Buy, Hold or Sell: Maximizing the Value of Your Business

Part 2: Specific Valuation Techniques

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This article is the second of a two-part series about buy, hold, and sell decisions. The first article in the series provided several frameworks to help shareholders evaluate buy, hold, and sell decisions. This article focuses on case studies of businesses — tailored to industry-specific stories — and provides detailed analyses of how businesses might be valued using a simple multiple of earnings calculation. The authors of this article are two private equity executives who have bought and sold multiple companies within the compatible imaging supplies industry, and their perspective is informed by conversations with approximately 100 potential sellers and communications with more than 1,000 potential buyers.

Companies are valued using a variety of different techniques including, but not limited to: discounted cash flow analyses, multiples, comparables, asset values, and liquidation values. One of the simplest and most common methods to value a business is using a multiple of earnings, or EBITDA.

EBITDA stands for Earnings Before Interest, Taxes, Depreciation, and Amortization. EBITDA is used as a regular determinant for earnings because it does not account for interest, which is affected by the capital structure; taxes which vary substantially depending on the tax bracket, state, and other factors; and depreciation and amortization, which are affected by capital expenditures and assets. Although it has its limitations, EBITDA is perceived to be the purest form of cash flow on which to base the ultimate value of a business.

Many shareholders of small enterprises (sales less than $50 million) have some background on the earnings or EBITDA multiple valuation technique and are aware of "common multiples" ranging from 4X to 6X EBITDA, with 5X being the standard for "average" companies. Many of these same shareholders have a friend, associate, competitor, or a relative who "reportedly" received an 8X, 10X, or even 15X multiple offer for their company. In some cases, they even have "reportedly" sold their businesses for that amount. Rest assured, few companies are valued at such high multiples, for a number of reasons. The most significant reason companies in the lower middle market are not valued at 8X EBITDA is that it is hard, if not impossible, for a buyer to make any money on such a transaction and most organizations or entities with millions of dollars to use acquiring other companies did not acquire their millions of dollars by overpaying on prior deals. Buyers complete their first set of deals because they create compelling offerings for sellers. Buyers complete their remaining transactions because they create compelling offerings for sellers and, more importantly, provide returns to their investors.

Structurally, earnings multiples are governed by the sources of funds for

the acquisition. Specifically, banks provide debt, private equity firms provide equity (as their name implies), and selling shareholders resolve the gap between what the market will offer and the value agreed upon by the buyers and sellers. Banks, which are federally regulated, cannot provide debt beyond certain levels. Private equity firms, which are governed by their agreements with their limited partners, cannot provide equity that is not expected to achieve certain returns, typically 30 to 50 percent. (Smaller deals, defined as deals with less than $100 million of total value, require higher returns because, by nature, they are more risky.) Most importantly, sellers will be challenged to resolve a significant gap (seller note, earn-out, etc.) because the business itself cannot afford it.

Figure 1: Why Five Times?

The financial rationale for upper limits on purchase prices

Capital Structure

	Valuation	Capital Structure		%-age	Assumptions
Revenues	$ 10.00	Equity	$ 4.00	40%	Typical amount of equity in a deal
EBITDA	$ 2.00	Senior Debt	$ 4.00	40%	5-year term, straight line amortization
Multiple	5.00	Seller Debt	$ 2.00	20%	5-year term, straight line amortization
Value	$ 10.00	Total	$10.00		

Cash Flows

	2008	2009	2010	2011	2012	Assumptions
Revenues	$ 10.00	$ 10.00	$ 10.00	$ 10.00	$ 10.00	Constant revenues
EBITDA	$ 2.00	$ 2.00	$ 2.00	$ 2.00	$ 2.00	Constant EBITDA
Depreciation & Amortization	$ 0.53	$ 0.53	$ 0.53	$ 0.53	$ 0.53	$8MM goodwill, 15-year amortization
Interest	$ 0.54	$ 0.42	$ 0.30	$ 0.18	$ 0.06	10% interest rate
Profit Before Taxes	$ 0.93	$ 1.05	$ 1.17	$ 1.29	$ 1.41	
Taxes	$ 0.42	$ 0.47	$ 0.53	$ 0.58	$ 0.63	45% tax rate
Profit After Taxes	$ 0.51	$ 0.58	$ 0.64	$ 0.71	$ 0.77	
Available Cash	$ 1.04	$ 1.11	$ 1.18	$ 1.24	$ 1.31	Add back D&A
Principal Payments	$ 1.20	$ 1.20	$ 1.20	$ 1.20	$ 1.20	Payments on loans - senior and seller
Available Cash	$ (0.16)	$ (0.09)	$ (0.02)	$ 0.04	$ 0.11	
Cumulative Cash Flow	$ (0.16)	$ (0.25)	$ (0.27)	$ (0.23)	$ (0.13)	

Equity Returns

	2008	2009	2010	2011	2012	Assumptions
Multiple	5.00	5.00	5.00	5.00	5.00	
Enterprise Value	$ 10.00	$ 10.00	$ 10.00	$ 10.00	$ 10.00	EBITDA X Multiple
Outstanding Debt	$ 4.80	$ 3.60	$ 2.40	$ 1.20	$ -	5-year straight line amortization
Equity Value	$ 5.20	$ 6.40	$ 7.60	$ 8.80	$ 10.00	
Return	30%	26%	24%	22%	20%	Equity Rate of Return
Required Value	$ 5.40	$ 7.29	$ 9.84	$ 13.29	$ 17.94	Value Assuming Minimum 35% Annual Return
Amount Under Value	$ 0.20	$ 0.89	$ 2.24	$ 4.49	$ 7.94	Gap between required and actual

Figure 1, titled "Why Five Times?," provides a financial rationale for an upper limit on purchase-price multiples. The chart is broken into three sections:

- Capital structure — the enterprise value and the financial structure for a transition
- Cash flows — analysis of the available cash generated by the business post-transaction
- Equity returns — analysis of the equity contribution and the prospective returns for the equity investors

Each of these sections provides a different component of the story as to why five times is, in many instances, an overpriced multiple.

In the "Capital Structure" section, the first column labeled "Valuation" shows the revenues of the firm at $10 million, the EBITDA of the firm at $2 million, the multiple of EBITDA at 5X, and the total value at $10 million ($2 million in EBITDA x 5). The second column, also labeled "Capital Structure," shows how the buyer is financing the $10 million purchase, in this instance with $4 million of equity, $4 million of senior debt (from a bank), and $2 million of seller debt (from the selling shareholders). The senior debt and the seller debt are both assumed to have five-year terms with a straight-line amortization (very standard for the market), which means they will be paid back in equal increments over a five-year period of time.

The second section of Figure 1, labeled "Cash Flows," depicts the forecasted revenues and EBITDA of the business over the next five years. It is assumed, in this scenario, that the business maintains its profits but neither grows nor shrinks its earnings. As most shareholders know, five years of constant performance is relatively rare. Clearly, businesses that grow in earnings will increase the available cash, and businesses that shrink in earnings will decrease the available cash. The section then displays the various outflows of cash from the business including depreciation and amortization, interest, and taxes. The amortization assumes an $8 million goodwill (the difference between the asset value and the purchase price), which amortizes, for tax purposes, over 15 years. The amortization is a non-cash charge, so it is added back to the available cash flows. Interest is assumed to be 10 percent, which is roughly market interest. And taxes are assumed to be 45 percent, which is amongst the highest federal and state tax rates. After taxes, in 2008, the business generated $0.51 million of profit. This number increases to $0.77 million by 2012, solely as a result of decreasing interest payments on declining debt levels — as the debt is paid back, the interest payments decrease. As mentioned above, the amortization is added back to the business because it is a non-cash charge. So, in 2008, the business has $1.04 million in available cash. Unfortunately, the business must pay $1.2 million each year to pay off all of the debt in five years ($6 million of debt divided by five years is $1.2 million per year). As a result, the business has a negative cash flow of $160,000. As can be seen, the negative cash flow remains until 2011,

when the business is cash flow positive. However, cumulative cash flows have the entire business being in a negative cash position over a five-year period. In summary, a business that does not grow cannot pay back 3X its EBITDA in debt ($6 million of debt on $2 million of EBITDA) over five years . . . for this reason, most senior banks are only willing (or allowed) to finance 2X EBITDA (at a maximum level) in an acquisition. Clearly, in a situation in which the earnings of the business decline over five years, the business would be in a more severely negative cash position.

The third and final section of the chart, labeled "Equity Returns," depicts both the returns generated by this acquisition as well as the returns necessary for an equity investor to get the "approval" of its limited partners to finance a transaction. The returns generated by this acquisition are calculated by taking the enterprise value — assumed to be $10 million over the life of the investment (5 x $2 million of EBITDA) — less the outstanding debt. The resulting number is the equity value, which is the fourth row from the top of this section. The return is determined based upon the initial equity contribution of $4 million valued at $5.2 million in 2008, $6.4 million in 2009, etc. In 2007, the equity return is 30 percent and by 2012, the equity return has deteriorated to 20 percent. (Returns go down over time because the straight line de-leveraging of the entity does not equal the compounding effect of returns.) At a 20 percent IRR in five years, where the value is 2.5X the amount initially contributed, a transaction will most likely not be completed for a private equity firm, because the gain is too modest. The required value row (second from the bottom) depicts what the equity value needs to be in order to achieve a 35 percent IRR. By 2012, the actual equity value is almost $8 million under the required equity value. Private equity firms require a 35 percent IRR because of the high degree of risk in a transaction. If the base is 35 percent investors presume the actual result will be 20 percent.

So, for the reasons listed above, a company that is projected to remain flat that is valued at 5X EBITDA with 60 percent of the cash down at close will be unable to meet its debt obligations and will generate unacceptable returns for private equity firms. Shareholders can postulate the necessary EBITDA growth rates for a business to command a premium beyond 5X its historic EBITDA. So, the next time you hear about an 8X, 10X, or more transaction, you may feel tempted to ask how the business could support such a capital structure, or how the buyer could justify paying such a price. Most businesses, unless they are growing at 50 percent or more per year, will go bankrupt post-transaction if the purchase price is that high.

Case studies

Valuing a business can be an extraordinarily complex task because it involves projecting the future earnings of the business with incomplete and inaccurate information. Public companies, particularly large public companies, as previously discussed, receive substantial coverage on valuation. Small, private companies receive no coverage. Public companies trade at significantly higher multiples for the following reasons:

1) Equity investments are liquid and can be removed at any time; the ability to increase and decrease positions at any point has substantial value

2) Large, public companies have less risk of failure; as a result, shareholders are assuming substantially less risk when they make their investments

3) Public companies provide visibility and controls governing their performance (Sarbanes-Oxley); this creates a premium for value

Figure 2, "Multiples of Public Companies," provides information on several very large companies (GE, IBM, and Wal-Mart), some OEMs within the imaging supplies industry (HP, Lexmark, Xerox, Global Imaging,

Figure 2: Multiples for Public Companies

		Revenue	EBITDA	Equity Value	Equity Market Value to EBITDA (EBITDA Multiple)	Multiple to Sales
General	General Electric	$ 163.00	$ 34.82	$ 384.00	11.03	2.36
	IBM	$ 91.00	$ 16.85	$ 153.00	9.08	1.68
	Wal-Mart	$ 348.00	$ 25.96	$ 205.00	7.90	0.59
	Berkshire Hathaway	$ 98.00	$ 25.87	$168.00	6.49	1.71
	Microsoft	$ 44	$17.60	$287.48	16.33	6.49
Industry Specific	HP	$ 91.00	$ 9.85	$ 123.00	12.49	1.35
	Lexmark	$ 5.10	$ 0.62	$ 4.85	7.77	0.95
	Xerox	$ 15.90	$ 1.77	$ 18.05	10.19	1.14
	Global Imaging*	$ 1.00	$ 0.14	$ 1.50	10.56	1.50
	IKON	$ 4.20	$ 0.27	$ 1.81	6.78	0.43
	Danka	$ 1.12	$ (0.01)	$ 0.06	NA	0.05
Wholesale Manufacturer	Turbon Group	$ 145.00	$ 8.70	$ 33.00	3.79	0.23

* Robert Baird, analyst report, 2007.

Ikon, and Danka), and the single wholesale manufacturer within the compatible supplies industry that is public (Turbon). The companies have multiples of EBITDA that range from a low of 3.79 for Turbon to a high of 16.33 for Microsoft, one of the most profitable companies in the world. HP, the largest technology company in the world, has an EBITDA multiple of 12.49. Wal-Mart, the second largest company in the world, has an EBITDA multiple of 7.90. And GE, one of the most successful companies in the world, has an EBITDA multiple of 11.03. (Long-term liabilities and debt levels may affect the valuations of certain businesses, but the figures are directionally correct.)

To note, the company specifically within the compatible imaging supplies industry, Turbon Group, with limited historic growth and modest margins, trades at a 3.79 multiple to EBITDA. The company is amongst the top 5 largest compatible toner wholesale manufacturers in the world. Furthermore, given these multiples, shareholders of small, privately-held companies must make a compelling case, based upon the comparable multiples of the aforementioned entities, in order to garner of multiple valuation higher than 3X to 5X.

The series of case studies that follows provides more detailed financial arguments for the multiple valuations of companies with certain performance levels. The purpose of the case studies is to provide readers with a series of fictional business situations that typify scenarios in which business owners might actually find themselves. The case studies have been tailored, by design, to the compatible supplies industry. Each case has a beginning, middle, and end, and each case tells a "transaction" story.

Figure 3: Strategic Case Study 1

Healthy, growing modest retail service and supplies business

Valuing A Profitable, Growing Business

	2004	2005	2006	2007	2008	2009
Revenues	$ 3.00	$ 4.00	$ 5.00	$ 6.00	$ 7.00	$ 8.00
Revenue Growth Rate		33%	25%	20%	17%	14%
Gross Profit	$ 0.90	$ 1.28	$ 1.70	$ 2.16	$ 2.52	$ 2.88
Gross Margin	30%	32%	34%	36%	36%	36%
SG&A	$ 0.60	$ 0.88	$ 1.20	$ 1.56	$ 1.82	$ 2.08
OE	20%	22%	24%	26%	26%	26%
EBITDA	$ 0.3	$ 0.4	$ 0.5	$ 0.6	$ 0.7	$ 0.8
EBITDA %-age	10%	10%	10%	10%	10%	10%
EBITDA Growth Rate		33%	25%	20%	17%	14%

Higher Multiple	6X	50%	**Percentage Cash At Close**
Total value	$3.00	$ 1.50	**Total Cash At Close**

Case Study No. 1 (Figure 3): Healthy, growing modest retail service and supplies business

Case study No. 1 is a profitable, growing retail business. Imagine the company is owned by a husband and wife team — each with different backgrounds. He has an engineering degree with 10 years of experience as a Xerox technician. She has a sales background and an outgoing personality. The company sells hardware, services, and supplies. The culture is quite familial, with monthly pizza lunches, quarterly family fun nights, and regular acknowledgment of employee accomplishments. Revenues grew from $3 million to $5 million from 2004 to 2006, and are projected to grow an additional $1 million a year for the next three years, resulting in an $8 million revenues business. Gross margins increase over time as the retail outfit benefits from economics of scale, reduced component costs from Future Graphics and Oasis, and improved direct core sourcing efforts. Offsetting these gains are increased investments in SG&A, from 24 percent of sales in 2006 to 26 percent of sales in 2007, which holds constant through 2009. The company is clearly investing in employees and sales, and its investments are paying off in revenue growth. Throughout this time period, the EBITDA percentage or sales stays steady at 10 percent, and the EBITDA value grows at the same rate as revenues (33 percent growth in 2005, 25 percent in 2006, and 14 percent in 2009). In 2006, the husband and wife decide to take some of the risk off the table and take advantage of the current capital gains tax rates. The couple identifies a boutique private equity firm with specific industry knowledge. Together, the private equity group and the couple value the business at 6X the current EBITDA of $500,000, which both parties acknowledge is a generous valuation given the size of the business. The couple expresses an interest in working for several more years before they retire, and agreed to a

moderately aggressive growth trajectory for the business, adding $100,000 per year to the EBITDA. Given their confidence in the future earning potential of their business and their desire to work with a disciplined partner to assist them in achieving their goals, they decide to maintain the maximum amount of equity the private equity firm will allow them to maintain, which is 49 percent, and financed a portion of the deal with a seller note. The note is necessary given the small size of their company, the limited available debt financing for such transactions, and the high multiple. Over the next four years, the couple successfully grows their business at a higher rate than they had projected, enjoys the lower capital gains tax rate on their seller note (which increases their annual cash flow) and sells the enterprise for $7 million, which nets the couple $3.5 million, more than they ever expected.

Figure 4: Strategic Case Study 2

Growing wholesale business with aggressive investment to achieve growth

Valuing An Aggressively Growing Business #1

	2004	2005	2006	2007	2008	2009
Revenues	$ 15.00	$ 20.00	$ 27.50	$ 40.00	$ 52.00	$ 65.00
Revenue Growth Rate		33%	38%	45%	30%	25%
Gross Profit	$ 5.25	$ 6.60	$ 8.53	$ 12.40	$ 16.12	$ 20.15
Gross Margin	35%	33%	31%	31%	31%	31%
SG&A	$ 4.50	$ 6.00	$ 8.25	$ 10.00	$ 13.00	$ 16.25
OE	30%	30%	30%	25%	25%	25%
EBITDA	$ 0.8	$ 0.6	$ 0.3	$ 2.4	$ 3.1	$ 3.9
EBITDA %-age	5%	3%	1%	6%	6%	6%
EBITDA Growth Rate		-20%	-54%	773%	30%	25%

Higher Multiple	20X	15%	Percentage Cash At Close
Total value	$5.50	$ 0.83	Total Cash At Close

Case Study No. 2 (Figure 4): Growing wholesale business with aggressive investment to achieve growth

Case study No. 2 is the first of several aggressively growing businesses we'll examine. Imagine the company is owned by two friends, like brothers, who have wanted to go into business together since middle school. The company started in a garage, and the two friends toiled away in relative obscurity for the first three years, until the business took off with a life of its own in 2000 and grew to an impressive $15 million by 2004. The business appeared on the Inc. 500 list for two years in a row. The two friends captured some large accounts (private label retail chains), invested additional capital into hiring a bigger and more aggressive sales force, and moved to a much larger facility to handle the increased production volume. The investments paid off, and, in 2006, revenues approached $30 million, almost twice the annual revenues in 2004. Unfortunately, in part as a result of the intense and disciplined focus on growth, gross margins declined and, in 2006, caught up to the operating expenses. The friends discover, much to their surprise, the EBITDA has actually declined over the three years, even though the business is substantially larger. Even worse, the growth required increased financing, which they received from vendors, resulting in liabilities that were greater than the assets. The business was technically insolvent. In 2006, they realize that, while they are great salesmen and operational managers, they do not understand finance well and need assistance not merely managing the books (which a CFO could provide), but also in making the right strategic decisions and maintaining discipline in implementing those decisions. After speaking with a few banks, the friends receive feedback that no bank is willing to provide debt to the company given the rapidly declining earnings. Devastated and surprised, the friends look for alternate sources of capital and find a niche private equity firm that only makes growth capital investments. After a few months of due diligence, a deal is done. The friends receive an incredible multiple for the business — 20X (which, no surprise, they share with everyone they know . . . and even some golf acquaintances at the country club that they do not know so well). However, in order to maintain a compelling equity stake in their business, aka their baby, the friends commit to increasing EBITDA levels by 40X in three years and receive almost no cash at close. A few well-intentioned advisors counseled the friends that they were giving away the business for nothing, but the friends acknowledged without earnings and mounting debt, the business, at that point in time, was not worth much and would be worth even less if they continued their current path.

Having conducted a thorough due diligence in the industry, the private equity firm realizes that within three years, achieving a 6 percent EBITDA on $65 million in sales, is not inconsistent with industry standards for this business model. The private equity firm expects to contribute discipline, structure, analytic resources, and financial reviews to the company, a seemingly simple yet incredibly important task. The friends will continue to contribute their expertise to the company.

The friends realize that they have conceded some value that they might have otherwise received by keeping 100 percent of the business, but they also realize that they have increased the probability of success and expedited its time frame. The friends, who really enjoy the business, recognized that more of the same could jeopardize the entire business. By the middle of 2007, the business is on track to achieve $2.4 million of EBITDA. Roughly speaking, this values the business at $12 million, already twice the value of the business when the transaction took place. The friends are pleased with their decision and look forward to the day in three years when they will cash out for an anticipated $10 million.

Figure 5: Strategic Case Study 3

Business grows aggressively with substantial SG&A investments

Valuing An Aggressively Growing Business #2

	2002	2003	2004	2005	2006	2007	2008	2009
Revenues	$ 10.00	$ 20.00	$ 30.00	$ 30.00	$ 25.00	$ 20.00	$ 25.00	$ 30.00
Revenue Growth Rate				200%	-17%	-20%	25%	20%
Gross Profit	$ 5.00	$ 10.00	$ 15.00	$ 15.00	$ 12.50	$ 10.00	$ 12.50	$ 15.00
Gross Margin	50%	50%	50%	50%	50%	50%	50%	50%
SG&A	$ 4.70	$ 9.70	$ 14.70	$ 12.00	$ 7.50	$ 6.00	$ 7.50	$ 9.00
OE	47%	49%	49%	40%	30%	30%	30%	30%
EBITDA	$ 0.3	$ 0.3	$ 0.3	$ 3.0	$ 5.0	$ 4.0	$ 5.0	$ 6.0
EBITDA %-age	3%	2%	1%	10%	20%	20%	20%	20%
EBITDA Growth Rate		0%	0%	900%	67%	-20%	25%	20%

Case Study No. 3 (Figure 5): Business grows aggressively with substantial SG&A investments

Case study No. 3 is a hyper-growth Internet retail business that buys ads on Yahoo, Google, and a host of other premier Web sites. The company is owned by a young, extremely aggressive college dropout, who intends to create the next Amazon.com. The Internet retailer is his third startup — the other two businesses have been dissolved after a few years of revenue growth followed by poor cash management and eventual pursuit by vendors, all of which has now been resolved. The entrepreneur hits the ground running, and his business grows to $10 million in three years, adds another $10 million from 2002 to 2003, and then grows yet another $10 million in 2004. In 2005, the founder learns the very unfortunate news that his best friend since middle school has just been killed in Iraq. In an emotional response, the founder loses interest in his business and decides to stop growing the company and milk the business for cash by dramatically reducing the SG&A investments. In the first year of pursuing this "cash maximization" strategy, the EBITDA of the business jumps to $3.0 million and there are no lost revenues. The entrepreneur assumes, given the historic growth rate of the business, that the company is now worth 7X or 8X EBITDA, approximately $21 to $24 million. He maintains the "cash maximization" strategy through 2006, and his reduced investments in the business results in an additional $2.0 million of EBITDA, so that in 2006, on $25 million in revenues, the business yields $5.0 million of EBITDA — not too shabby. Reflecting back on his lost friend, the owner decides to sell the business and is looking for a mere $25 to $30 million from a strategic acquirer or a private equity firm.

A number of different prospective acquirers evaluate the business with mixed results. Potential buyers are primarily concerned with the declining revenues and the lack of continued investments in SG&A, which have been reduced from 50 to 30 percent of sales. Due to these two factors, the owner receives several offers for 2X to 3X EBITDA ($10 to $15 million), all of which have a substantial shared risk component, at which he takes umbrage, particularly given his projections that the revenues will increase and the EBITDA percentage of 20 percent will be maintained after he is gone. Potential buyers are not convinced by his story, given that the business has never grown AND maintained a high EBITDA margins simultaneously. Even at a 2x to 3x multiple, buyers must assume the business can generate EBITA and not decline.

In the end, the seller realizes that he may make substantially more capital by

milking the business over the next 4 to 5 years rather than exiting today at a lower multiple. He decides to do exactly this and becomes a successful and very happy multimillionaire … without selling his company.

Case Study No. 4 (Figure 6): Wholesale business with a healthy history and a dramatic decline

Case study No. 4 is a modest-sized regional wholesaler, which, having been founded in 1992, reached respectable revenues of $5 million after 10 years of business. In 2002, the company managed to land a very large, first-tier customer, who contributed $2 million of additional business in 2003, $5 million in 2004 (while the rest of the business declined by 20 percent), and a whopping $9 million in 2006. The manager-owner focused a good portion of his attention on this prized account, a $2 billion national retailer and catalog company. The owner provided his customer with frequent sales training events for its sales executives, four-color private-label boxes, and a state-of-the art, fully customized B2B Web site to assist with ordering. In 2005, he signed a five-year contract with this massive customer and took his wife on a one-month tour of Africa and the Middle East to celebrate. Having watched his business take 10 years to get to $5 million in revenues and $500,000 in EBITDA, the owner had a lot to celebrate as his personal income had almost tripled in three short years. Upon his return, he was honored by a local business networking group as one of the fastest growing companies in the state.

Unfortunately, in 2006, due to the general consolidation of the office and electronics supplies distribution industries, his large customer struggled financially and sold with almost no notice to an international competitor.

Figure 6: Strategic Case Study 4

Wholesale business with healthy history and a dramatic decline

Valuing A Declining Business

	2002	2003	2004	2005	2006	2007	2008	2009
Revenues	$ 5.00	$ 7.00	$ 9.00	$ 12.00	$ 3.00	$ 8.00	$ 13.00	$ 20.00
Revenue Growth Rate				140%	-75%	167%	63%	54%
Gross Profit	$ 1.75	$ 2.45	$ 3.15	$ 4.20	$ 0.60	$ 2.40	$ 4.55	$ 7.00
Gross Margin	35%	35%	35%	35%	20%	30%	35%	35%
SG&A	$ 1.25	$ 1.75	$ 2.25	$ 3.00	$ 2.25	$ 1.60	$ 3.25	$ 5.00
OE	25%	25%	25%	25%	75%	20%	25%	25%
EBITDA	$ 0.5	$ 0.7	$ 0.9	$ 1.2	$ (1.7)	$ 0.8	$ 1.3	$ 2.0
EBITDA %-age	10%	10%	10%	10%	-55%	10%	10%	10%
EBITDA Growth Rate		40%	29%	140%	-238%	-148%	63%	54%

The acquiring entity had a pre-existing $20 million private label compatible toner business that was sourced globally from two separate vendors. As part of its ongoing "global sourcing/supplier consolidation initiative," the acquirer canceled the existing five-year contract with the regional wholesaler and transferred all of the business excluding five hard-to-get SKUs over to its current vendors, two $200+ million companies with international operations and internal core sourcing capabilities. Overnight, the wholesaler lost 75 percent of his revenues and dropped from $12 million in revenues to $3 million in revenues.

In addition to a rapid reduction in gross profits and a significant overhead burden, the owner realized he would have to make some hard personal decisions about how to fund the losses he was sure to experience for the remainder of the year. Overcoming his own personal preferences, he made the hard decision and laid off 60 percent of his labor force and a good portion of his senior management team. Despite cutting his overhead expenses by more than 70 percent in two months, he still had to pay out severance, rent, and a substantial tax burden from his profits the prior year.

So, given his poor luck, the owner decided to approach several of the larger wholesalers within the industry to evaluate opportunities for some type of merger arrangement. The owner stood convinced, given his prior success, that the business would not merely return to its prior levels, but exceed them significantly within another three years. He projected 6X to 7X growth by 2009 to $20 million in revenues. EBITDA would, over the same time period, return to its former percentage and equal $2.0 million annually.

Generally, in this type of situation, financial acquirers will be unable to contemplate a purchase because a) the business has experienced such volatility, b) the balance sheet, most likely, is upside down, and c) the overall size of the entity is just too small. Strategic acquirers may be interested, but the largest acquirers will be challenged to

spend much time on such a small deal (less than 2 percent of revenue appreciation for the largest players) while mid-sized or other small strategic acquirers will be hard-pressed to present any cash up front or close a transaction in which the seller feels as if he is being appropriately compensated for his business. Sellers in this type of situation want a valuation that appropriately rewards them for the past success of the business or captures the potential upside for the future, yet buyers cannot "afford" to pay for history or an uncertain future. Even less beneficial for the seller is the fact that, in a consolidating environment such as the wholesale toner remanufacturing industry, his potential for landing future large contracts will very much be based upon his ability to be a low-cost producer. So, the best resolution for the manager-owner of this business is to grow his business back to its historic levels and look for an exit when that has been completed. Alternatively, a buyer might try to strike a deal with a healthy "tail" or earn-out provision that gives the seller the advantage of low-cost purchasing and a shared economic incentive if the business does return to its historic levels. However, many buyers might ask the question of what value the seller brings in such a scenario, aside from the role of sales rep.

Business owners would be well advised to understand the risks of customer concentration and the impact that it can have on valuation. While a large customer can contribute to the growth of a strong business, it creates a risk profile that can make any type of sale a challenge, even if the concentrated customer has a long-term contract in place.

Ultimately, the owner decided to hold off on a transaction until he had grown the business' value back to a meaningful number.

Case Study No. 5 (Figure 7): Wholesaler with gradually deteriorating history, many efforts to grow and cut costs, not enough to produce economic value at organization historically

Similar to the prior case study, case study No. 5 is a fictional national wholesaler that has experienced impressive growth from 2002 through 2004. The company, in addition to building one of the largest outbound telemarketing sales teams in the industry (almost 100 account executives, which increased operating expenses), also began competing for national retail and distribution accounts with the largest remanufacturers in the world and was forced to offer lower prices (which dropped gross margins) and back-end incentive programs (which the company chose to run through SG&A). The company founder strongly believed these investments were essential for his three-letter acronym national wholesale business to increase share and take advantage of the benefits of economies of scale. Unfortunately, the investments increased at a faster pace than the profits of the business, so, while the company grew from $60 to $100 million in revenues, over the same period of time it shrank from $3.6 million in EBITDA to a $2.0 million negative EBITDA.

Having observed two recent industry transactions — one company that was acquired by an OEM valued at 1.5X sales and another one acquired by a strategic player looking to get into the industry who paid just over 1.0X sales — the owner presumed his business, too, being in the general strategic and industry vicinity to the other two acquisitions, would be valued somewhere between 1.0X to 1.5X sales. Furthermore, he believed that with a few modest changes, such as eliminating his poorest performing sales reps, reducing marketing expenses, and pushing back on a few of his customers to eliminate the aggressive back-end programs, he might be able to reduce his SG&A costs substantially and swing $7 million of additional profit out of his business. In addition to making these adjustments to his cost structure, the owner reflected

Figure 7: Strategic Case Study 5

Wholesaler with gradually deteriorating history, many efforts to grow and cut costs — not enough to produce economic value at organization historically

Valuing A Stagnant Business With Declining EBITDA

	2002	2003	2004	2005	2006	2007	2008	2009
Revenues	$ 60.00	$ 80.00	$ 100.00	$ 100.00	$ 100.00	$ 100.00	$ 120.00	$ 150.00
Revenue Growth Rate		33%	25%	0%	0%	0%	20%	25%
Gross Profit	$ 21.60	$ 28.00	$ 34.00	$ 33.00	$ 32.00	$ 30.00	$ 36.00	$ 45.00
Gross Margin	36%	35%	34%	33%	32%	30%	30%	30%
SG&A	$ 18.00	$ 24.80	$ 32.00	$ 33.00	$ 34.00	$ 25.00	$ 30.00	$ 37.50
OE	30%	31%	32%	33%	34%	25%	25%	25%
EBITDA	$ 3.6	$ 3.2	$ 2.0	$ -	$ (2.0)	$ 5.0	$ 6.0	$ 7.5
EBITDA %-age	6%	4%	2%	0%	-2%	5%	5%	5%
EBITDA Growth Rate		-11%	-37%	-100%		-350%	20%	25%

back on the growth from 2002 to 2004 and felt confident that he could also grow his business in the future by at least 50 percent. He viewed the growth as the easy part of the equation, given the challenges that his competitors faced (a quality problem or two among competitors, excessive growth not managed well, and a bankruptcy here or there).

By connecting with local and industry contacts, the owner was put in touch with several prospective acquirers, both strategic and financial. Financial acquirers took the position that the business was in a turnaround position, with four successive years of declining earnings. Two turnaround firms offered the owner relatively similar offers with a small amount of cash at close combined with a significant future upside, if he hit his targets. The owner felt the two offers were offensive — he would not cede control of his business for scraps. Another private equity firm was willing to offer more cash at close, as they intended to use his business as a platform for an industry consolidation. However, they had an entire management team they wanted to put in place and he would retain no equity upside. He turned down this offer as well.

In contrast, the strategic acquirers were already in the business and represented slightly larger organizations with higher overall earnings but much less growth. In general, they had a more conservative culture. The owner enjoyed the meetings with his competitors and felt comfortable they could come to an agreement — that is until the subject of valuation came up. As the owner advocated a 1.0X to 1.5X sales price, the strategic acquirers independently did an analysis on how much it would cost to capture the customers of the national wholesaler and realized that for a small fraction of $100 to $150 million, say $20 to $30 million, they could probably steal two or three major accounts. Granted, for the strategic players, it might take an extra year or two, but to save $80 to $120 million, it was certainly worth it.

… sellers look at a company based on what they have invested into it, while buyers look at a company based on what they will get out of it.

In the end, the owner decided not to sell the business, after having invested six months of his time and a lot of money with accountants, lawyers, and bankers. He believed, quite thoroughly, that he was getting short-changed throughout the process and that everyone was looking to “steal” his business from him. From his vantage point, financial companies only cared about the numbers, without thinking of the other “strategic” value he brought. And, according to him, strategic companies were crooks that were trying to steal his company. Despite the efforts of his bankers and accountants to counsel him and offer some suggestions, he was determined to create a company that would be sold at 1.0X to 1.5X sales. He resolved to spend another three years getting his company up to $7.5 million in EBITDA and then try to sell it again for $150 million, a 20X multiple. His advisors wished him luck … and suggested that he work with a different group of advisors next time.

Assessing the case studies

These five case studies represent typical, yet highly generalized, situations in which businesses can find themselves. While tailored specifically to compatible imaging supply industry stories, these case studies could easily be replicated in any industry with suppliers, vendors, customers, revenues, profits, sellers, and buyers. The purpose of the case studies is to highlight sample financial trajectories and articulate the points of view, looking at these trajectories, of both the buyer and the seller. Oftentimes, the views vary dramatically as sellers look at a company based on what they have invested into it, while buyers look at a company based on what they will get out of it. Some call this optimism versus pessimism, a glass half-full versus a glass half-empty, or any other name. However, it is this fundamentally different viewpoint that stands in the way of deals getting done.

The situations described are quite common for entrepreneurs and independent shareholders of businesses that founded their company. Many times, across numerous industries, owners perceive that hard work, revenue growth, and significant investments made in the company should compute into something of value. The counterargument to this basic premise is whether the capital invested in the entity will generate a sufficient return to motivate the capital providers. The financial markets have an efficient and relatively honest method of assessing the value of a business overall based on, as referenced earlier, a few key factors:

▶ What is the current scale of earnings and the projected likelihood of future earnings? Will this earnings base grow or decline? — Low earnings tend to suggest low value. Earnings that have not had a history of prior growth are also worth less than earnings that are increasing.

▶ What is the return on investment for the capital put into the business? What thresholds are required by the capital providers to be allocated this amount of funds? If the capital put into the business will not generate the necessary returns required by the capital providers, they probably will not put in the capital.

▶ What is uniquely different about the business model that would cause someone to pay an excessive amount for it? In the commodity compatible imaging supplies industry, which has some 2,500 retail players and 50+ wholesalers, differentiation can be challenging.

▶ In examining comparable purchases, how similar is your business model to the business model of the company with the high valuation? Might the acquirer have required something that the acquired company was uniquely positioned to provide? Unless your business has some unique component to it, which makes it a one-of-a-kind business, it will be rare to achieve a premium valuation for the business.

Unfortunately, for both buyers and sellers of businesses, personal perceptions can often come in the way of opportunities for tremendous value creation. Sellers are criticized for becoming overly focused on multiples, cash at close, and speed of closing. Buyers are criticized for not honoring earn-out agreements, establishing a cumbersome due diligence process, and nickel-and-diming agreements. Oftentimes, the most value can be created by a joint acknowledgement of the current state of the business combined with a mutual set of objectives and shared action plan for the future objectives for the business.

Conclusion

The compatible imaging supplies industry is clearly in transition from a high-growth, high-profit and widely fragmented structure to a slower-growth, lower-profit and consolidated structure. Companies within the industry and across the value chain will find themselves in one of a variety of different situations, such as:

- A highly profitable, fast-growing printer services and supplies business
- An aggressively growing wholesale business with limited cash flows
- A hyper-growth Internet retailer with substantial SG&A investments, that was then milked for cash

… or a number of other scenarios

And, as we have said throughout both installments of this article, while there are millions of imaginable scenarios, shareholders still have three basic options:

- Buy
- Hold
- Sell

Ultimately, shareholders' personal preferences and lifestyle decisions will help determine how they evaluate the options, and which one they choose. Non-financial influences, such as the shareholder's risk aversion and ambitions, will be powerful motivators. The drive to create value is often generated from a desire to be successful, not from a lucky creation of a profitable business model.

Of course, economic factors will also play a big role in decisions regarding a business. Savvy shareholders should be watchful of industry patterns, such as the overwhelming evidence supporting the current consolidation of players within the imaging supply market. The prevalence of buyers in the market, or a finite number of sellers, will also create conditions that are favorable to transactions. There are many, many opportunities for shareholders of small and large companies to create value in the compatible imaging supplies industry. Effectively making the buy-hold-sell decision is one of the, if not the, most important, decision for creating and capturing this value. Ⓡ

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