

The logo for DAI Perspectives features the letters 'dai' in white on a dark blue background, with a small orange cube above the 'i'. To the right, the word 'Perspectives' is written in a large, orange, rounded font with a white outline. Below the logo, a grey bar contains the text 'Information to help you buy, sell, or finance a business.'

DAI Perspectives

Information to help
you buy, sell, or finance a business.

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In a recent PROFIT magazine article, sellers are cautioned to “brace for one of the hardest slaps in the face of the entrepreneurial experience: the initial offer for [their] company.”¹

Many owners believe that their business is worth more than what the market will ultimately offer. This is because they are emotionally tied to their business. It’s a huge piece of their life and as such, it is worth more to them than any other rational person could believe or pay for.

Because the initial value carries so much emotional weight from the owner’s perspective, it regularly creates a substantial gap between what a buyer would pay and what the owner believes the business is worth. This is especially true in the current recessionary environment, where capital markets have tightened dramatically and business valuations have already retreated by 1.5-2.0 X EBITDA.

Sellers need to understand that prospective buyers determine value from a quantitative standpoint, not an emotional one. Strategic and financial buyers derive value using a process that is largely based on earnings and return expectations.

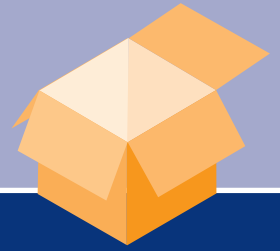
These measures – while not all-encompassing – are very objective. As a result, sellers must exercise a degree of impartiality and ensure that their price expectations don’t go beyond what the market will bear or beyond a measure of reasonable financial returns.

Components of a Divestiture

It may help to envision the sale of a business as three distinct components: tangible assets, such as land and buildings, equipment and working capital; goodwill, or the amount paid for the relationships, brand, knowledge, and other factors that keep customers coming back to the seller’s company each year, plus the strategic value of the synergies to be obtained if a competitor is buying the business; and the third possible component—the ever-elusive future incremental value represented by new and additional earnings that the vendor believes the purchaser is going to receive due to the vendor’s efforts while he/she owned the business.

1 - Jim McElgunn, “Selling your baby,” PROFIT magazine (March 2009) http://www.canadianbusiness.com/entrepreneur/personal_development/article.jsp?content=20090201_30011_30011&page=1, accessed February 2, 2009.

“It takes **20 years to build** a reputation and **five minutes to ruin** it. If you think about that, you’ll do things **differently.**” – Warren Buffett



DIVESTITURE

There is seldom much dispute regarding the tangible asset value of the business as various appraisals and valuations can be commissioned to determine fair market value of the fixed assets. However, working capital is the one component of tangible assets that is often a hotly disputed issue between the vendor and purchaser. Vendors wish to minimize the amount of working capital that is included in the sale of the business, while the purchaser wants to ensure that an adequate amount of working capital is maintained in the company being acquired.

Business owners often believe that there is significant goodwill built into their company based on years of hard work, but from a rational and external point of view, the true value that accompanies the business is usually less than what owners would like to believe. Once again, this is an area where emotion often overrides logic.

In closely held, owner-operated companies there are two major categories of goodwill: institutional goodwill and owner/personal goodwill. Institutional goodwill is associated with the business, its position in the marketplace and its ability to effectively serve its customers. Owner/personal goodwill relates to the skill,

reputation and relationships of the individuals that operate mid-sized enterprises, and this often cannot be wholly transferred with the business entity itself. If the business is reliant on the existing owners to operate day-to-day, then why would someone pay you to leave?

A sub-component of goodwill that owners often believe they should share in, but purchasers disagree with, is the value of synergies that may exist upon integration. Once the two businesses are integrated, there are often redundancies, and vendors believe they should share in the financial gain from these synergies. Purchasers, on the other hand, believe that such synergies are elusive and rarely produce anticipated savings without significant effort, if at all. Most purchasers will not share in potential business synergies.

The last component of value that vendors wish to be paid for, and that purchasers find difficult to recognize, is future incremental value. An example of this would be a significant increase in revenue from a new location that will only start contributing in the upcoming year. Vendors feel they should be paid for this value while acquirers have little evidence to justify this additional purchase cost.

BRIDGING THE GAP

Tools of the Trade

How do we bridge the valuation gap that usually exists between the vendor and the purchaser? First, it is important for sellers to separate emotional attachment from the divestiture process. As one entrepreneur put it, “the key is to strip out your emotional attachment to [the] firm so you can decide as objectively as possible what’s best for you and your family.”²

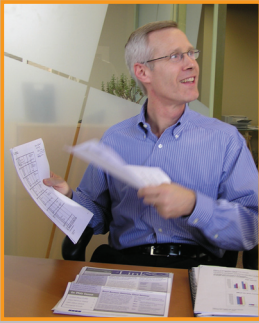
Next, there are a couple of common tools that can be employed to close the value-gap that forms between buyer and seller. It is customary for the vendor to be paid the entire value of the tangible assets of a business, along with some amount of goodwill at closing. The remaining component of goodwill (if there is any) is the amount that the purchaser views as higher risk.

Purchasers will sometimes agree to pay an additional portion of goodwill over time, in order to ensure that all the relationships of customers, suppliers and employees are transferred to the new owners. This is often accomplished through a vendor note. A vendor note allows for additional compensation to the seller and is paid over time to reduce the level of risk for the purchaser. Rarely is the future incremental value of a business

paid for up front. This component of value is usually structured as an earn-out. An earn-out is a financial payment that is agreed upon in advance, should the actual financial performance which the vendor has identified materialize. An example would be when a vendor believes that a new branch will contribute significant earnings to the business operations in the upcoming year. The purchaser agrees to pay the vendor some amount of additional compensation only if that new branch actually delivers the stated financial performance.

Bridging the Gap

Many divestitures never close because buyers and sellers cannot bridge the valuation gap. Oftentimes, this gap is caused by the seller’s emotional attachment to his/her business and results in the seller placing an irrational value-premium on the company. Sellers who can shed this emotional attachment will learn that they have numerous tools at their disposal, tools that will help them facilitate a lucrative transaction between both themselves and buyers. This rational approach, along with vendor notes and earn-outs, will ultimately “Bridge the Gap” that commonly plagues divestiture transactions.



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DAI Capital Advisors Inc. is a mid-market corporate finance and investment banking firm located in Edmonton, Alberta. **DAI Capital** provides a full range of acquisition, divestiture, corporate finance and advisory services to mid-market companies. We help owners of mid-market firms grow their business and harvest their wealth.

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