August 2017

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5 Tall Tales Entrepreneurs Tell to Bolster Business Value

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I have worked in the corporate finance industry for a number of years now. I can't say that I've seen it all, but I have noticed some reoccurring themes over the years. One thing I see (or, more specifically, hear) a lot are tall tales from entrepreneurs who are trying to support their business value. I cringe every time I hear these justifications, but social niceties have prevented me from saying what's really on my mind... Until now.

It's time for a bit of tough love. Here are the five stories I hear from business owners over and over again to support an unrealistically high value for their business.

Tale No.1 — I believe the value of our business is $10 million because our assets are worth $8 million. Oh, by the way, our EBITDA is $1.5 million.

The value of a business is based on future cash flows, not asset value — unless you think you will get a higher value from liquidating your assets (which might be the case). Based on EBITDA, the implied valuation multiple of $1.5 million on a $10 million purchase price is 6.7x. Unless this business has an unbelievable competitive advantage, and it's expecting to grow at a significant rate year over year, this value expectation of $10 million is pure fantasy — and it borders on lunacy.

Also, I just don't believe a business' asset value is $8 million unless the owner can provide a detailed listing of every asset in the business supported by a conservative independent appraisal. It's not you, it's me; I'm skeptical. So are most buyers.

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Third, and most importantly, how does the return on assets (ROA) compare to the industry? If your ROA is trailing your peers, it makes one question the company's operational efficiency. My advice to the business owner in these cases? Right-size the business by liquidating under-used assets. We can talk again when ROA looks a little more attractive.

Tale No.2 — I have been working in this business for 30 years and we have built a tremendous amount of goodwill.

A business is not a fine wine — it doesn't necessarily get more valuable with age. Just because this business has been around for years doesn't mean it has any commercial goodwill. At all. Goodwill is not granted with longevity, it is earned by building a business with systems and processes that allow for sustainable future earning potential.

Although most people see goodwill as a fuzzy, feel-good concept, there are ways to support its value. Here's what I would ask this entrepreneur:

- Can you demonstrate customer satisfaction based on customer surveys or statistics on attrition?
- Can you show sales performance indicators that prove your projected revenues are achievable?
- Can you measure brand value with a documented margin advantage over your competitors?

These are examples of how a business owner can prove goodwill. If there are no cold, hard facts around these and other performance measures, there's no point even talking about how much goodwill the business might have.

Tale No.3 — Why would we sell at 4X EBITDA? If we stay in business for another four years, we get that value plus we still own the business.

If you sit down and do the math, it's easy to see that this is just wrong. If a business generating $3 million in EBITDA is offered a purchase price of $12 million, that suggests a 4X multiple. The after-tax proceeds received on the sale, assuming a 25% tax rate, are $9 million.

Now let's say the owner keeps the business. The net present value of $3 million EBITDA earned over the next four years, assuming a 25% tax rate and WACC of 15%, is $6.4 million. Compare these two numbers: Unless this business is growing at a good clip, this argument to keep it just doesn't add up.

Yes, you will still own your business at the end of four years, but if you sell it today, you'll have a bag full of cash and carry none of the risks that come with holding the business. This is exactly why people sell their businesses.

This tale reveals for me and any potential buyer that the business owner is not really serious about selling the business.

Tale No.4 — Our business is unique and we have no real competitors.

Sorry, not possible. You'd be hard pressed to do a Google search on a company and not come up with other companies that provide similar products and services. If what you have is worth selling, it would be crazy to think you're the only one in the game.

The wise thing to do is create a competitive analysis of your industry and other participants in the marketplace. Thoughtfully evaluate how you are different from your competitors and define your value proposition. It is also important to identify areas where you can get better and develop action plans to address any noted weaknesses.

Tale No.5 — We can easily double our revenues and profits, but we choose not to.

Go ahead and get to it. Call me if and when it happens. Do you seriously think any buyer would pay a premium for doing all the work to build your business value in future years? Come on, man!

That said, a projection that has a realistic plan on how to grow the business would be welcomed by any buyer. Have detailed assumptions and an understanding of any additional resources (capital equipment, people, etc.) that are needed to achieve the results. Buyers, investors and banks not only assess the validity of the projections, but also the past track record of the company in preparing credible projections. If your value expectations are significantly based on future growth, proving that you are damn good at forecasting results for your business is a must.

A Wake-Up Call for Entrepreneurs

I love entrepreneurship. I work hard each and every day growing my own business so that I will have the privilege to call myself an entrepreneur. This is not about trying to be negative, but being realistic. It's why I send this stern message to my peers: Stop telling stories and find the facts! Otherwise, you're likely to get your reality check at the negotiating table when a potential buyer hears your tall tales and laughs you out of the room.

John Carvalho is president and founder of Stone Oak Capital Inc., an M&A advisory firm. For more than a decade, John has served his clients on numerous valuation, acquisition and divestiture assignments in a wide variety of industries, but is now focused on companies in oil & gas service, manufacturing and other industrial service sectors. John holds the Corporate Finance designation, is a Chartered Business Valuator and a Chartered Accountant. He is also a member of the Association for Corporate Growth (ACG).