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How Saleable Is Your Business?

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Synopsis: Far too many business sale attempts fail. Estimates of the failure rate range from 50% to higher than 75% and tend to correlate inversely with the size of the business. Assessing the saleability of your business is an essential first step on the path to successfully realizing its value. It helps you objectively assess the likelihood that your business will be sold if you embark on the process and mitigate the risk of failure.

Read on for our views...

How Saleable is Your Business?

Your business is unique, and its saleability requires a unique, objective assessment. Ignoring this step is dangerous because attempting a sale and failing have heavy costs. There are eight attributes that drive the saleability and ultimately the value of your business:

1. ***Financial Performance:*** Has your revenue been stable? Do you have high margins? Is your business capital-intensive? How professional is your record-keeping?
2. ***Growth Potential:*** How likely is the business to grow? At what rate?
3. ***Cash Generation:*** Does your business require significant working capital? Does it consume cash when sales increase quickly?
4. ***Revenue Quality:*** What proportion and quality of your revenue is automatic and annuity-based? How frequently do your customers pay you?
5. ***Stakeholder Dependency***: How dependent is your business on any one employee? Customer? Supplier?
6. ***Competitive Position:*** How well-differentiated is your business from its competitors? Is your position defensible?
7. ***Customer Satisfaction:*** How likely are your customers to re-purchase from you? How likely are they to refer you?
8. ***Owner Dependence:*** How would your business perform if you were unexpectedly unable to work for three months? How many of your customers do you know on a first-name basis.

The remainder of this white paper will explore each of these considerations in more detail.

Financial Performance

The present value, or valuation of a business is often expressed as a multiple of current earnings, or more precisely EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). This is because the value realized by an acquirer is derived from the future profit stream of the business. The present value of a business is equal to the future profits that the business will generate, discounted by an annual rate consistent with the desired growth of the investment. This rate is referred to as the ‘discount factor’. Because of the risks involved in the acquisition of a private business, it is not uncommon for an acquirer to seek a discount factor of 15% on EBITDA for an acquisition. The following table illustrates the effect that a 15% discount rate has on the value of a business projecting $10,000,000 in EBITDA per year for the next ten years:

Table 1: Discounted cash flow model of a sample business with $10 million in EBITDA

($ Thousands)	Prior Year	Forecast Year 1	2	3	4	5	Terminal Value
Revenue	100,000	105,000	110,250	115,763	121,551	127,628	131,457
EBITDA	10,000	10,500	11,025	11,576	12,155	12,763	13,146
Less: Cash Taxes		(2,100)	(2,205)	(2,315)	(2,431)	(2,553)	(2,629)
Less: Capital Expenditures		(2,100)	(2,205)	(2,315)	(2,431)	(2,553)	(2,629)
Less: Changes in Non-Cash Working Capital		(500)	(525)	(551)	(579)	(608)	(383)
Unlevered Free Cash Flow		**5,800**	**6,090**	**6,395**	**6,714**	**7,050**	**7,505**
Terminal Growth Rate							*3.0%*
Terminal Value							**62,538**
Years to Cash Flow		0.5	1.5	2.5	3.5	4.5	5.0
Discount Rate		*15%*	*15%*	*15%*	*15%*	*15%*	*15%*
Discount Factor		0.9325	0.8109	0.7051	0.6131	0.5332	0.4972
PV of FCF		5,409	4,938	4,509	4,117	3,759	
PV of Terminal Value							31,092
Implied TEV	**53,823**						

Key assumptions:
EBITDA is 10% of revenue
Tax rate is 20% of EBITDA
Capital expenditure (Capex) is 2% of revenue
Net working capital is 10% of revenue
Revenue growth is 5% annually over the next five years, followed by 3% annually in perpetuity.

Notice that the present value of a business projected to bring in annual EBITDA of $10 million discounted at a rate of 15% is $53.8 million. This implies a 5.4x EBITDA multiple.

The price an investor is willing to pay for a business relates to how risky he or she perceives the future stream of profits to be: the riskier the investment, the higher the return an investor will demand. In general, acquirers of small businesses with low EBITDA tend to demand higher discount factors. This is because acquirers perceive small businesses as riskier than large businesses.

Most owners are familiar with the profit-increasing techniques specific to their business. From our experience, however, there are a few general techniques that a business owner can implement to

increase valuation, and ultimately saleability. First, ensure that the business profits are not diluted artificially because of the benefits realized by the owner (i.e. above-market salary). Additionally, it is essential for your business to have professional accounting and bookkeeping practices in place, as an acquirer will want to see historical financial statements validated by a third-party auditor. Speak with your accountant about conducting a verified audit if this is not routinely performed already.

Growth Potential

Businesses with high growth potential will typically achieve a higher valuation. Growth potential impacts the value an acquirer sees in a business in three ways:

1. **Synergies**: Acquirers are often driven to businesses based on their perception of potential synergies. Such synergies usually take three forms:
   a) ***Cost Synergies:*** With some businesses, there can be dramatic margin improvement in the business' revenues by rationalizing capacity. Doubling target EBITDA margins post-integration is not unusual.
   b) ***Distribution Synergies:*** Selling your current offerings through an acquirer's vast distribution channels, using your distribution channels to distribute a broader offering to your customers, or a combination of both can have a significant impact on the EBITDA your business generates in a strategic acquirer's hands.
   c) ***Working Capital Release:*** Inventory and AR reductions can release cash and reduce funding required, reducing the effective purchase price.
2. **Scalability**: The growth potential of your business is also determined by its scalability. Broadly speaking, there are two ways to scale a business:
   a) **Channel Leverage**: Channel leverage, sometimes called vertical extension, markets a new product or service to your existing clients. These new products are usually within a similar industry but occur either before or after on the supply chain for an existing product. For example, a kitchen appliance retailer may enter into the service and maintenance business for its products, offering these new services to existing clients. There are often many opportunities for channel leverage, and successful implementation can improve both the saleability of a business and the monetary value perceived by a potential acquirer.
   b) **Channel Extension**: Channel extension, sometimes called horizontal extension, markets an existing product or service to a new demographic. Channel extension is often achieved by expanding into other geographic, often international markets.

3. **Present Value Considerations:** Growth potential positively impacts valuation. In the present value calculation above, present-day EBITDA was $10 million, and only grew at a rate of 5% over the first five years. If revenues are expected to increase such that EBITDA grows at an annual rate of 15%, the present value becomes $74.1 million with the same 15% discount rate. This calculation is shown in the table below.

Table 2: Discounted cash flow model of a high-growth business with $10 million in EBITDA

	Prior	Forecast Year					Terminal
($ Thousands)	Year	1	2	3	4	5	Value
Revenue	100,000	115,000	132,250	152,088	174,901	201,136	207,170
EBITDA	10,000	11,500	13,225	15,209	17,490	20,114	20,717
Less: Cash Taxes		(2,300)	(2,645)	(3,042)	(3,498)	(4,023)	(4,143)
Less: Capital Expenditures		(2,300)	(2,645)	(3,042)	(3,498)	(4,023)	(4,143)
Less: Changes in Non-Cash Working Capital		(1,500)	(1,725)	(1,984)	(2,281)	(2,624)	(603)
Unlevered Free Cash Flow		**5,400**	**6,210**	**7,142**	**8,213**	**9,445**	**11,827**
Terminal Growth Rate							*3.0%*
Terminal Value							**98,557**
Years to Cash Flow		0.5	1.5	2.5	3.5	4.5	5.0
Discount Rate		*15%*	*15%*	*15%*	*15%*	*15%*	*15%*
Discount Factor		0.9325	0.8109	0.7051	0.6131	0.5332	0.4972
PV of FCF		5,036	5,036	5,036	5,036	5,036	
PV of Terminal Value							49,000
Implied TEV	**74,178**						

Key assumptions:
EBITDA is 10% of revenue
Tax rate is 20% of EBITDA
Capital expenditure (Capex) is 2% of revenue
Net working capital is 10% of revenue
Revenue growth is 15% annually over the next five years, followed by 3% annually in perpetuity

In the example above, a business expecting a 15% annual increase in EBITDA acquired at a discount factor of 15% represents an approximate 7.4x multiple on current EBITDA ($74.2 million/$10 million = 7.4x). In general, both the discount factor and the growth percentage are variable. The table below illustrates the relationship between valuation and discount factor and growth rate, expressed as a multiple of EBITDA.

Table 3: Sensitivity Analysis of EBITDA Multiple based on Revenue Growth and Discount Rate

		Revenue Growth				
		5.0%	*10.0%*	*15.0%*	*20.0%*	*25.0%*
Discount Rate	*10.0%*	9.2x	11.1x	13.3x	16.0x	19.0x
	12.5%	6.8x	8.1x	9.6x	11.3x	13.4x
	15.0%	5.4x	6.3x	7.4x	8.7x	10.2x
	17.5%	4.5x	5.2x	6.0x	7.0x	8.1x
	20.0%	3.8x	4.4x	5.1x	5.8x	6.7x

Table 4: Sensitivity Analysis of EBITDA Multiple based on Terminal Growth Rate and Discount Rate

		Terminal Growth Rate				
		2.0%	*2.5%*	*3.0%*	*3.5%*	*4.0%*
Discount Rate	*10.0%*	12.1x	12.6x	13.3x	14.1x	15.0x
	12.5%	9.0x	9.2x	9.6x	9.9x	10.3x
	15.0%	7.1x	7.2x	7.4x	7.6x	7.8x
	17.5%	5.8x	5.9x	6.0x	6.1x	6.3x
	20.0%	4.9x	5.0x	5.1x	5.1x	5.2x

Each of the remaining drivers of saleability is designed to either increase the EBITDA growth percentage of your business, or decrease the discount factor an acquirer will need to achieve. EBITDA growth can be achieved by raising revenues and/or cutting costs. The discount factor is a function of the perceived risk in your business' future profit stream, so anything that decreases the risk also lowers the discount factor.

Cash Generation

Aside from your business' revenue and growth potential, the nature of its cash generation also impacts the saleability. The Cash Generation section is concerned with how the cash flow, gross margin and profitability of your business contribute to the overall value. The less working capital required to operate the business, the more saleable your business is. If your business consumes cash as sales increase, an acquirer will be forced to inject cash into the business as it grows, which can result in a lower saleability.

Table 5: Discounted cash flow model of a highly capital-intensive growth business with $10 million in EBITDA

($ Thousands)	Prior Year	Forecast Year 1	2	3	4	5	Terminal Value
Revenue	100,000	115,000	32,250	152,088	174,901	201,136	207,170
EBITDA	10,000	11,500	13,225	15,209	17,490	20,114	20,717
Less: Cash Taxes		(2,300)	(2,645)	(3,042)	(3,498)	(4,023)	(4,143)
Less: Capital Expenditures		(3,450)	(3,968)	(4,563)	(5,247)	(6,034)	(6,215)
Less: Changes in Non-Cash Working Capital		(3,000)	(3,450)	(3,967)	(4,563)	(5,247)	(1,207)
Unlevered Free Cash Flow		**2,750**	**3,163**	**3,637**	**4,182**	**4,810**	**9,152**
Terminal Growth Rate							*3.0%*
Terminal Value							**76,264**
Years to Cash Flow		0.5	1.5	2.5	3.5	4.5	5.0
Discount Rate		*15%*	*15%*	*15%*	*15%*	*15%*	*15%*
Discount Factor		0.9325	0.8109	0.7051	0.6131	0.5332	0.4972
PV of FCF		2,564	2,564	2,564	2,564	2,564	
PV of Terminal Value							37,917
Implied TEV	**50,739**						

Key assumptions:
EBITDA is 10% of revenue
Tax rate is 20% of EBITDA
Capital expenditure (Capex) is 3% of revenue
Net working capital is 20% of revenue
Revenue growth is 15% annually over the next five years, followed by 3% annually in perpetuity.

Note the dramatic impact on the valuation. In this high working capital example, the enterprise value is $50.7 million (or 5.1x EBITDA) compared to the high-growth scenario in Table 2, which is otherwise identical, where the enterprise value is $74.2 million (7.4x EBITDA).

Alternatively, if your business can accumulate cash as it grows, it will be much more saleable. Revising the cash-flow cycle of your business can make a significant impact. Receiving a (larger) percentage of payment upfront while delaying payment on expenses can alleviate the working capital constraints for your business. If you charge your customers in installments, consider shifting more of the fee to earlier payments. If a significant portion of your operating expenses is from third-party vendors, see if you can extend those payment deadlines to free up more cash. Whichever method

works for your business, it is ideal to have these changes implemented prior to the sale engagement to ensure that the financial statements for your business reflect this change.

Another possibility is to change your revenue model to a subscription-based system for recurring customers to increase your inbound cash flow before expenses are accrued. This approach will be discussed further in the next section on Revenue Quality.

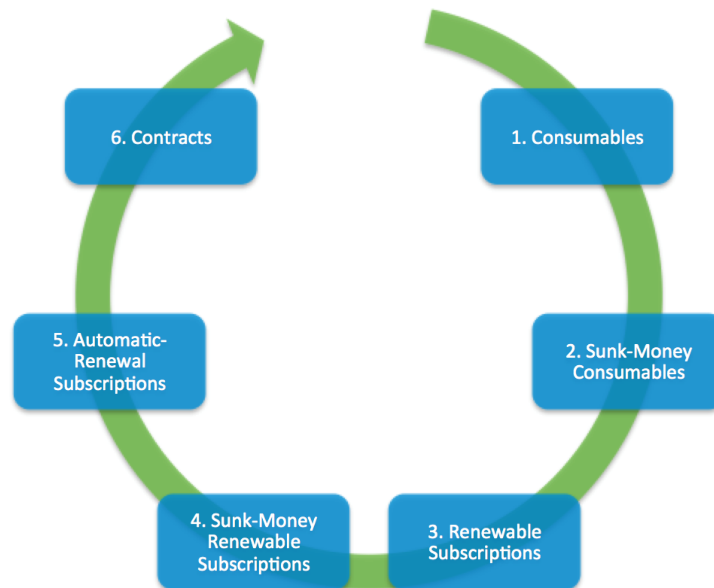
Revenue Quality

Your business will be more valuable, and ultimately more saleable if you can show that the revenue stream will remain stable in the future. Recurring revenue eliminates some of the risks regarding the future success and financial sustainability of your business. This results in acquirers accepting a lower discount factor for their investment.

There are different types of revenue models. On one end of the spectrum are consumables: food, soap, toothpaste, and most office supplies. There is little motivation for a customer to repurchase the product from the same company, aside from brand loyalty. A business that relies heavily on this type of revenue model carries more risk.

On the opposite end of the spectrum, revenue models based on contractual payments are secure and low-risk options. For example, most cell phone service providers charge a monthly fee that the customer opts into with a contract. Acquirers view these sorts of revenue models favourably. The greater the proportion of revenue that is contractual or automatic, the more saleable your business.

Figure 1: Model of Recurring Revenue



There are six models of recurring revenue. In order of least to most desirable, these are: consumables, sunk-money consumables, renewable subscriptions, sunk-money renewable subscriptions, automatic-renewal subscriptions, and contracts. Acquirers place more value in revenue that is most likely to recur.

Stakeholder Dependency

Businesses are more saleable when they are not overly reliant on any one employee, customer or supplier. Mature companies are independent and relatively self-sufficient. When a business is too reliant on any one particular person, it increases the associated risk. A potential acquirer would be wary to enter a company that could be severely impacted by one individual compared to a more diversified company.

If most of your company's revenue comes from one customer or client, the business is less saleable. Again, the concern is the risk associated with a discontinued sale mandate from your key customer. A single investment is riskier than a diversified portfolio of investments. Likewise, there is a greater risk when a business relies predominantly on one source of revenue. A business is generally more saleable when it services a vast pool of customers and clients.

Additionally, saleable businesses are not reliant on any one employee. If your business is too reliant on any one employee, there is a significant added risk. Indispensable employees may choose to leave, and often at the worst time. For example, key employees may threaten to leave when they learn about an upcoming sale or demand a piece of the pie. Moreover, they can put the business at a disadvantage when it comes to negotiating salary. If an acquirer perceives this as a risk, it will impact the saleability of your business. Although not the focus of this section, note that the business can also be overly reliant on you, the business owner, as will be discussed in greater depth in the section on Owner Dependence.

Although it may seem strange, acquirers will also look at your company's suppliers. If your current procurement policies rely predominantly on one supplier, look around for others. If you have the flexibility of incorporating additional suppliers, consider it as a pre-sale strategy. Otherwise, keep an updated document of alternate suppliers for your most common inventory purchases, along with their costs and fees. Reassure potential acquirers that your company would not be adversely affected if your current supplier ceased its operations.

Competitive Position

Competitive advantage will help alleviate some of the risks an acquirer sees in your business. An inherent risk for any business is that a third party will outcompete and eventually disrupt the current business offerings.

Even in the absence of external disruptive innovation, competitive advantage can help your business maintain, or even grow its market share. Virtually all businesses become commoditized at some point. Nevertheless, it is important to retain some form of differentiation, regardless of the maturity of your specific industry. Attaching a particular service to your product or branding your service differently can give you a unique advantage in the marketplace. This differentiation will look attractive to a potential acquirer and increase the saleability of your business.

Customer Satisfaction

Customer satisfaction measures two important attributes – the likelihood of customers repurchasing, and the likelihood of customers referring your business to others. Acquirers will want to see objective measurements showing that your customers are happy interacting with and

purchasing from your business. If the average customer is unlikely to re-purchase from your business, an acquirer will be wary, and the value of your business will suffer.

Internal market research and customer surveys are useful tools to assess customer satisfaction. Since customer satisfaction is abstract, it can be hard to quantify customer satisfaction empirically. It is important to ensure that your business uses a reputable methodology in assessing customer satisfaction. Many acquirers will insist that you perform an accepted and reputable survey with your customers before investing in your business.

Owner Dependence

Mature businesses are not reliant on any one employee. This includes the business owner. Independent companies are significantly more saleable than those that depend on the owner for continued operational support.

In our experience, owner dependence is one of the greatest obstacles to overcome in achieving a saleable business. Business owners often enjoy interacting directly with their customers. Furthermore, when problems arise, it is usually a faster and more efficient use of resources to have the business owner oversee the solution. However, this tendency can have negative repercussions for the saleability of your business.

The following strategies can be used to decrease the reliance of your business on you as the owner, and improve its overall saleability:

1. **Develop Documented Protocols and Procedures**: Documented protocols and procedures are imperative for highlighting the maturity of the company's operations. If these protocols are used routinely in operations, an acquirer will see that the business is structured, reproducible, and not reliant on the owner.
2. **Train a Successor**: Prepare a key employee to assume the reigns once the business is sold. Instead of solving problems as they arise, discuss the issue with a key employee and ask what they would do if they were CEO. Training employees to competently run the business will make your transition out of the business much smoother.
3. **Go on Vacation**: Take some time away from the business. Many business owners who we have worked with have never been away from their business for an extended period. The best indication of a businesses' independence can only be measured accurately when it is truly operating independently. Address any concerns your employees may have before you leave and follow up with the interim manager when you return to work on developing their independence.

Distancing yourself from the business and decreasing its reliance on you as the owner will improve the value and ultimately the saleability of your business.

Conclusion

The process of selling a business involves a wide range of complex and critical decisions to be made as business owners aim to realize its maximum value as well as avoid the risk of failing to close the sale. While it is crucial to find the right buyer for your business, it is equally important to establish and implement business practices that drive the saleability of your business well before you start a sale process.

The quality and stability of your cash flow, as well as the sustainability of its growth, have a significant impact on the value of your business and its saleability. Moreover, the amount of working capital required to operate your business has an inverse relationship with the saleability of the business. It is therefore crucial to ensure that your business is not burning cash too quickly when there is a considerable increase in revenues. Aside from that, the highest valuation is usually achieved when a potential acquirer perceives a growth potential that can be realized through various types of synergies, as well as the scalability of your business, which can be highlighted through either channel leverage or channel extension.

Lastly, building and maintaining a unique competitive advantage, increasing customer retention, and assessing customer satisfaction are not only vital to your business as a going concern, but also dramatically increase the desirability of your business from an acquirer's perspective. Combined with the practices and procedures that help minimize stakeholder and owner dependency, these conclude the key factors that help determine whether your business is saleable, and if implemented correctly, result in unleashing and realizing its highest potential value.

About Valitas

Valitas Capital Partners is a relationship-focused merger & acquisition (M&A), corporate finance, and strategic advisory firm. We collaborate with ambitious owners of high-performing businesses with a potential value of at least $100 million, to discover, unleash, and realize their full business value potential.

Owners and their leadership teams rely on Valitas when they:

- Want to triple the value of their business in five years or less, but realize they lack the expertise and experience to achieve this alone.
- Want to sell their company now, assured they will look back after the transaction knowing they got the best possible outcome.
- Seek the peace of mind of taking some chips off the table now, to secure their family's financial future without giving up control or the future increased value in their business.
- Are anguished they had to say no to growth opportunities they worked so hard to create because their bank cannot keep up with the needs of their fast-growing business.
- Are frustrated at the lack of traction they are getting with their acquisition efforts, whether it is not seeing enough quality acquisition opportunities, or by wasting time and money coming up empty-handed in auctions.
- Are dispirited by the significant investments in expensive specialists, technology, systems, and financial modeling capabilities required to execute their audacious strategic goals.
- Are intrigued by the idea of selling their business to their management team over time but want to recognize the full value now, while getting their cash payments as quickly as possible.

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About the Author

Paris Aden, Partner

Paris Aden is the founding Partner of Valitas Capital Partners. Since 1994, he has been involved with more than 100 M&A transactions with an aggregate value exceeding $80 billion. He has advised clients at Morgan Stanley, Credit Suisse First Boston and RBC Capital Markets and has acted as a private equity investor at Clairvest Group where he served on portfolio company boards. Paris was also a co-founder of Alluence Capital Advisors, a mid-market M&A advisory boutique that focuses on cross-border transactions.

Paris is recognized as an expert in business strategy, M&A and corporate finance. Previous roles and speaking engagements include:

- Lecturer at the Stephen J.R. Smith School of Business at Queen's University in their Master of Finance (MFIN) program
- M&A subject matter expert for Moody's Analytics' Advanced Capital Markets Program for capital markets professionals
- Three-time expert panel moderator for the Toronto Business Transitions Forum
- TEC Canada "2018 Speaker of the Year" recipient
- Guest speaker for various industry and business leadership organizations

Paris formed Valitas to meet the unanswered needs of ambitious business owners seeking to:

- At least triple their business value in five years or less; or
- Are seeking an elite advisory boutique as their trusted advisor for their complex, mission-critical transactions.