How to Increase the Value of Your Business

"Value Drivers" and the Wonderful World of Multiples

The What, How and Art of Creating and Applying Multiples

The most critical step in selling a business is to know how much it is worth. The relevant conversation: Just what is fair market value?

Fair Market Value is defined as:

"The price a willing seller and a willing buyer, both possessing complete information, agree on; when there is no undue pressure to act on either side".

Remember the reality is **your business will be valued by how much the new owner thinks he can make from operating it, today and in the future. Not what you think** he should be making!

So what makes a buyer pay more? The better the performance in the following areas called the **"Value Drivers"**, the higher the multiple (which is multiplied by your cash flow) the higher a price that will be paid for the business. This evaluation of performance from these following areas is the "art form" of the valuation process. The more you can improve each value driver, where applicable, the higher the multiple and price paid for your business.

#1 Value Driver: Clean, Reliable Financial Information

Valuation starts here, this is the foundation for all buyers to place a value. The ability to see clearly from an accurate financial statement, where all revenues are generated, validates the business's profitability and derives the **Seller's Discretionary Cash Flow ("SDCF")** which the multiple will be applied to.

The discovery of the **SDCF** starts with the company's profit and adds back the owner's salary (minus what it would cost, if necessary, to replace the owner with another employee), benefits, bonuses, distributions, and any other of the seller's financial benefits paid for by the company. The financial identification of the **SDCF** is the "science" of the valuation process – real verifiable numbers. SDCF recognizes all of the "real world" financial benefits the company generates for the owner.

Buyers will perform some level of due diligence and the more comfortable a buyer is that the numbers are verifiable, the easier it will be for him to affix a value and the easier it will be for a seller to consummate a sale. The important word here is "comfortable". The buyer needs to see and understand the stated numbers. If a seller says he generates total financial benefits of $1M,

$2M, or $3 million + he must prove it!

Therefore, Sellers should under-state, when in doubt, their financial benefits and never-over state. Experienced buyers will know how to review financial statements. If a mistake or over-statement occurs, chances are the buyer will find it and will have questions or begin to doubt everything stated from there on out. At that point, usually, you have lost your buyer. If there is an over sight or miss-statement discovered, much rather it be a pleasant surprise. The lack of integrity in the production of the financial records is the most common down-fall in the sales process.

#2 Value Driver: Sustainable and Increasing Cash Flow

When buyers research business listings, the first thing they usually look for is cash flow. The higher and more reliable the cash flow – the greater the attraction. This is the attention-grabber. A business with a sustainable and growing cash flow will bring a premium price when it is sold. The price associated with acquiring the available cash flow is directly related to risk through time. The lower the risk of losing that cash flow (in a transfer of ownership and the years going forward) the higher the multiple and therefore a higher price will be paid to acquire it. Finally, if “recurring revenues” comprise a material portion of a company’s overall revenues, this recurring revenue stream can be priced at an even higher multiple than a business with non-recurring revenues.

Examples of recurring revenues are maintenance contracts, monthly support agreements, annual license agreements, warranties, subscriptions, or other revenue streams that are contractual and repeating in nature over a specified time.

Buyers are willing to pay the highest amount when their perception is that cash flow is predictable, sustainable and will increase into the future.

#3 Value Driver: Market and Growth Potential

When a buyer reviews a company he generally will look at three areas, the people, the quality of the product or service and the market, today and the future. Is there a there, there tomorrow? Is the company sustainable and the cash flow growable after it is acquired? Buyers will apply a go-forward strategic plan that if implemented and successfully executed will lead to a business’s higher future value. Buyers will look at the following areas of opportunity:

- Is the business in a growth industry?
- Are there new markets that management could pursue?
- Are there new products or services that existing customers may need?
- Can profit margins be expanded?
- Will new, refreshed marketing campaigns and sales efforts increase growth?
- What is the possibility of developing new products and reaching new customer bases?
- Can growth come from expanding reach to new territories or countries?

The more positively a buyer sees these questions translating to the acquisition, the higher the price a business will bring.

#4 Value Driver: Quality of Management and Workforce Infrastructure

Buyers will look closely at who in the company possesses the know-how and talent to both operate and help grow the business. The more dependent the owner is to the operation of the business, the harder it will be to sell.

Key employees are assets and can be critical to the sale of a business. The employee’s length of employment, their expertise, age and commitment to the success of the business are factors all buyers will value. Employment agreements for the critical performers and strong incentive programs only go to enhance a buyer’s comfort level with an acquisition.

#5 Value Driver: Customer Diversity

A broad customer base in which no single client accounts for more than five to ten percent of total sales revenue helps to insulate a company from the loss of any single customer. It reduces the risk of serious cash flow issues if one or more customers do not stay under new ownership.

#6 Value Driver: Operating Systems and Procedures

The “how you operate your business” through the creation and documentation of a company’s procedures and systems only reinforces the buyers comfort level with maintaining the profitability after the sale. Systems may include computerized records and manual procedures used in the day to day operation of the business that generates the revenue and controls expenses. Particular emphasis on customer identification, how products and services are delivered and client history are greatly valued.

#7 Value Driver: High Barriers to Competitive Entry

This is about what advantages your company has over the market; the strength of your strategic position versus your competitor’s or possible future entrants. The larger the breadth and depth of your company’s separation from a possible competitor the more value it brings to a suitor. Some barrier examples would be:

- Patents
- Trademarks
- Copyrights (and their maintenance)
- Proprietary Designs, Know-how, Databases
- Brand and/or Trade Names
- Customized or Proprietary Software Programs

- Hard to acquire licenses, zoning, regulatory approvals
- Contracts with customer bases in difficult-to-penetrate businesses and entities (governments – Federal, State, Local)
- Special Accredited skills or experience or education

#8 Value Driver: Product Diversity

The more limited your product or service mix the more exposure to risk and the lower the valuation by a prospective buyer. An expansive product and service mix, the broad reach of multiple industries, the elasticity of pricing opportunity only increases the value for a buyer.

#9 Value Driver: Technology, Facility and Equipment Condition

The maintenance of technology compared to industry competitors is critical to the health of the business. All too often, as a business owner approaches the horizon of ownership, the less and less of capital assets are devoted to technology. The market is changing so rapidly that without best in class technology the more vulnerable a company is to a competitor or a change/disruptor in the market place.

In addition, business equipment, and facilities need to be well maintained to be viewed as assets rather than a liability that will need re-investment. A buyer will not pay a premium, and may very well discount an offer, for a run-down, disorganized warehouse, office or other building. Additionally, seeing disorganized or poorly maintained facilities and equipment may cause the buyer to perceive that other aspects of the business may be similarly disorganized (employee records, financial records, system processes and procedures, compliance records, etc.). Owners should be sure that facilities and equipment are maintained in peak condition before beginning the sale process.

#10 Value Driver: The Ability of an Owner to Take a Vacation – at any Time!

That’s right, the ability to leave at any time. The more dependent a business is on the involvement of the owner, the less valuable it is to a potential buyer.

When these drivers are nurtured, maintained and improved the higher a price the business will likely command!