

Creating value and preparing your company for sale

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Key Takeaways:

- Value creation should begin years before a sale and include increasing profitability as well as reducing risks
- During the sale of a business, there are several common issues sellers may face during the due diligence process.
- By growing value and addressing key items in advance, you may help increase the likelihood of closing a transaction on favorable terms.

What this may mean for you:

- If you are considering selling your business, increasing its value and properly preparing it for sale may help improve your terms and help streamline the process by helping reduce the potential of the unnecessary delays and expense

In our experience, many business owners feel they run a well-operated business and are often focused on maximizing the revenue or perhaps profits. While it is important to increase a business' value, buyers invariably find problems during the due diligence process. The odds of everything lining up perfectly without proper grooming and preparation is typically close to zero. Owners need to focus on creating value in their business but also carefully prepare it for sale.

Value Creation

Buyers tend to value a business based on its current cash flow, potential for growth, and risks to future cashflows. An owner can create value in their company by increasing its current and future profitability but also by lowering the risks in their business.

Most owners are primarily focused on growing their business which often means growing revenue. While revenue is important, profits and cashflow will be the basis of valuation in a sale. Focusing on higher margin business may not always grow revenue the fastest but it may help increase profits and generally result in higher valuations. Sellers need to have the discipline and reporting acumen to review their customer base and business segmentation to understand which areas deserve focus and which may deserve less resources. The effect is two-fold when buyers begin their assessment looking at revenue and cashflow which is usually characterized by Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). A seller benefits from higher EBITDA, but the multiple placed on it usually grows with EBITDA margin (EBITDA/Revenue). A very low margin but still incrementally profitable business could actually lower a business' value.

It is important to build forecasting and reporting capabilities and develop the discipline to review business to build value as you prepare for a sale. The exercise of forecasting can force a company to assess growth opportunities through new or expanded customer relationships and market segments. Being able to articulate the source of future growth (both organic and through acquisitions) is essential in creating value for a future owner...as well as its current owner.

Besides increasing EBITDA, it is important to understand the risks to future cashflows. Competitive pressures and concentrations in customers, suppliers or even employee responsibilities represent significant risks to most buyers. Similarly, exposure to commodity pricing, economic/industry cycle, interest rates and other external forces are often hard to mitigate. Finding supplier alternatives is often relatively easy compared to the time and effort it takes to diversify one's customer base. Growing smaller customers and finding new ones (ideally in different sectors of the economy) is hard. Risk also comes from competitors and changing market conditions, so companies need to understand the landscape, innovate, adapt and create barriers to entry where possible. Business owners need to take a sober look at the risks to their business to determine which can be mitigated and then manage their value expectations for those they can't.

Perhaps the most common source of risk is the company's dependence on its owner. The owner often represents the single largest risk to the company and efforts to build a management team and de-centralize the owner can take many years. This effort can be critical for business valuation but also defines the transition alternatives available to the owner. It is often the hardest element of value creation, but it is usually the most important.

Preparing for sale

Business owners tend to ask, “what can improve the value of my business?” which is valid – but the better question **“Is your business saleable in its current state?”**

Once you have created value, there are things you can do to help prepare and potentially avoid common pitfalls and better position your business for a successful sale. Preparing your company today can mean a shorter sale process, thereby increasing the likelihood of a successful sale

Common issues and tips

While every business has unique dynamics, there are a few common issues that arise during the sale process.

Topic	Common issues	Tip
1. Financial records and documentation	<ul style="list-style-type: none">Not having books and records in saleable condition may extend due diligence and negatively impact the sales process.	<ul style="list-style-type: none">Remove any owner items included on the financials that are not business relatedConsider having your financials reviewed by a CPAConsider engaging a CPA to prepare a Quality of Earnings reportOrganize your corporate books and records so they are current and easily accessible.Documenting key roles and procedures may improve the salability of the business.
2. Working capital	<ul style="list-style-type: none">Non-cash net working capital not at proper level relative to revenue.Excess inventory or receivables do not usually increase the sales price.	<ul style="list-style-type: none">Manage inventory and receivables as efficiently as possible to demonstrate the company can function leanly.
3. Concentrations (customers and suppliers)	<ul style="list-style-type: none">In our experience, customer concentrations above 20-30% may make selling more difficult.Supplier concentrations can be a concern if the loss of a supplier could significantly impair your ability to deliver your product.	<ul style="list-style-type: none">Consider diversifying your customer base rather than growing your relationship with your biggest customerConsider developing relationships with alternative suppliers
4. Management Team	<ul style="list-style-type: none">Your management team can impact the type of buyer and salability of the company.Are they committed to the company?Do you have sufficient bench strength?	<ul style="list-style-type: none">Make sure you have the right team in place, and they are incentivized to stay with the new owner
5. Financial performance	<ul style="list-style-type: none">Not meeting projections or declining financial performance is a common reason the sales process stalls.	<ul style="list-style-type: none">Don't start a sale process unless you are confident in your company's near-term financial performance

Lastly, make sure your CPA and attorney are up to the task. Confirm that they have experience with business sales. To illustrate the importance of an appropriate advisory team, consider the experience of a seller that discovers during the process that they should have charged sales tax for the last 10 years but their CPA had not advised them to do so. When the sale closed, the seller had to pay an amount equal to what the company owed in past due taxes plus interest and penalties. If your business has grown significantly since you hired your CPA or attorney, you may benefit from upgrading to professional advisors with subject matter expertise in business sale planning.

Preparing your business for sale

If you are considering selling your business in the next few years, begin getting your house in order. Being prepared helps you to start the sale process when your business may be in the best position to sell. Begin to build your advisory team now, including a CPA, attorney, and investment banker/business broker. To learn more, contact your advisor.

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