What Buyers Look For In A Business?
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Profitability is generally the by-product of a well run business. The underlying qualities of the company dictate the company's success and value. Equally as important is the company's ability to continue in a profitable, growth mode after a sale takes place. Buying a closely held business is a risky venture. Investors are generally adverse to risk. Many businesses go bankrupt after a purchase because they do not always maintain the same profitability after a change of ownership has occurred. Buyers often wonder why the "cash cow" they thought they bought turns into a "white elephant".

This article will help the attorney identify the attributes of a successful business and how those attributes translate to enhanced or diminished value. .

A successful business is made up of a combination of the following factors:

Quality product or service

Sales and marketing efforts may get a client in the door at least once, but it is the <u>perception</u> of a good product or service that keeps clients coming back for more. For instance, there are many forensic experts that attorneys perceive to be good when they are really not that good. Nevertheless, there is a perception of being good. This perception will keep the client coming back which creates the base from which to grow the revenues. A business that has to find new customers to replace lost customers is not one that lends itself to high goodwill value unless the new customers are finding their way to the business via company or firm(not personal) reputation. However, in a divorce situation, the personal reputation of a partner is generally not bifurcated from the business when determining value.

Strong marketing plan

In that same vain, a good product does not always get sold just because it is good. A good marketing plan is important. The term "if you build it they will come" may have been good for a ballpark in the movies, but if a good product or service isn't marketed properly it will not achieve its potential. Our favorite comparison is Microsoft and Apple. Apple's operating system was said to be the best, yet through good (possibly unfair) marketing Microsoft had dominated the market on almost all desktop computers. It appears that Apple as of late is getting its just revenge.

Key people/Management Depth

Small, successful companies where the owner wears all the significant hats that drive the revenues and the profits may be considered too high a risk for an investment buyer. The ideal structure would be to have several key people that will remain after a sale takes place. Commonly, in a smaller business, it is the chief salesman who is the key person next to the owner. This key person needs to be part of the transition process if not part of the new ownership. Savvy due diligence by the buyer will ferret out whether the business is overly dependent on the exiting owner and whether the exiting owner's relationships can be transitioned. Again, however, in a divorce setting this may be overlooked because the business generally is being valued as is with no transition to be considered because a sale is unlikely to occur. The value to the holder concept is generally in force.

Customer Dependence

The risk in a business model is drastically curtailed if the company has a significant amount of customers or clientele with none making up a significant percentage of revenues. **Perhaps the highest risk in any business is the reliance on a few customers and continuity of the customer base after a change in ownership**. This is true whether it is a litigation or actual sale situation. A business that is thriving due to one customer making up a significant percentage of business is sellable but generally with significant contingencies. With personal service businesses, business continuity is most threatened when there is a change in management. It is less risky where there is a specific product sold unless the mode of sale and prices change right after the sale.

Sometimes a few large high profile customers are fine with a buyer that already has an existing business and needs to penetrate another company's customers with their own products. This is known as synergy. For example, supposing there is a computer service company with greater than 50% of its revenues derived from a few Fortune 500 customers. This company may be a good acquisition target of a software company whose target businesses are these large customers. What better way to get in the door than buying a company with the needed clientele? However, there is still significant risk to this model and most likely contingent buy out arrangements are made.

Customer dependence will often reduce the value because of the higher risk to the buyer. Alternatively, synergistic purchases may dictate a premium.

Proprietary Content

The unique quality of the products or services offered is another aspect of where a valuation premium can be manifested. Products that are unique and protected from copying, have a significant market and growth potential or an unexploited use may allow for a value that is beyond normal business valuation models.

Profitability

For "bricks and mortars" businesses, quality profitability is a key factor. A strong gross profit margin or a low cost of sales is many times more important than the bottom line profitability. This is because in many businesses this is an area that cannot be controlled. Administrative overhead can more easily be altered with better management than the gross profit on sales can be.

Efficient controllable costs (administrative costs) are also important. Although uncommon there are times when the owner is doing so many tasks and running so lean that the profits are more than that of the norm in the industry. In that case it can be difficult to find a buyer to pay the normal multiple of income because the buyers may feel they would not be as efficient as the current owner and would have to pay three salaries to make up for this one salary. More often than not, buyers would want a "lean and mean" operation.

On the other hand a company that is run too frugally may not have made an investment in the future of the company. The current owner's accounting systems may be outdated or the factory and the facility may have been run down and not maintained. Informed buyers will be looking closely at these items and assessing what amount of capital additions would be required. This will have an impact on the value.

Employee Turnover and Employee Relations

It is more comforting to a buyer that the target company have low employee turnover, especially in service type businesses. A buyer is looking to step into the shoes of the existing owner as seamlessly as possible. Having a strong falloff of staff after an ownership change will likely be extremely detrimental to the new owner.

A potential buyer will have to be comfortable that the employees are not too dedicated to the current owner. This would be especially true in an industry that competes for the same workers. Many employees stay with an owner because they are treated well or have a strong loyalty to them. A buyer cannot expect to replace the ownership easily if such is the case. If the seller does not stay with the company, the employees may be inclined to leave.

Management Information Systems

Often this is the part of a business that is ignored by the owner. They figure they are making money and who cares, other than the IRS, what the details are. However, a buyer cares. A buyer wants to know what products are selling, who they are being sold to, trends in sales, cost of sales by product line, etc. They also need to easily prove all the representations made by management and their Merger and Acquisition advisors. If the company's MIS system can not produce these types of detailed reports, , the potential buyer may not be willing to go further in the negotiations. In many cases, deals never get off the ground due to inadequate information systems.. In smaller companies, (especially in litigation settings) poor books and records are not generally a factor in assessing risk because the opposing party should not be punished because the owner/partner keeps poor records.

Accounts Receivable and Inventory Turnover

Cash flow, either current or future, is one of the main drivers in valuation. Proper inventory control and collections of receivables is critical. A business can sell its products all it wants to, but if it is overstocking, or not collecting receivables timely, their investment in working capital is raised, and their ability to turn profits into cash occurs too slowly. This translates into diminished value. In summary, a company that manages its collections and controls its inventory shelf life in an efficient manner is very attractive to a buyer especially if coupled with profitability.

All of the above qualities are not found by reading the financial statements or tax returns. Only a thorough due diligence examination will reveal these factors that will give the potential buyer either the comfort to go forward with the purchase or to step away. Often in litigation settings, a due diligence review is not performed. It is important however, for the valuation expert to analyze and obtain as much evidence as is practical to conclude on these factors since they are critical in the valuation.