

When Potential Beats Profit

It is not always the balance sheet that makes a business look attractive to a would-be buyer.

By Tom McKaskill

Few businesses are capable of creating a sale price of more than four times their revenue or 40 times their net profit, but it does happen. Furthermore, if a business has the right attributes, a strategy can be developed with a high chance of achieving a premium selling price well above what the balance sheet might have suggested. The key to a high premium on a sale is to find a way by which a potential acquirer - the strategic buyer - can increase the revenue to new heights by using assets and capabilities that are already built into the business. The strategic buyer takes what already exists or is being done in the business, and puts them into a new environment where they can be exploited for higher revenue and profit. The size of the opportunity is what justifies the size of the sale premium.

Conventional valuation techniques are based on what could be called the independent investor model. That is, the amount investors make as a return on investment by buying a business and paying themselves a dividend of the free cash that it produces. If future uncommitted cashflow is discounted by the prevailing rate of return needed by an independent investor, a value can be assigned to the business. Entrepreneurs typically push up their market value by improving profitability and providing a platform for future growth. But this model fails to take into account the extra benefits that a corporation could achieve by leveraging the assets and capabilities of the acquired business in a much larger entity.

An owner looking for a strategic buyer has to ask some key questions:

- What corporation has a large customer base that would buy my products?
- If I have a large customer base, what corporation has a set of products that could be readily sold into my customer base?
- Could my products or underlying technology be used to open up new markets for a big company with the resources to fund market development?
- Do I have products that could be easily modified or extended to create new products that could be sold to the customer base of a big corporation?
- In conjunction with the capabilities and technologies of a large corporation, could my business provide the catalyst for a large corporation to break into a new growth market?

Most often, the seller and the strategic buyer are in the same industry. They often sell to the same customers and markets. As a result, potential buyers readily appreciate an opportunity once it is presented to them. The best acquirers will be experienced acquirers. They will have staff who frequently undertake acquisition evaluations, experienced executives who assist in the integration of new businesses, and acquisition processes that are able to readily evaluate an obvious synergistic opportunity.

But even a good opportunity will not normally get results without some preparation. A premium selling price can be justified only if the vendor's business can be rapidly integrated into the buyer's organisation and if the opportunity can be readily exploited.

That means the business must be ready for immediate sale, with no underlying problems, risks or potential litigation. Internal systems for performance management, compliance and operational efficiency have to be in place and working.

Key employees need to have incentives to prepare the business for sale as well as be willing to assist in the transition of the business to the new owner. Finally, the seller and the senior executives who are not part of the acquisition need to be able to prove to the new owner that they have built a robust succession capability.

A strategy for achieving a strategic sale needs a planning horizon of about four years. The first two years are spent reducing risks in the business, preparing a list of potential strategic buyers and building informal or trading relationships with those on the list.

The two years after the sale include the period required to integrate the two businesses as well as the early stage of opportunity exploitation. The more revenue that the buyer can produce in the early days of the acquisition, the more value the seller can extract as a premium on the sale.

Of course, there is a need to have more than one potential buyer when the time to sell arrives. This lets an auction develop among several potential acquirers where each will see a compelling reason to make the acquisition. It is also essential to obtain the best professional advice that can be afforded. Professional advisers experienced in working with large corporations on acquisitions are very useful in the seller's corner.

Does this process work? Yes. An examination of the situations where high premiums were achieved by vendors will always show that the buyer was seeking some underlying strategic asset, and that the current revenue and profit of the acquired business had little to do with the price paid.

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