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12 THINGS TO CONSIDER BEFORE SELLING YOUR BUSINESS

BUSINESS OPTICS

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Many people are so caught up in building their business that they do not really consider what their long-term goals and strategies are. Very few people ever consider an exit strategy when they are in the throes of starting up and running their company.

Yet, planning an exit strategy is an essential part of the start-up process. Not only will there come a day when you will need to walk away from your business but ultimately, when you know what you want this exit to look like, you are much more likely to make the right, informed decisions along the way.

So, what are the steps you must take to get your business shipshape and ready for your planned exit?

When you are preparing to sell a business, the first rule is to give yourself plenty of time. I advise my clients to prepare at least five years in advance, as there tends to be a gap between what the business owner wants to achieve and what someone is prepared to pay.

Here are my twelve steps to get you thinking and planning:

01

Have a sensible valuation

"Focus on the value to be transferred rather than on the price to be received."

We first need to determine the type of investor we are talking to. This can be done by asking a series of questions during the initial telephone conversation at the start of the acquisition process. It is important to remember that, despite the numerous ways of valuing a business, in essence, a business is sold based upon profit, or more accurately the cash flow generated by the business.

Every business, industry and investor is different and the levels of risk vs reward will vary as well. By preparing your business correctly, you will be able to decrease the risk and increase the reward for the investor, making your business a more desirable proposition compared with the thousands of other companies for sale, as well as improving the chances of a smooth sale. You may need the help of an experienced person who knows how to put these steps in place and can advertise your business to the widest possible market. As a serial entrepreneur with experience in acquisitions and business strategy, this is my area of expertise and I would be pleased to work with you to prepare your business for market.

By seeking the support of a professional as early in the process as possible, you will be able to learn the reasons for the current state of your financials, what can be done to increase performance and what changes are needed to maximise the value of your business.

02

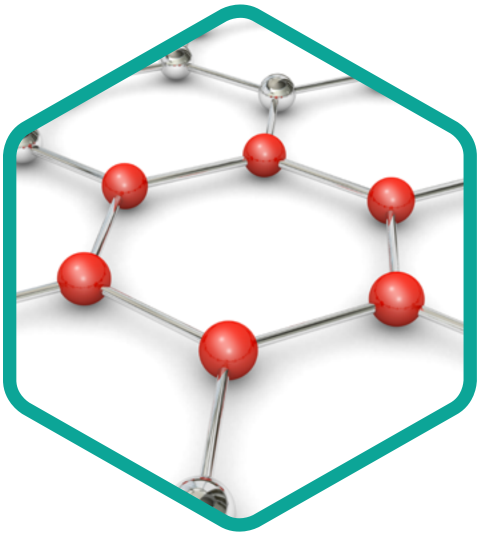
Understand the deal structure

"Do not be so dependent on banks and lending houses to get your business sold."

The value of any market is reinforced by the availability of finance. This availability creates leverage; however, it also makes any market vulnerable when it is dependent on this finance.

Take the housing market for example. If a property investor has £25,000 cash, they could leverage this cash to purchase an investment property worth £100,000. The mortgage payments are £2,160 per annum and they proceed to let it for an annual rental income of £7,200. The investor makes a return of 20% on their own money, whilst using the bank's money to finance most of the deal.

Without finance from the bank, this would be a more difficult process and would cause the property investor to either seek alternative ways of financing the deal or to simply wait until they have enough capital saved to fund the purchase themselves.



When it comes to acquisitions, many business investors want to apply the same principles. The difficulty is that obtaining finance is much harder because the business value is based upon both tangible assets (buildings, machinery, etc.) and intangible assets (goodwill, trademarks, etc).

Most commercial banks will lend against tangible assets - the things you can touch, such as plant, machinery, buildings, stock, etc.

What a lot of business owners do not realise is that banks will rarely, if ever, finance intangible assets. Intangible assets consist of things such as goodwill, which is based upon reputation, a loyal client base, brand, etc. Although these are all benefits to a company, they are classed as intangible assets because their value cannot be precisely quantified. This value is the difference between the agreed purchase price and the value of the tangible assets.

The biggest mistake I see business owners make is when they believe that businesses are all sold for cash on completion and subsequently turn down good offers where the deal structure differs from this belief. This is particularly true of businesses that have little to no tangible assets, such as accountancy practices or estate and lettings agents. It is extremely difficult to obtain commercial finance on these types of acquisition and therefore, purchases will rely heavily on deal structures that use alternative ways of financing the acquisition: one such method is vendor financing.

Vendor financing is where you, the business owner, fund most (sometimes all) of the acquisition.

Vendor financing is immensely powerful as it offers a lot of advantages:

- Knowing that the business owner will offer vendor financing gives banks confidence when financing the tangible assets. It shows confidence in the business.
- Vendor financing gives the investor confidence in the business as it acts as a guarantee that there is nothing untoward concerning the business. I would personally be wary of a seller who would not be open to this method of sale in some form. If a business owner will not 'put their money where their mouth is', it may raise a concern that they could be hiding something.
- It provides the business owner with a regular source of income for the duration of the deal.
- If the investor is unsuccessful at running the company, the business owner could take back control, however this is not obligatory.
- Vendor financing could offer some tax advantages.

There are also disadvantages to this sort of deal structure in that the investor may default on payments or run the business into the ground. There is a chance you will not receive all the money owed to you. This carries a risk but, by using a good acquisition solicitor, you can mitigate some of this risk. Take a step back for a second and look at all the alternatives:

- You could wait for the perfect buyer who will give you most of the money on completion. Should you do this, there is an extremely high risk of never selling your business.
- By taking this very calculated risk you can sell your business and move on. You could even have a clause in the Sale and Purchase Agreement stating that the investor must take out an insurance policy that will cover at least 80% of the finance you are providing; therefore, should the investor default in any way, the insurance policy would pay out and you would get most of your money.

Business owners who are closed to the concept of vendor financing can end up with their business on the market for years and, inevitably, profit and performance will fall. This reduces the value of the business and along with it, the range of options available to the business owner.

When you sell your business, it is advantageous to consider all options, including vendor financing. There are many ways to structure a deal and the key is to be prepared for as many situations as possible. As you manage your business, remember to always keep an eye on your debts and if you need to take on new leases or loans, ensure these would be transferrable to a new owner, as this will make the sale process a lot easier.

We need to be prepared for extraordinary situations. At the start of the Covid-19 pandemic, financing disappeared overnight and any financing that remained available was extremely expensive. This immediately changed the acquisition landscape and made business owners acutely aware of the need to move to a model that is not reliant on banks or external entities to secure acquisitions. In making this shift, vendors will not be so dependent on banks and lending houses to help get their business sold.

03

Future potential does not count

"Future prospects are only possibilities until someone brings them to reality."

"There is a new housing development being built a few miles away and my company has been made the preferred estate agent."

The business owner trying to inflate the valuation of the business beyond the profit-based value is a common occurrence. Here, they attempt to use impending industry changes or potential new opportunities to increase the price. Please know that, although these benefits could make the business more attractive to an investor and therefore more saleable, they will not affect the price because any future opportunities will still have to be realised by the new investor and so it is they who should benefit.

Alternatively, you could wait until an opportunity comes to fruition so that you can realise the rewards before selling the business.

It is always a good idea to keep a list of all future growth prospects and new business possibilities. If you can seize these to grow your sales and profits now, this will increase the value of your business prior to marketing.

04

Focus on profit and cash flow

"Turnover is vanity - Profit is Sanity - Cash flow is Reality"

It makes little difference if your business generates sales of £1,000,000 or £10,000 with no profits. If no profits are made, your business is not worth anything, unless you have something a Strategic Investor is willing to pay for. All your energy and focus should be on profitability, particularly maximizing profits while minimizing the assets and operating capital required, whilst converting those profits into cash in the bank.

At least once each year, it is a worthwhile exercise to evaluate your business. To stop providing unprofitable products or services, do an expense audit or perform a customer analysis. You can find more information about carrying out a customer analysis at www.businessoptics.co.uk/resources.

05

Be careful of Add-Backs

"Don't mix business with pleasure."

If you have ever employed the services of a business broker, you may have heard the terms 'add-backs', 'normalizing' or 'recasting' of financial statements. In other words, they will ask you to list all the items, with their corresponding amounts, that you personally take out of the business that are not related to the operating of the business. For the purposes of generating a valuation, these costs are then added back to the bottom line, potentially taking a loss-making company to one that appears to be making a healthy profit.

To give you an example: A business owner I met spent £25,000 per year on mobile phone contracts for his family, trips and meals out for 'business' purposes, as well as other personal expenses that he put through the business. He then added those amounts back when carrying out his valuation as these expenses would not be part of the company when he sold. I get a little nervous when I see things like this because you are not supposed to use company money in this way, but many do.

When purchasing a company, I will only take into consideration those expenses I can easily see have nothing to do with the business once I take the company over: things that leave a clear paper trail, like mobile phone bills, or payments to non-working directors. Any other 'expenses' that cannot be verified, will not take into consideration.

Should there be any commercial financing available, the add-backs would not be taken into consideration. This is another reason why add-backs are not really a good idea.

It is best to keep things simple and keep clean management accounts. This will help you achieve a higher value for the business and will enable the investor to obtain further finance, should that be available.

06

Only the recent past counts

"History may increase saleability but does not necessarily increase value."

Due the Covid-19 pandemic this statement is never more true than today. Anything that happened pre-Covid-19 or after any other global or economic event will be taken with a pinch of salt. Investors will only consider the most recent past but may place a weighted average on previous years, depending on the type of business. However, few will look at anything over 3-5 years in the past.

Although having a long history and a compelling back-story will help make the business more saleable, it will not impact the actual valuation, which is based upon profit and the ability to turn that profit into cash.

Remember that history does not add to the valuation; focus on profits and cash flow!

Post Covid-19 – A New Metric

I firmly believe that investors will look at a new metric, one that I term 'Bounce Back'. Bounce Back is a metric showing how quickly a company who has gone through this pandemic is able to get back to pre Covid-19 trading levels.

My suggestion to every business owner looking to exit in the next 10 years is to create a COVID-19 report, showing how the company performed before the pandemic, what happened during that period and the post-pandemic trading levels directly afterwards. How quickly the business is able to return to pre Covid-19 trading levels will give an indication of the company's resilience. This could have an impact on valuation or the saleability of the business.

07

Creating balance creates value

"Do not put all your eggs in one basket."

There are three areas that will cause an imbalance to your business, increasing the risk and decreasing the value:

- Employees
- Customers
- Suppliers

Employees

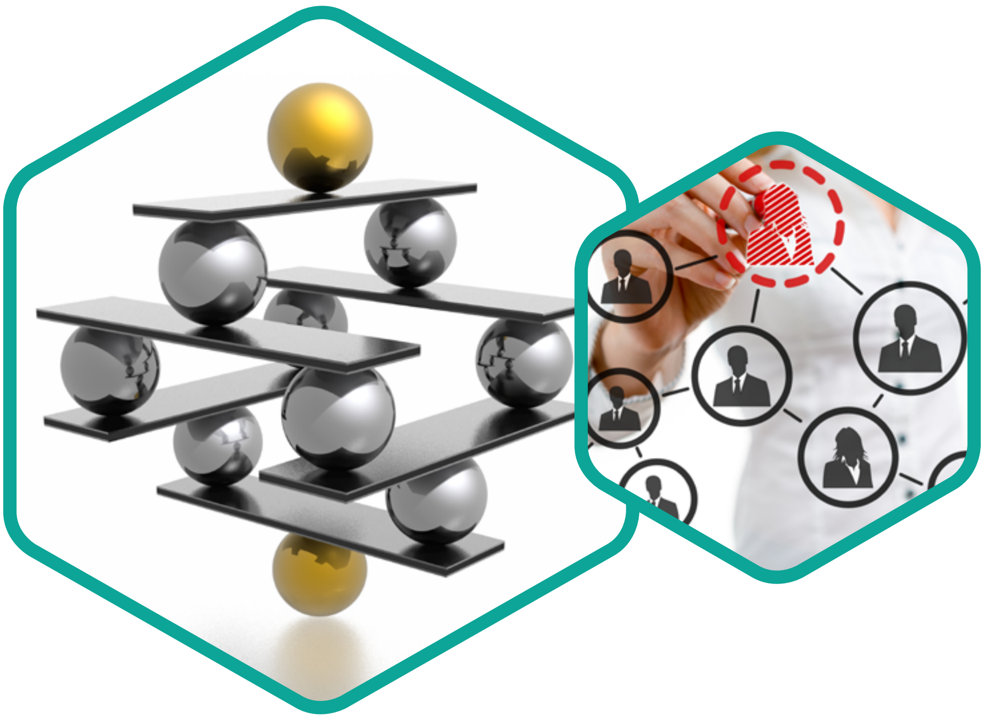
Look at the overall workload and responsibilities within your business. Are there one or two employees shouldering most of the strain? If this is the case, your business is vulnerable, both from a management and an investor's perspective. For that person or persons, feeling the strain of too much responsibility could result in them leaving, which would leave the business exposed. Conversely, should they stay with the company, the stresses and strains could impact their performance and, over time, productivity may slow. It is advisable to create a balance within your workforce so that people are happy and productivity remains high and, if someone does leave, for whatever reason, the gap can be filled very quickly.

Customers

When you examine your client list, look at your business as a whole and find out which customers are contributing the most to your overall turnover. The aim is to develop as many top-grade customers as you can, but the key is to never have a single customer contributing more than 10% of your annual turnover. If a customer is responsible for more than 10% of your annual turnover, should that client leave or stop trading, your business could be left vulnerable. Always try to spread the risk and avoid a single point of failure.

Suppliers

As for customers, you should not rely on one suppler for more than 10% of your total spend. In the same way, should that supplier cease trading, change product ranges or increase prices, this could leave your business vulnerable. At least once a year, ideally twice a year, shop around and add more suppliers to your list. This will create redundancy within your supply chain and give you options should anything change in the future.



08

Don't forget about stock

"Is your money gathering dust?"

When was the last time you did an accurate stock-take?

When I first started out in business, I used to hate stock-taking. Not only was it boring and time consuming but I would also find stock that had been lying around, unattended to, for months (if not years!). The thought of simply taking an average from the previous year was appealing, however there are downsides to doing this, namely:

1. Your business may show a profit but, in reality, be making a loss. You will probably be paying tax on that profit as well!
2. Old or unaccounted for stock may be soaking up much needed cash that could be invested in faster-moving items, giving you a healthier return.

I once looked at a business that sold high-end clothing for hunting and outdoor pursuits. The owner, of 20 years, loved a bargain and could not resist a deal. When I came to value his stock, which turned out to be in the region of £165,000, it transpired (after a little digging) that out of the £165,000 only about £70,000 was current, saleable stock. This meant that, over the past 20 years, he had accumulated almost £100,000 of dead stock.

In no way did this affect the valuation of the business because the valuation was based upon the profit and cash flow. However, it did mean that, on completion, the owner would be left with the dead stock, meaning that he could have had that £100,000 in his bank account rather than it gathering dust on his shelves! I am sure many of you would agree with my thinking here, that leaving money on a shelf to gather dust is crazy!

What can you do about old stock? For stock that can still be sold, have a discount sale and sell those items for at least cost price. In this situation, it is more important to get the cash back in your bank account to re-invest than to be concerned about profit margins. Write off, dispose of or give away any stock that cannot be used or sold. It is better to have well-organised stock that generates a return to prevent this from happening again.

"Tidy stockroom, tidy profits", I always say!

Going forward, do a stocktake at least once a year, ideally once every six months. Then sell, use or get rid of any old stock.

09

Maximise Tangible Assets

(Plant, machinery, equipment, etc.)

"Assets drive profits; profits drive cash."

Every asset within your business must contribute to your overall income and provide a decent profit.

For example, when I owned my demolition business, I had the option of purchasing a 4.5 tonne excavator. I predicted that we would only use this particular machine around half a dozen times a year and I calculated that the capital outlay and expense of owning this piece of machinery would have caused this asset to break even. For me, that was not good enough when compared to the option of renting an excavator each time one was needed. Renting the excavator for the periods when I required one would have generated a return of over 40%, not to mention not having the hassle of maintaining and storing an owned machine.

For any tangible assets you own: Do you look after them? Are they well-maintained? Are they in good working order and do you have maintenance logs for each piece of equipment? These factors are all important to an investor.

Over the coming months, take an inventory of all the tangible assets within your business, sell any unused assets, find out which assets are a drain on your profits, look at which assets need some maintenance, etc. For any new purchases, look to see if there are any other ways of acquiring these: this could be by using a lease agreement or a short-term contract. Make sure any debt can be transferred with the business to a new owner, should you sell within the contract or lease period.

10

Put your best foot forward - the 'shop front'

"First impressions count: your physical space and your digital footprint."

First impressions count! In this day and age, you have two 'shop fronts', your physical space and digital footprint.

Your physical space

In the same way that we expect good hygiene in a restaurant, customers and investors want to feel they are in a professional environment: a place in which the owner and staff are proud to be working.

Is your office clean, tidy and well organised? Is the furniture and equipment presentable and in good order or do they look old and tired? Is the actual building well maintained or is the landlord letting things slip? Having a good workspace will improve staff morale and investor confidence. If your current office has served its purpose, maybe it is time to move on and look for a space that will allow you to grow and expand.

Your digital footprint

This is probably the very first thing a potential customer and investor will see: your website, social media platforms and customer reviews. All these elements need to be up-to-date and professionally managed. If one of your staff has the skills and expertise, task them with this duty. Alternatively, there are a great many individuals all over the world who are experts in these areas, often at a fraction of the cost of someone local.

On both 'shop fronts' be quick to display awards, testimonials and even quicker to resolve any negative feedback.

This is not only important for an investor but it makes good business sense to always have your customer facing 'shop fronts' looking neat, tidy and professional at all times. Maintaining consistently high standards will go a long way to increasing your sales and will ultimately make your business worth more when the time comes to sell.

Many successful businesses do not transmit a sense of pride. Sometimes you need a fresh set of eyes to come in and give you some advice to make your business look successful and proud on the inside and out.

During the next few months, implement a maintenance schedule for both your physical and digital spaces. It is always beneficial to have an outside person with a fresh pair of eyes to offer some advice on how your business is perceived. They could offer valuable insight as to how they see things from a customer perspective and this will ultimately impact what an investor is likely to see and experience.

11

Create Standard Operating Procedures

"Work smarter not harder."

To attract the widest pool of investors, you will need to systemise your business and create a management team. This will enable employees to follow clearly defined steps and procedures for their role within the business. These roles and responsibilities are documented in a Standard Operating Manual. This allows you, as the owner, to be less involved in the day-to-day tasks, enabling you to focus on your strategic management role.

This set-up is very similar to that of a franchise model. What you get, in essence, when you buy a franchise license is a proven system with all the operating procedures laid out for you. All you must do is follow them. However, if you run your business with all the systems and processes known only to you or a select few, you will never be able to separate yourself from the day-to-day tasks, let alone be left in peace when you go on holiday.

An investor is always going to prefer a business that is well organized and whose employees understand their roles and responsibilities. As they know what is expected of them, employees also feel more secure, so this is a win-win.

In the months ahead, if your systems and operating procedures are not yet documented, get all your employees to write down the steps and processes of their daily tasks. Ask their manager (this could be you) to check these steps and then document them officially. Even better, if you are able to create short 'how-to' videos, these can be used as a training tool. Create job descriptions, organisational charts and systems showing each employee's area of responsibility. This will add great value to the business.

12

Preparing a Risk Analysis

"If you fail to plan, you are planning to fail!"

BENJAMIN FRANKLIN

Similar to a Standard Operations Manual, a Risk Analysis shows an investor that you have thought of instances when your business may fall on hard times or the unexpected might happen. This has become a lot more relevant since the 2020 Covid-19 pandemic.

The Risk Analysis outlines potential threats to the business and the measured response to each threat.

Threats could include natural disasters such as flood, fire, earthquake or more recently, a pandemic. What would your response be to each scenario? What would need to be in place to keep the business running? How and where would your employees work? How much cash would you need in reserve, should the business cease trading for three months? This kind of forethought will give your business the best chance of survival and will be invaluable to an investor. In the military, I was taught to pay attention to the small detail, which would mean all the other detail would, by definition, be taken care of. This is the same for an investor: the small detail of having a Risk Analysis will show the investor that the bigger areas of the business will be well thought-out, organised and taken care of.

You could even go a step further and include other threats, such as new technology, new competition, long-term sickness (you or an employee), loss of a key employee, or lack of access to the business bank account resulting in inability to pay suppliers or staff. These are all very real and present dangers that are best prepared for in advance.

Over the next year, have a look at all the potential risks that could impact your business and devise a plan for how you and your team will react to and deal with each situation to mitigate the risk to the business. Hopefully, you will never have to use this document but, trust me, when the time comes you will be extremely grateful that you put in the effort when you had both the time and clarity of thought to do so.

Moving forward

Take some time away from your business and create an action plan to map out where you are now and where you want to be, within the timescales you need. If time is on your side and you have another 10 to 20 years left in your business, aim to be in a position to sell, should you wish, within the next five years. This will give you the options and quality of life that you can enjoy sooner rather than later. If time is of the essence, focus on the 12 steps outlined above, getting some of your team involved to ease the load. If you have any questions or need help to implement these steps please feel free to email me at hello@businessoptics.co.uk for a free hour's consultation.