MERCER CAPITAL

Value Matters™

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Corporate Value Engineering

Is Your Business Ready for Sale?™

Every business will sell - either partially or totally. And every business will sell either voluntarily, with the support of its owner(s), or involuntarily. The Business Transfer Matrix below provides examples of transfer scenarios.

The Business Transfer Matrix

	Partial Sales / Transfers	Total Sales / Transfers
Voluntary Transfers	Options Phantom Stock Stock Appreciation Rights ESOPs Private Equity Recaps Management Buy-ins Gifts/Transfers to Family Members Gifts to Charities/Charitable Trusts Buy-Sell Agreements Direct Public Offering (?) IPO (?)	Sale of the Business Private, Negotiated Sale Financial Buyers Strategic Buyers Private, Auction Sale Financial Buyers Strategic Buyers MBO Sale in Consolidating Roll-up Instalment Sale to Relatives ESOP ESOP/MBO
Involuntary Transfers	Divorce Forced Sales in Restructurings Shareholder Disputes Buy-Sell Agreements	Death Divorce Forced Sales in Restructurings Bankruptcy Shareholder Disputes Buy-Sell Agreements

At Mercer Capital Advisors (the investment banking division of Mercer Capital Management, Inc.), we are often asked by potential clients, "Is my business ready for sale?" and, if not, "What things should we be focused on to position the company to attain the highest possible sales price?" Over the years, Z. Christopher Mercer, CEO of Mercer Capital, has developed a framework for thinking about the financial considerations of your business that he calls "BIG TIPS from MOSES™." He does not pretend to have ever been in the presence of a burning bush; however, he and we at Mercer Capital Advisors use this acronym to guide our discussions with clients of the financial concepts that are significant to their businesses.

In this article, we will focus on the important aspects of a business that is "ready for sale" (not necessarily "up for sale") so that you can use them as a guide in evaluating whether or not your business is operating at optimum performance and so that you can better understand the nature of value in your business. Remember, "ready for sale" does not mean on the market or up for sale. It simply means that if a favorable opportunity arises or if circumstances necessitate a sale, the company is ready and has the characteristics for which rational buyers of capacity will pay a reasonable (or better) price.[1]

Let us first define BIG TIPS from MOSES™, or the key concepts which we call *Corporate Value Engineering*:

B	*Balance Sheet*			
I	*Income Statement*		**M**	*Management in Place*
G	*Growth*		**O**	*Oversight*
		from	**S**	*Strategic Direction*
T	*Technology and CapEx*		**E**	*Employees in Place*
I	*Information and the Internet*		**S**	*Stock Considerations*
P	*Products and Services*			
S	*Sales and Marketing*			

Focusing on "BIG"

The Balance Sheet. The balance sheet should be relevant to the business. A company's balance sheet is an important part of the overall valuation equation. The nature, composition and quality of a company's assets are extremely important to valuation. On the liability side, financing should be secure, and equity should provide an appropriate degree of funding to maximize value at acceptable risk levels.

In many companies that we review as a possible candidate for sale, we often find that the balance sheet is not positioned correctly for sale of the company or its assets. We also find situations where there are certain assets on the balance sheet that are not relevant to the business. For example, we recently reviewed a medical products distributing company where the owner made all of his personal investments inside the company. To further compound the issue, the company is a C corporation. The company had certain operations of non-related businesses inside the company as well as millions of dollars of hunting and other land investments that at fair market value were approaching the underlying value of the operating entity.

Needless to say, to position this business for sale, we would have to separate these non-operating assets from the core operating business. This will take time to accomplish, thereby delaying any possible sale, and such a delay could be damaging to the ultimate price. Why? Because now is an excellent time for quality companies to be on the market if their balance sheet is positioned well.

The balance sheet is the foundation upon which most companies stand. To maximize value, a company's balance sheet should be built on solid rock, and not on the shifting sand of excessive leverage.

1 Keep in mind that in this article we discuss what rational buyers seeking reasonable market returns might pay for your business. What you really want to find, at the time you decide to sell, is an irrational buyer who will overpay for your business, or a strategic buyer with unique reasons for paying up that may be quite rational in light of that buyer's unique strategy. Unfortunately, irrational buyers are hard to find, especially when you most need one. Therefore, we will continue to focus on the requirements of rational purchasers of businesses.

The Income Statement. The positioning of the income statement is a very important part of any analysis made in the consideration of selling a business. Questions to ask include:

- What are the trends of the business? Are they up or down? Are they flat?
- How are the margins holding up? Are they lucrative or are they trending down?
- A key ratio analysis is very important in looking at a company. How does the company compare to itself over time? How does the company compare to the industry and its peer group currently and over time?
- What type of returns does the company generate? Are the returns on equity higher than, the same, or lower than that of its peers?

We are currently in the process of selling a company that has been highly profitable over the last five years and has been able to maintain a very good profit margin over this time period. However, at the same time, the company has experienced a drop in its overall dollar sales revenue for the last three years because the business revenue mix has changed over this time period. The decline of the top line has made the sale of the company somewhat difficult, even though profit margins remain quite strong.

The income statement provides evidence of a company's ongoing flow of business, and needs to be managed carefully and consistently if a company is to be ready for sale.

Growth. In looking at the growth of a company, the real question is "Has there been any growth"? A company on the grow is always more attractive than similar businesses that are stagnating, declining, or losing money.

Many business owners run their companies in maintenance mode. They are happy with the status quo. Historical and perspective growth are very important to potential acquirers. Some buyers (either strategic or financial) like high-growth situations, while some like a relatively stable growth of revenue and earnings. The subject company and its prospects for growth will determine the type of buyer that we will seek in the marketplace.

Other questions to ask are:

- Where does growth come from?
- Is the company expanding its market share of products and/or services?
- What is the competitive landscape of the company?
- Are there new innovations of products and/or services that can get to the market before the competition?

When selling, every business owner desires to sell the unlimited prospects for future growth available to purchasers. Those prospects are inevitably more believable if there is a clear, historical record of consistent growth in sales and earnings. Absent such a record, potential buyers may never bridge the gap between a company's lackluster record or declining trends and the selling owner's vision of a grand and glorious future. Value inevitably suffers as a result.

From the standpoint of potential purchasers, one of the best indicators of management quality is a history of improving performance, or sustained performance at or above industry norms.

Focusing on “TIPS”

Technology and CapEx. In today’s world, it is rare to see a company that does not have some technology in place and plans for additional spending in this area and on capital expenditures. However, it does happen. We recently interviewed a company that was considering selling, and it was apparent that they had not invested to update their technology nor had they invested in capital expenditures for its facility or manufacturing process. As such, any potential acquirer would severely penalize this company because of the apparent conditions of its facility, its equipment, and its systems. This company’s profitability would have to be adjusted downward if put on the market for sale. By not investing in its facilities and systems, this company hurt itself. The ownership of this company learned that there must be some reinvestment in the business to help fund the ongoing operations of the company.

Bottom line: If a company is to grow, you must invest in it.

Information and the Internet. One question that we always ask prospective clients is “Does the company have an information system to control the business?” We recently dealt with a company whose growth rate appeared far superior to almost anything on the market. Upon closer due diligence, we found that the company’s information system was inadequate to handle the fast growth and there was a lack of competency on the part of some internal personnel managing this portion of the business. Therefore, the owner consistently lacked sufficient information to adequately run the business.

In addition, this company’s financial statements contained serious errors even though they were reviewed by an outside accounting firm. We believe that any company considering selling should have an audit, or at least a review of the financials, by an outside accounting firm that is competent to do the job. This company had to hire another outside accounting firm to review its books – at a significant expense – only to discover that its profits (and growth rate) had been greatly overstated. Needless to say, this company’s owner was devastated upon discovering this. Fully functioning and accurate internal information systems are vital to the success of any business.

Companies should also have an Internet strategy in place that is adequate for that particular business and is very clear in explaining what the company is all about. A website that is more than an electronic billboard is an expected part of every company’s communications strategy and can be a very helpful tool to showcase the company once it is on the market.

Pay attention to your internal information systems and consistently check them for accuracy.
You ignore them at your own peril.

Products and Services. We often see companies whose product or service lines are no longer competitive. Their product or service offerings may have become stale with no plans for new product or service offerings or enhancements. Obviously, these companies are not candidates for sale.

It is all too easy to become overly comfortable with a product or service that has been successful over a long period of time. However, companies must stay one step ahead of their competition to continue to be successful on an ongoing basis. It is a fact of life that many companies, especially closely held entities, are unwilling to invest in the research and development that would continually update and improve product and service lines to gain additional or new market share. Business owners and management have to focus like a laser on continual product improvement.

In order to stay competitive and grow, companies have to continually update
and improve their product and service lines.

Sales and Marketing. When conducting due diligence on a company for potential sale, we ask: "Does the owner support the sales and marketing team? Is there a marketing vision for the company? Does the owner do what it takes to support the sales effort?"

We worked with a company whose sales group did not believe that the owner supported them in a way that helped them continually close sales. It was a problem of the owner's expectation of gross profit levels per each sale. The owner had set a very high percentage of gross profit expected from every sale and that, in turn, dampened the number of sales that could be closed. The sales group disagreed with this philosophy and believed that they could close more sales, thereby adding to total revenue, if the owner would only provide them some leeway in the margin. In this case, the business owner could not see the forest for the trees.

Companies must have a vision of where they want to be in the future and a good sales and marketing plan, along with a strong sales and marketing culture and team. These are very important to the total equation of success.

Written and actionable sales and marketing plans are vital to the success of a company and important to prospective buyers.

Focusing on "MOSES"

Management in Place. In the company that is ready for sale, we look for many indicators of management competence, including:

- *"Key-man" issues.* We ask if these have been minimized by having a well-trained, stable and experienced management team in place. Few things can diminish the value of a business more quickly than the loss of the one person who really drives things and who has failed to train subordinates and to delegate responsibility appropriately.
- *Management Team Competence*. We seek to determine if the business will run reasonably well, perhaps indefinitely, during absences of the owner. In addition, is management building values in the business conducive to the goals, aspirations, and potential of the business and employees?
- *Financial Management*. Strong companies do not leave financial management to chance. Historical financial data should be available. Current management information should also be available and used regularly to effectively oversee the business. We ask if management is looking to the future in the form of a solid and meaningful budget for the current year and a business plan for the next two to five years or so.
- *Incentive and Reward System*. Are they in place to provide appropriate motivation and encouragement for management? It is critical to be sure that the reward systems encourage desired behavior and results.

Oversight. One of the most effective mechanisms to stimulate improvements in getting a company ready to sell (and an effective sign to an outside party of such improvements) is a system of checks and balances within the management of the company. This can be achieved by the development and utilization of an active board of directors. Ideally, such a board consists of members of internal management, as well as outside parties. An active board can transform a company from a business dominated by a few key persons to a true enterprise.

The perception of the company by potential buyers as an ongoing enterprise (beyond the current owner or management) is a key ingredient in the ability to sell.

Strategic Direction. Being "ready for sale" means making your company attractive to an outside investor. The most important initial question that most investors have about a company relates to growth. More specifically: What is the source of growth? This is obviously a simplified version of the numerous strategic questions that a company's management must ask and answer in developing a strategic direction, but the point is clear.

No matter how successful a company has been, it is vital to have a plan for what the company will be in the future.

Employees in Place. It is often said about companies that their most important asset is their people. To be ready for sale, it is not enough to simply have a complete team of employees. Buyers look for companies where employees are committed to the strategic direction outlined by management. Nothing can put the brakes on a potential transaction quicker than conflicting stories told by an owner/management and the company's employees.

The intangible asset of "good attitudes" can be surprisingly valuable in the context of a sale of a company.

Stock Considerations. In addressing stock considerations, business owners need to ask another critical question: Is the distribution of stock (or partnership interests) where it should be? The owner who procrastinates in making gifts to children, grandchildren or charities may lose opportunities for tax-advantaged planning if an unexpected offer comes along.

If there are unrelated or uninvolved minority shareholders, it may be appropriate to plan for an orderly and reasonable repurchase program to avoid potential problems in the event of a later sale or recapitalization of the business. Business owners often make formal or informal promises to provide key employees with equity interests in their businesses.

Promises regarding equity are difficult or impossible to keep in the heat of an impending and unexpected sale or initial public offering. Such unfulfilled promises can cause problems with deals or even cause potential purchasers to back away from transactions.

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Valuing Shareholder Cash Flows: Quantifying Marketability Discounts	*Quantifying Marketability Discounts* has been updated and is now offered as an e-book. Titled *Valuing Shareholder Cash Flows: Quantifying Marketability Discounts - 2005 E-Book***,** this edition provides a brand new chapter which discusses each of the five assumptions of the QMDM in depth. As a bonus, when you purchase the e-book, you will also receive the *QMDM Companion*, the latest edition of Quantitative Marketability Discount Model in spreadsheet format. We plan to continually add content to this e-book and as a purchaser, you will receive this added content *free of charge when it becomes available.*	*Currently available*
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Valuation for Impairment Testing	The first SFAS 142 valuation resource for CFOs and auditors. Also available in printed form from our website at www.mercercapital.com.	*Currently available*
Are S Corporations Worth More Than C Corporations?	An e-booklet that adds to the S Corp vs. C Corp debate	*Currently available*

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MERCER CAPITAL ON THE ROAD

August 2, 2005
"Mergers & Acquisitions: The Transactions Behind the Transaction"
Wichita Program on Appraisal for Ad Valorem
Wichita, Kansas
Travis W. Harms, CFA, CPA/ABV and
Z. Christopher Mercer, ASA, CFA

September 20, 2005
ESOP Panel
FCG Annual Conference
Chicago, Illinois
Kenneth W. Patton, ASA

September 30, 2005
"The Integrated Theory of Business Valuation"
8th Annual Conference of the Arizona Society of CPAs
Phoenix, Arizona
Z. Christopher Mercer, ASA, CFA

October 18, 2005
TBA
Financial Executives International, Memphis Chapter
Memphis, Tennessee
Z. Christopher Mercer, ASA, CFA

The professionals of Mercer Capital have a great deal of experience speaking to industry and professional groups across the nation on topics such as:

- The Integrated Theory of Business Valuation
- Is Your Business Ready for Sale?™
- Purchase Price Allocation
- Valuation of Employee Stock Options
- Litigation Support and Expert Testimony
- Valuation of Privately Held Businesses, Partnerships, or LLCs
- Financial Institution Valuation
- ESOP Valuation

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- Valuation of Employee Options
- Valuation of Intangible Assets
- Fairness Opinions

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