For what it's worth

Why sellers should know the value of their company before an M&A event

INTERVIEWED BY ADAM BURROUGHS

There is a broad spectrum of concerns first-time sellers have as they approach an M&A event. Sellers wring their hands over the future of their employees and the legacy of the business, but it's the sale price that can be tough to accept.

"It's very common that sellers think their business is more valuable than what buyers will pay for it," says Sean R. Saari, a partner at Skoda Minotti. "Business owners invest so much of their time and money into their business that their estimate of its value is often inflated, and that can create challenges during a sale event."

Smart Business spoke with Saari about the importance of an accurate valuation in the M&A process.

What common misconceptions do sellers have regarding their company's value?

It's not uncommon that sellers, being so focused on running their business, aren't familiar with the valuation process. It's more than just applying a multiple to earnings before interest, taxes, depreciation and amortization (EBITDA). It takes time and careful analysis of the company's historical and projected financials to determine what multiples are appropriate to apply to that particular business in that specific industry. The end result may look simple, but it takes skill and experience to make sure the valuation assumptions are reliable.

Another common misconception is sellers believing they can retain the accounts receivable of their business without an adjustment to the purchase price. What they don't realize is that the offered purchase price typically assumes that a level of working capital will be delivered with the business that allows its operation to continue uninterrupted. If the accounts receivable balance is not acquired, the buyer has to make up for the cash flow shortfall during that collection period by investing more of their own money, and is rarely willing to do so without a corresponding reduction in the purchase price.

"Sellers know their business better than anyone else, but they're only one side of the equation. Considering both the buyer's and seller's perspectives offers a more accurate picture of the company's value."

What are the differences between enterprise value and equity value?

Equity value is the value of the ownership interest in the company or the pre-tax proceeds an owner gets in the event of a sale.

Enterprise value represents the value of the company as a whole, regardless of how it's financed. Enterprise value equals the equity value plus the interest-bearing debt minus cash. Many times investment bankers talk in terms of enterprise value.

It's common for manufacturers to fund working capital or fixed asset investments with debt, so there can be times when equity value and enterprise value differ significantly. Therefore, it is very important that sellers understand whether the values being discussed are equity values or enterprise values so that they can appropriately estimate their proceeds from a sale.

What are the differences between financial and strategic buyers?

Broadly, financial buyers aren't operating in the industry of the business they intend to purchase. They're buying for a stand-alone investment.

Strategic buyers are often competitors in the same industry as the company they're seeking to buy. They view the purchase as a growth opportunity. They may be willing to pay more for a business because they could potentially unlock synergies by combining the companies.

Whether pursuing a sale to a financial or strategic buyer, there's a benefit to having the right advisers to protect and manage the flow of the seller's confidential information throughout the marketing process. For example, there is more perceived risk with strategic buyers since information regarding customers, vendors, pricing and personnel may be shared. These risks are limited if the marketing process is managed correctly.

What are the factors that drive differences in value between buyers and sellers?

A disconnect is created if there is a difference in:

- The expected future cash flows.
- The perceived risk and required rate of return for the investment.

The value of any potential synergies and whether the buyer is willing to pay for some portion of those potential benefits may also drive differences in value.

Sellers know their business better than anyone else, but they're only one side of the equation. Considering both the buyer's and seller's perspectives offers a more accurate picture of the company's value. ●

e-book: For more information on valuing your business, download, *How a Company is Valued* at skodaminotti.com/value.

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