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Several ways of enhancing your business valuation in a down economy

April 14, 2011 - Connecticut

As business brokers serving firms in Connecticut with annul revenues that range from those with $500,000 to $20 million, the first question we're often asked is "what can I get for my business?". Our usual response is "it depends". The purpose of this article will be to answer why our answer is evasive.

The slow economy is affecting valuations for almost all businesses. The lack of acquisition credit, the impaired balance sheets of many buyers and the slow economy and corresponding decline in revenues and earnings for most firms have all contributed to business valuations that are anywhere from 20 to 50% lower than their peaks of four or five years ago. Nonetheless, firms can command a good valuation if their business fundamentals warrant it or if they implement changes to their operations to increase it.

Four characteristics of a company determine its valuation: earnings (EBITDA), assets and the nature of the assets, the size and scope of revenues and the industry it is in. Certain types of businesses command higher multiples because they are in demand or measured by different rates of return, and businesses that are asset intensive have a greater likelihood that a bank will finance the acquisition which enhances its value. Nonetheless, if the business is not generating good earnings, then just having a lot of assets or operating in a hot industry won't guarantee a high valuation. Of these four characteristics, earnings is by far the most important.

So, how does a company enhance its valuation? First, given that earnings are the most important factor, then having good earnings is critical. A firm may need to undertake a program to improve them before they put it up for sale. This may involve making hard choices about staffing levels, or eliminating products or services that are marginally profitable. While this is often difficult, once it is finished, the company will be in a much better position for a sale.

Second, having good financial reporting systems in place is important to a prospective buyer. Firms need to generate monthly income statements, accounts receivables, accounts payables, aging and sales order backlog reports or whatever else is pertinent to the business. Buyers like to know real time information and if this is readily available, it gives them a sense that the firm is well managed.

Additionally, firms should organize their income statements so that they conform to standards found in their industry. Sophisticated buyers are going to examine operating ratios such as gross profits and other expense and balance sheet ratios and want to know how the business compares to others in their industry. I used to own an office furniture manufacturing firm that generated annual revenues of $8 million, and we patterned our income statements after the industry leader Herman Miller, a publically traded company with annual sales of $2 billion. Lastly, businesses should convert their accounting system to the accrual method from the cash method if that is what is being used. It's better recognized and gives a real time picture of the business.

Third, businesses that have breadth and depth to their customer base are viewed much more favorably than those that don't. If the firm relies too heavily on one or two clients, then it not only reduces the value of the company, but it makes it more likely the firm will be sold under terms where the owners are paid over a period of years contingent on whether or not these clients stay with the business. Expanding the sales base is critical to enhancing a company's valuation.

Last, like a customer base, firms need to have as deep a supervisory and management team as possible. It's music to our ears when owners tell us that they only spend fifteen to twenty hours a week running their business. Usually this indicates they have good people and management systems in place. A prospective buyer will view this as a real asset since as much as anything, what buyers worry about is ensuring the transition to new ownership is a smooth one.

For companies that have already addressed these issues, then now is as good a time as any to sell the business since there are plenty of buyers in the market willing to pay fair value for a well run company. For those that have not, then now is the time to begin to do so. It will be the difference between selling the business for between 1 to 2 times EBITDA and 4 to 5 time EBITDA.

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