fact sheet

Selling your Business: Strategic Issues

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Introduction

For many owner-managers the question of how best to preserve the legacy of the companies they have set up, is never answered. This all too frequently results in a hasty sale by an owner suffering from ill-health or the family of an owner having the unenviable task of selling the company after the owner's death. This will almost invariably lead to the owner or his family achieving a lower price for the owner's life's work than would have been achieved with proper succession planning.

This fact sheet analyses the key strategic issues (and underlying legal issues) that need to inform the decision of the owners as to the method and timing of his succession plan. However, we must first understand the key motivations of the owner or owners.

The importance of understanding motivation

For many business owners the decision to set up their own business will have been driven by factors other than maximising their income or building a company that can be sold to generate a capital profit. The founder will often be passionate about a product or service that he or she has conceived: the motivation for setting up may have been the opportunity to bring that product or service to market.

A key driver may have been the desire for independence, perhaps to escape a large corporation where career progress may have been driven by political skills.

Loyalties to staff, to customers and to suppliers may be as or more important than the highest sale price that could possibly be achieved.

Advisers experienced in acting for owner managers can play a crucial role in guiding them in their succession planning. Understanding those motivations and non-financial issues are likely to be key to the decision making process.

Growth/life cycle of typical company

The typical growth/life cycle of a company is shown in the chart on page 3 of this fact sheet.

The typical inflection points for businesses are highlighted by reference to 'chasms', listed as one, two and three. The chart shows the likelihood that there will be a start-up phase where the new company makes losses before the product or service is successfully brought to market . Statistics show that one third of companies fail in their first three years of trading (*"Small Businesses – An Anthropological Insight" by Paul Hague, B2B International*). The founders must first prove the technical viability of their new product or service and their ability to manage cash flow and profitability. In our chart this point is described as *chasm one*.

A sale of a company before *chasm one* has been crossed may be possible. The buyer may want a particular technology or intellectual property, or is able to rationalise and reduce costs in order to make the business profitable. However, for most companies if *chasm one* cannot be crossed, the owner is facing a distressed sale. Cash and time invested will have to be written-off. Skilled professional advice including that of an insolvency practitioner may allow something to be salvaged even if it is only employment for the founder and his team.

Assuming the founder's confidence in the product or service and the market for them proves well-founded the future growth of the business will be crucially dependent on whether a well-rounded management team can be recruited and/or trained, as the business has reached a stage where its growth is limited by the capability of particular person(s) in the business (often the owner).

In our table we refer to crossing *chasm two*. In order to cross *chasm two*, there will almost certainly need to be the beginnings of an efficient team of managers. The business will have matured from the "technician" owner-manager and systems and processes will be needed so that the company has the capability to "scale-up": to win market share in the chosen market and to do so with a sustainable production, marketing and financial plan.

Crossing *chasm two* is almost certainly going to represent a significant challenge. The very behavioural characteristics that motivated the owner to set up in the first place and allowed him to survive the first years in business, will often be obstacles to crossing this *chasm two*.

Any well-advised buyer of a company will be wary of paying "top dollar" for a company that is still significantly dependent on the founding owner-manager. Best prices will be paid when the owner can demonstrate a management team independent of him and systems and processes that are allowing a significant scale-up in the operation.

On the basis that buyers want to buy companies with real growth potential, the ideal time for a sale will be after the company has entered the steep growth curve shortly after *chasm two*.

An owner who holds on until the top of the growth curve may be disappointed with the price offered by the buyer, usually based on a multiple of profits. High multiples are dependent on convincing the buyer of the future growth potential.

A business that has achieved high but plateau profits may have nowhere to go but downhill. At this stage future growth may need to be overseas or other markets and *chasm three* (an international operation perhaps) may be the next logical step to justify a high multiple or perhaps the company will need to introduce new products or services.

These broad generalisations, of course, all depend on the size, growth potential and the level of competition in the relevant market. New markets with few competitors may enjoy high margins. Mature, highly competitive markets may lead to very low margins and such markets are unlikely to attract good prices for a seller.

Prevailing market for company sales

Irrespective of the fundamentals of the company being sold, a key factor will be the prevailing market for company sales. If stock markets are depressed or there is a shortage of bank debt the prevailing market may be poor and make it difficult to sell.

A strategic buyer (perhaps an industry consolidator) may mean that a particular market sector has high prices that can be achieved.

Profile of management team

For many companies in the current market the obvious (perhaps only realistic) potential buyer may be the management team. The team may need to be significantly strengthened in order to replace the skills of the owner who is no longer working actively within the company.

It is therefore very important to assess the needs, capabilities and motivations of the existing management team and identify any gaps that need to be addressed as the business grows.

Barriers to a sale

There may be many potential obstacles to a sale. Some of the more common of these are listed below:

- *over dependence on a particular person (often the owner-manager) for sales or production.*

If a company has not identified the processes or skills that has made it successful, the strength of a business could lie in a few key individuals, who if they left, would mean that the business would not be able to achieve the levels of profit previously generated or projected.

- *over dependence on a key customer*

It is relatively common that companies are set up to service a particular customer (perhaps one dissatisfied with other suppliers), and the company ends up very dependent on this customer for its continued survival. A buyer is unlikely to place a premium on such companies. Indeed unless the key relationship is secure and the buyer is confident new business can be won it may be very difficult to sell the company at a price acceptable to the owner.

- *not owning key intellectual property*

If a company is founded on intellectual property it does not own (software companies can be a good example of this, especially where software is based on freeware), the Company may be vulnerable to competition.

- *over dependence on a key supplier*

A company that has a small number of key suppliers that are not easily replaceable may be vulnerable to those services or products being withdrawn or the supplier significantly raising the price of such products or services. This could mean the company is no longer profitable. A buyer is unlikely to place a premium on such companies unless confident that suitable replacements can be found on satisfactory terms.

- *obsolete technology*

Technology companies can often have a very profitable service or product which very quickly becomes impossible to sell due to the introduction of a superseding product or service. Buyers are therefore wary of such companies who are not ahead of the market or who have a small number of successful products/ services.

- *owners with differing personal objectives*

If there are a number of owners, and there are different opinions on how to take the company forward, then this can create a confused image for a buyer and a difficult sell as all objectives are attempted to be met. Typically this is because some owners may wish to enjoy an income or remain in control, whilst others wish to have an immediate capital return and/or see opportunities in the buying business.

- *legal disputes with customer or former customers*

A significant legal dispute will raise doubts with the buyer as to the quality of the product or service, or the way in which such product or service was sold. Buyers offer high multiples based on certainty of return, and anything which endangers that position will damage the position of the seller.

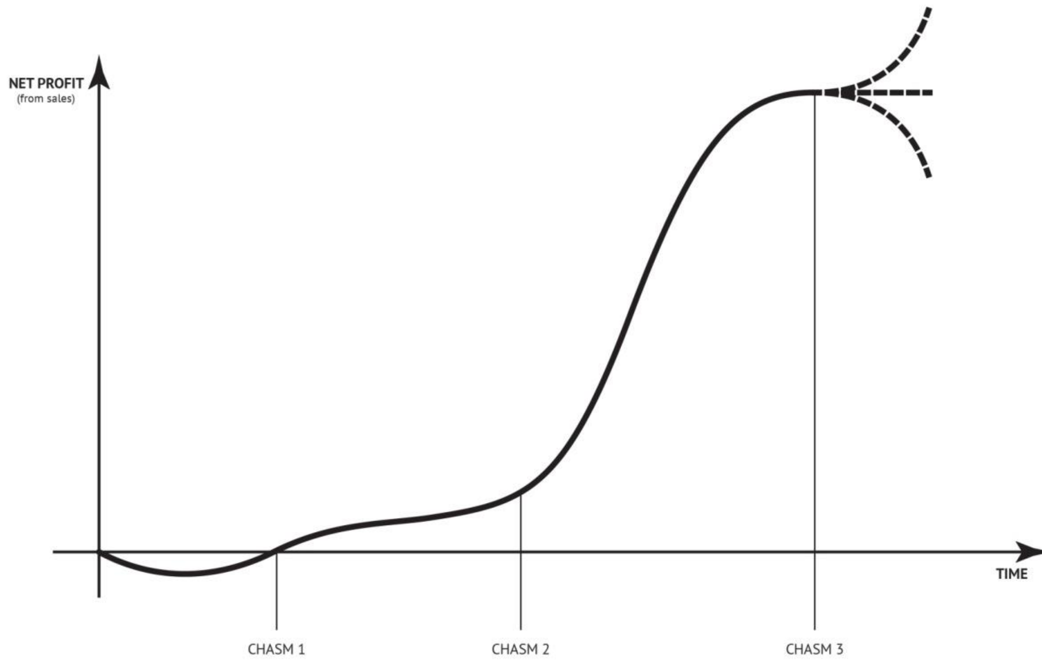

Chart 1 – The typical life cycle of a company

Since engaging Everyman Legal we have put in place an agreed legal framework for ownership succession. My company is now positioned for growth

Charles Purdy
CEO of Smart Currency Exchange

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