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MID-STATES ADVISORS
A Private Placement and Business Brokerage Firm
Newsletter

Mid-States Advisors, Inc.
Monthly Article & Updates

Good Morning,

In a follow up to our last article regarding how to choose a business broker, we continue on the topic of preparing for the sale of a closely held company. In this week's edition we discuss the questions lower middle market business owners should ask themselves when preparing or planning for a sale. While the idea can be difficult for many owners who have oftentimes committed much of their lives to their organizations, the best thing they can do is prepare the organization in advance of the date, helping to reduce the stress of the entire process.

In our second article of this issue we cover EBITDA, what it is, and why it has become commonly used in sales processes.

If you have any questions about our content or how we can help you in any way please feel free to reach out to one of our team members.

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Are you Preparing for the Sale of Your Business?

Many business owners are unprepared when the time eventually comes for them to sell their business. They've either avoided the discussion and related preparation or were not properly advised on what is required and how it could affect the potential sale. Below are questions every business owner should ask themselves when planning for a sale.

What is the ultimate value my company provides and how do we

differentiate from competitors?
Value drives the decisions we make in everyday life, and it is no different when it comes to selling a business. We constantly evaluate life: the best use of our time, the best restaurant for the money, the best place to buy our groceries and gas, all value decisions. Why forget that when it comes to selling a business? Buyers know that providing an outcome that is hard to otherwise achieve is important to the success and longevity of a business. Whether the value is in being a low cost competitor, a great location, providing superior service, or having the latest and greatest technology, be prepared to identify what it is that differentiates your business from its competitors.

How strong is the management team you will leave behind?
A strong management team is critical to a sale. Sometimes this can be negated by finding a strategic buyer, but typically, if the owner is the driving force and the expertise behind the business, it greatly hinders the chance of selling at what the shareholders think the company is worth. The best way to get around this is to think about your exit plans long before you plan to retire and to build a management team that is competent. It is very likely the seller will need to convince the buyer that there is a team in place that can sustain the business after the sale.

Do you have a diversified customer and supplier base?
Oftentimes, management becomes so engrossed in growing top line sales that they forget about the importance of customer and supplier diversification. While growing companies may initially experience a concentration, if it continues to the time of sale, the value of a mature business will be negatively affected. Even if it is a financially stable customer, the looming possibility that they could change suppliers for any reason will factor into pricing. When preparing for the sale, look at your supplier and customer bases, and decipher if any one supplier or customer accounts for more than 50% of revenue or inventory. If so, be prepared to discuss why and what would prevent the customer from moving to a competitor or how you would deal with a supplier going out of business or raising prices.

What is the state of your financial information? Is there staff in place that can easily and accurately put together requested information?
It is amazing how often business owners run their business without accurate or adequate financial information. In the sale process, everything in the financial statements needs to be explained. If your financial statements are being prepared to reduce your tax liability you need to have the supporting documentation of the expenses that are being applied. These expenses are regularly added back to reconstructed earnings and can increase the selling price. If you don’t have strong financial systems in place or are unable to explain the statements buyers will start to worry about the reliability of the information being provided, which can and often will impact the purchase price.

Is the timing right for a sale?
If sales and earnings are trending in a positive direction and are projected to continue, the answer is yes. If the company is coming off a down year, even if it is explainable, then the answer may be no. A financial model showing the trailing earnings or taking an average of last three years sales may help to achieve the sale price you desire, but sometimes it just might not be the right time to sell. That financial model will also help you evaluate expenses to

increase operating results, manage cash flow and improve your balance sheet – all items that increase the value of your business. Evaluate your situation. If you can hold off on a sale for even 6 months you may be able to demonstrate that the last year was an aberration.

If you would like to discuss the prospect of a sale of your business or the business of one of your clients, and could use some insight from experienced professionals, please feel free to contact a Mid-States representative at your convenience.

Understanding and Using EBITDA

The non-GAAP term EBITDA has come into common use, often supplanting Net Income or Operating Cash Flow. It is defined as **E**arnings **B**efore **I**nterest **T**axes (income) **D**epreciation and **A**mortization. Simply stated, it is Net Operating Income, a GAAP term, after adding back depreciation and amortization.

EBITDA has found favor because it is an easily understood approximation of cash flow for a stable business. It is a simplified, easy to understand starting point in the valuation process. But the widespread practice of using a multiple of it as the sole criteria in valuing a business is unwarranted. There are a number of other considerations that are important in the valuation process. The value of the balance sheet assets as well as the debt structure must be considered. The current value of discounted future cash flows, as well as the quality of current or future management should be taken into account. The market value of underperforming or non-core assets which can be sold is another factor.

A commonly used method of valuing a business involves some variation of a multiple of EBITDA. As previously stated, this is an oversimplification of the Valuation process as it ignores the strengths or weaknesses of the Balance Sheet. The value of the Balance Sheet assets, including receivables, inventory, plant and equipment, and intellectual property, as well as the role of both funded and non-funded debt weigh heavily in the Valuation process. Additionally, there are other financial measurement tools that often point to a higher or lower Valuation than that provided by a measurement based only on an EBITDA multiple.

Have you ever wondered why some of the largest Private Equity Funds pay very high multiples of EBITDA? These firms are well managed and do not overpay for the companies they buy. As part of their due diligence process, they prepare a projection of earning operating under their management and frequently use a multiple of discounted future cash flows to value the business.

A former partner of mine successfully used a process of valuing the various segments of a business. Assets, usually plants or equipment, that were not earning acceptable returns, or operations (product lines, divisions or subsidiaries) that were not key to the core business, were slated for sale. He acquired these businesses based on a multiple of EBITDA which undervalued the worth of the various pieces. He proceeded to sell the underperforming or non-core assets or operations and used the sale proceeds to repay debt or increase liquidity. He has become extraordinarily wealthy employing this process. Additionally, he inserted management that could grow volumes 5 and 10 times in a fairly short time. He then sold the businesses, usually to Private Equity Funds.

Which brings us to the next and perhaps the most important ingredient: Management. We know of Private Equity Funds that actively recruit successful CEOs with the express purpose of finding and buying a company for them to manage. Acquiring a business to match the talents and experience of an already successful CEO can also bring very dramatic operating results.

Successful entrepreneurs often build competent management teams. But in their heart of hearts, they often believe that no one can run the business as well as they can! That is simply not true, and if you remove the founder, the managers can sometimes move the company forward in dramatic fashion. This is particularly true if they have access to the capital and management support that a Family Office or PE fund can bring to bear.

Please understand that we are not discounting the use of a multiple of EBITDA as part of the Valuation process. Rather we are stating it is not the sole determinant in valuing a closely held business enterprise. It may be worth more or less.

This is not a comprehensive discussion of Business Valuation. Volumes have been written regarding Valuing a Closely Held Company. The Internal Revenue Service has its own formulas used for estate, gift, and income tax purposes.

If you are considering selling or buying a business and would like to discuss valuation, please call us.

At Mid-States Advisors, we are passionate about helping middle market business owners and their companies succeed. Our firm has over 100 years of collective experience on our team and a success track record that is stellar.

We are respected and well-known to a vast network of business professionals.

We hope you will contact us to learn more about how we can assist your company or client. Please do not hesitate to call or email a Mid-States representative for a free discussion. Here are the direct phone numbers and emails for our four primary principals (yes, we answer our own phones):

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