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.

- Not making your SME business "Sale Ready"?
  Abraham Lincoln said "I will prepare and someday my chance will come."
- 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.
- Not understanding how much their 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?
- Not running a professional sale process for your SME business
  You manage your business well, make sure you sell it in a professional manner
- Leaving it too late to sell,
  How many of us wish we had sold all our mining shares back in 2013?

Interested in learning how you can avoid these mistakes? Over the next five weeks we delve into each of these five common mistakes. Next week is "Not making your SME business "Sale Ready"?"

If you are an Australian business owner of a SME and are interested in a discussion on selling your business, please contact us 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.

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, (but more about this in a later blog) 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:

a) 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.
b) 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.

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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.

c) 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.
d) 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 paper about making your business "Sale Ready"?"

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

a) **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.

b) **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 adviser 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 adviser 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 their 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?

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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, e.g. the less secure the customer and supplier relationships, the higher the return on assets must be.

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 or if a 33% return is required they will pay up to 3 times.

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".

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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.

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, 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.

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.

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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.

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 certainly 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 adviser will be able to understand how your business makes money, 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 adviser running the sale process there is risk that you will become distracted away from your business. Part of the adviser'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 5% it may cost you 25% (5 times multiple) of the business value.

- **Expertise and experience**
  A quality adviser 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 advisers. The adviser knows how to challenge, extend and manage the other professionals. We recently came across a tax adviser had not highlighted that a sales 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.

You would probably not attempt to do DIY renovations on a $10m house, why chance a DIY approach on selling your business. Find a proven professional to help you through this important process.

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.

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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 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.

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