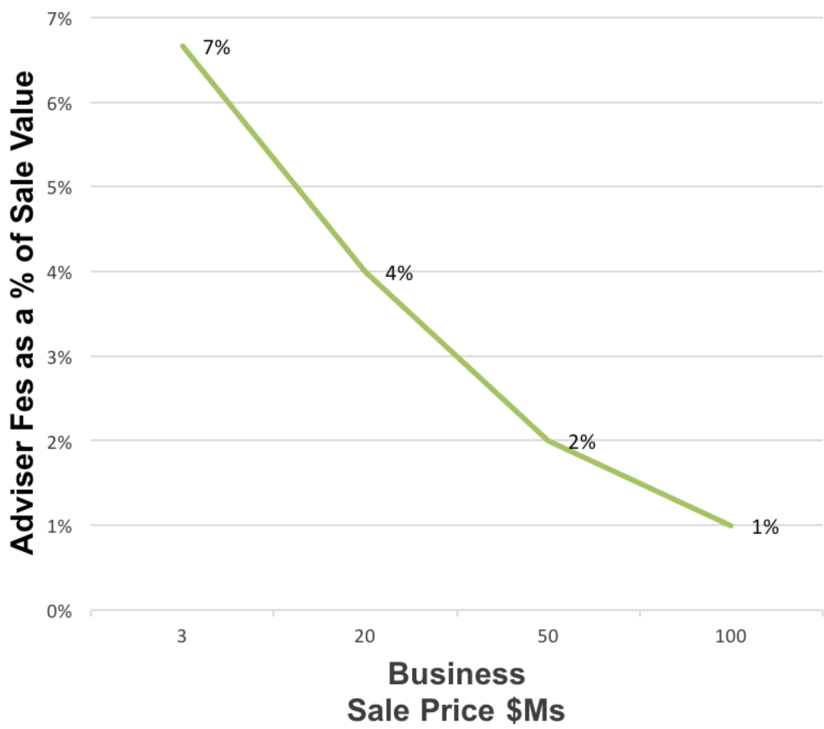
Useful points highlighted by the graph include:

- The Advisor fee is a significant cost, it is important that you select an appropriate Advisor and pay an appropriate fee.
- The Advisor fee in total increases as the business sale price rises.

A higher fee does not guarantee a better service.

The scope of work, skill required and time necessary on each business sale will be different and therefore fee levels will vary for businesses with similar values.

You might think that the Advisor fee would increase in direct relation to the deal size but this is not strictly true. There is a minimum fee that will need to be paid in order to engage a quality Advisor, and therefore, as sale price increases fees as a % of sale price will decrease.



## Negotiating a good deal with the Corporate Advisor to Sell your Small or Medium Sized Business

The good news for you the vendor is that only a modest portion of the total fee should be payable if the sale does not proceed. Only 20-40% of the total fee should be payable in retainers. Thus while the Advisor gets a large sum if your business sells, they will only get retainer fees if your business fails to sell.

As a seller you are benefiting from a form of pooling, where the successful sellers are compensating for the unsuccessful sellers in terms of Advisor fees charged. The Advisor is investing and betting on their expertise in a way you wish your flat fee charging accountant and lawyer would.

Advisors spend substantial time soliciting and bidding on work, whereas prospective sellers like you rarely sell businesses. Fee negotiation is therefore a game where the Advisor has a knowledge advantage but you, the prospective vendor, have the power.

Some Advisors decide if they can win every 2nd bid at 6% that is better than winning 3 out of 4 at 3% (and the maths and workload agrees with them). Fees charged are not standard.

Business Brokers can charge up to 10% on $1M sale and Advisors 6% on a $20M sale. We know of a $6M EBIT (Earnings before Interest and Tax) business that sold for a terrible price of $12M yet the business broker took a hefty 7% fee.

While a very low fee may ensure poor service, a very high fee does not guarantee excellent service or results. Be wary and speak to a few referees before you make your appointment.

To maximise the sale price for your business, we obviously would (and do) recommend you pay an appropriate fee to a well-chosen Advisor.

## How long will the sale process take

Most business owners dramatically underestimate the time and effort involved in selling a business. Six months from initiation to completion would be unusually lucky, 9 months more typical and 12 months unfortunately is not unusual.

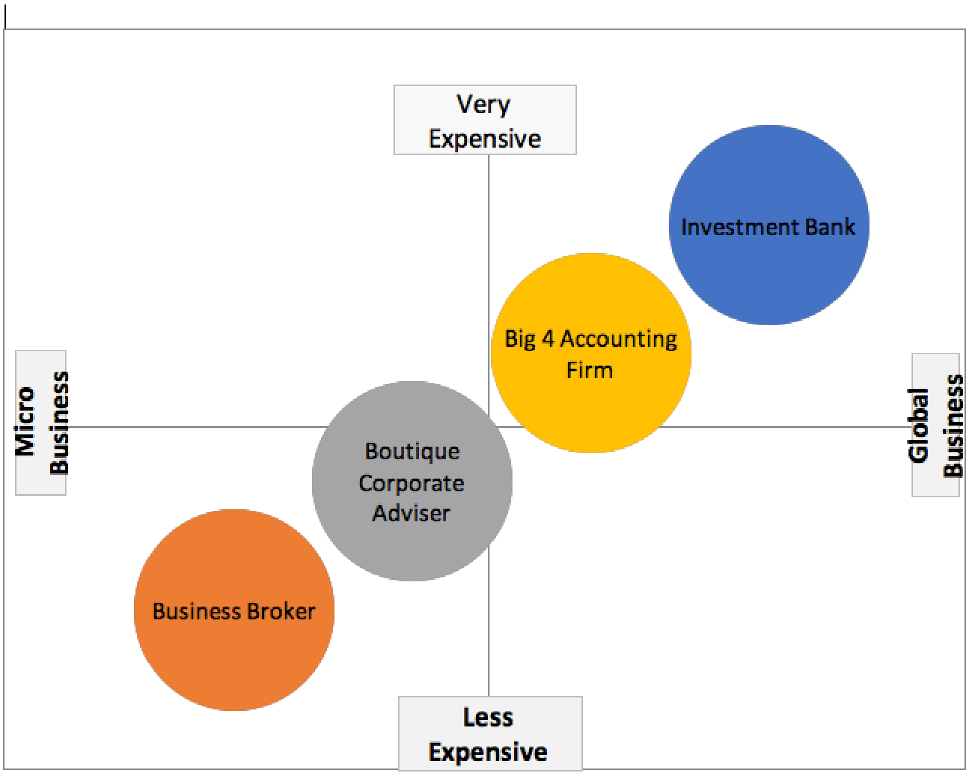
Please bear this in mind if anyone suggests a shorter than six-month time frame.

# Who Should I Choose to Sell My Business?

Poor choice of an Advisor can lead to failure to sell at the right price or to sell at all. You may incur excessive fees and a highly disruptive process that could weaken your business.

To help you avoid those risks this paper summarises some of the matters you may want to consider.

Firstly, it is worth acknowledging that there are many organisations that can advise you on the sale of your business. These Advisors are generically referred to as Mergers and Acquisitions (M&A) Advisors but be aware that the market is segmented into a number of key groupings.




The table above is not definitive but illustrates that SME business owners probably fall into the natural market for Boutique Corporate Advisory firms. These firms are typically run by experienced individuals that have led M&A in accounting firms or investment banks or been M&A experts in acquisitive companies.

Using a Business Broker, Big 4 Accounting firm or Investment bank could be a major and costly blunder. A business broker may not have the necessary skills, resources or processes and an investment bank is likely to be focused on multi-nationals and not know the likely purchasers relevant to a SME business sale.

We believe that if your business is valued between roughly $3m and $50m you are likely to be best served by a Boutique Corporate Advisory firm. They should have the skills, resources and networks necessary to provide you with the best outcome. Most importantly they will understand your business and be equipped to find you the right buyer.

Once you have decided on the category of Advisor to use the question of which specific Advisor becomes foremost.

Talk to potential advisors on a confidential basis, and get a feel for which you can best work with. Once you find one you like and trust, armed with the knowledge gained from this e-book, negotiate a suitable engagement agreement with them.

## Boutique Corporate Advisor Checklist

A checklist to run through would include:

- Do they understand business, have they actually run a business or are they just glorified car salesmen?
- Do they understand your business and its key drivers?
- Are they telling you want to hear rather than what you need to hear? It is not unusual for advisors to give you an unrealistic expectation as to the value of your business if it may help them get a sale mandate.
- Will they actively seek out industry players so as to enable you to achieve a premium price for your business?
- Do they have appropriate networks into financial buyers? There are platforms like Neu.Capital that they can utilise to get more financial buyers involved if it makes sense for your business.
- Are they able to discuss with you what factors about your business will be critical to gaining the best price?
- Are they able to present these factors in a persuasive and professional manner or will they just cobble your web content and some financials together and call it an Information Memorandum?
- Are they experienced and know the traps, pitfalls and opportunities?
- Do they have sufficient resources to devote to you or are they too busy?
- Will the people you meet be the people actually doing the work, or will your work be delegated to less junior skilled staff.

# Summary

A business sale process is a significant undertaking, one not to be entered into lightly. A considered approach should involve fully considering your options:

- **The Do Nothing Option**. Is now the right time to sell, or is it a temporary over-reaction?
- **The Do Something Option.** Is a full sale campaign likely to be the best option, or is family member or external succession, a full or partial MBO or a targeted trade sale likely to be better?

If you do decide to sell, whether it be through an MBO or some form of external sale, please feel free to call us for a no obligation initial meeting.

Please call either **Tony Holley** on **0417 313 136**
or **Michael Mahoney** on **0410 285 318** anytime.

*We at Hamilton Rich understand these conversations can be difficult to have during business hours so feel free to call us anytime that is convenient for you.*