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Introduction

When the time comes to cash in on all the years of hard work and challenges of running a business, most entrepreneurs simply assume there will be a buyer waiting at the end of the journey—someone who understands the true value and potential of the business and will offer enough money to send the entrepreneur into retirement, happily ever after. Unfortunately, and far too often, this is not the case.

In order to maximize value, entrepreneurs must understand how business value is derived. As many find out too late, the viewpoint of an investor or potential buyer is much different from the outside looking in. Despite all the years of running a business, most entrepreneurs never take the time to learn the concepts of business valuation and develop a plan that can maximize the value of their business when they decide to exit the business.

Not understanding business valuation, the keys that increase business value and the process involved in exiting a business, can cost an entrepreneur significant capital and heartache when the time comes to cash in on all the years of running a business.

It is painful to see how often simple and easy-to-learn concepts and strategies, that could have added significant value to the company, were not known or understood by the entrepreneur. These "unknown, unknown" blind spots are usually the most damaging to the entrepreneur.

I spent the first half of my business career acquiring printing companies. I had a simple philosophy—acquire them as cheaply as possible, close the doors, and consolidate them into our existing operation.

Like the company that offers to buy "Ugly Houses," my objective was to find reasons to acquire companies at significantly reduced valuations, and there was no shortage of prospects.

When a company had unmitigated risks, problems, or the owner didn't plan and prepare for an exit, we bought them at a deep discount. It was easy to make these acquisition profitable by simply closing their doors and rolling them into our operation. Like the grim reaper, my company, or a company with a similar business strategy, became the only exit option for these businesses. These businesses were sold for significantly reduced prices.

While I had yet to have any academic training in finance and business valuation, I learned the fundamentals of business valuation through this experience. By looking at dozens of prospective companies with my own capital on the line, I intuitively learned to value a business.

While my strategy was to find undervalued businesses and consolidate them into my operation, other acquirers bought printing companies that commanded a higher price in the market. Despite the fact that these businesses had similar characteristics including industry, size, number of employees, geographic location and a number of other features, there was a wide range of value.

Some could command a higher price and others sold for whatever they could get. While I had no formal training or framework for valuing a business, I knew when a business could be purchased for a price and

terms that fit our strategy as a discount buyer. I wanted to buy companies at a discount with a lower than average value and left the relatively higher valued companies for someone else.

In hindsight, I learned to swim by getting thrown in the water. What I didn't know at the time was that there was a basis and process for what I was learning on my own. There was, in fact, a whole subset of finance that was dedicated to business valuation and exiting a business for a higher value.

After years of acquiring and building the business, I sold the company to a private equity group. It was only by intuition and a little luck that I exited the business just before a market and permanent industry decline. I then had the unique opportunity to go back to school, obtain an MBA, and go on to complete additional work in the field of business valuation and obtained a CVA (Certified Valuation Analyst) designation.

I was able to learn the academic theory and put a formal process, framework, and financial discipline to what I learned on my own. As I put terms, definitions, and concepts to my years of experience, it was very affirming to realize that I had actually developed a very solid understanding of the valuation process and the steps required to exit a business. I could now support and communicate my intuitive understanding with a proven and accepted valuation and process. In essence, I had learned the art first and then the science behind it.

Entrepreneurs and investors began to reach out to me for advice on buying, selling, and valuing businesses. I also began to teach classes and workshops and, several years ago, joined the faculty at the Jones School of Business at Rice University where I now teach courses on business acquisition and valuation.

This book is a combination of my 30 years of learning the "art" by buying and selling companies with my own capital and the "science" learned in my formal studies of finance and valuation. My goal is to help entrepreneurs understand the importance of business valuation and teach both the underlying fundamentals and practical steps it takes to maximize the value of a business. This is my "I wish I would have known then what I know now" lessons in business valuation.

Al Danto

The Entrepreneurs' Dilemma

Successful entrepreneurs have the unique ability to conceptualize, create and build companies in an environment of uncertainty and often chaos. The start-up and growing company operates in a constantly changing figure it out as you go environment. Keys to success in the early stages are adaptability, flexibility and change. However, business value is increased by consistency and predictability. This consistency is typically achieved by establishing processes and controls which run counter the entrepreneur's natural tendencies. The entrepreneur who starts a business to get away from the chains of bureaucracy is now in charge of implementing them.

This is not a good match!

As the burdens of administration increase, the entrepreneur begins to lose the drive and passion that made him successful in the start-up and growth phases. The joy and passion of building a company transforms into the drudgery of managing it. If the right steps are not put into place, the business stays in a chaotic state, and this ultimately reduces company performance and value. Without an understanding of business valuation and a long-term plan in place to build value, the entrepreneur will often start making short-term decisions that hurt long-term value.

Over time as the drive and focus to build the company begins to wane, the entrepreneur starts to put personal needs ahead of long term growth opportunities for the company. Instead of reinvesting profits and time back in the company, the entrepreneur starts spending more time away from the business and profits are diverted to build retirement accounts or used for personal needs.

The passion runs out, risk tolerance levels change and entrepreneurs start to emotionally check out from the business; consequently, business value is diminished. The same skills that created and drove the business to success are now destroying the value of the business.

In order to maximize value, entrepreneurs must understand the fundamentals of business valuation and equally, if not more importantly, the emotional side. **They must know when to get out and how to get out.**

Valuation Basics

As a 28 year old entrepreneur, what do you say when you have a shot to buyout your largest supplier?

Stewart and Sullivan had been a vendor of my printing distributorship since starting the company three years earlier in my apartment. They were one of the oldest printing companies in Houston, and the chance to acquire them was a great opportunity.

Despite the fact that we had developed a close working relationship, I wondered what unknown skeletons would pop up if we bought the company. Would employees stay? Would customers leave? Would the equipment break down? Were their books accurate? Was I paying too much? Did I assess all the potential risks?

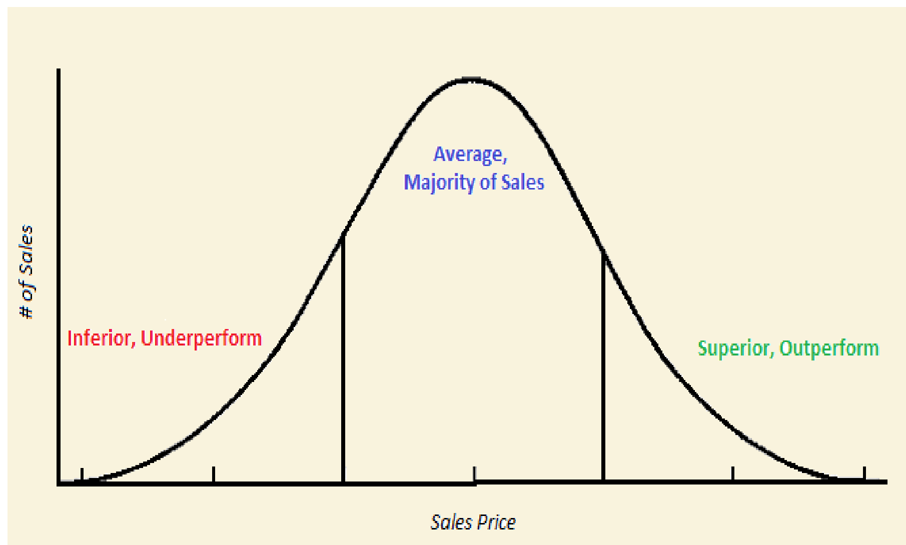
While the opportunity to buy the company looked great on paper and in strategy, it was very daunting and unnerving to think about everything that could possibly go wrong. These risks and fears resonated in my gut. With no formal understanding of business valuation, I was doing what every business purchaser and investor does—trying to predict the future of the business and relate that to the risk of achieving the outcome. After acquiring businesses and studying business valuation for over 30 years, I have come to understand that this "fear" or "risk" is the underlying driver of business valuation and is present in every potential business acquisition.

Business valuation and the exit strategy are built on top of this concept. Most educational material on business valuation focuses on the technical analysis of net income or cash flow, discounts rates or some type of multiple or return on this cash flow. This is important but one must understand that risk is the true underlying driving factor of business valuation and mitigating or eliminating risk is the basis for increasing business valuation.

Ultimately, lower risk, and a clearer future, equals a higher value. In the formal study of business valuation and finance, those risks are identified, quantified, and value is calculated in often complex financial models. However, underneath the complex formulas and finance terms lies a fundamentally simple concept: Business value is based on the future expected performance (Cash Flow) of a business discounted for the corresponding "Risk" (Fear). In simple terms, you must reduce the "fear" of the unknown that every person considering investing their capital in your business will have.

While this seems extremely simple, it proves challenging for most entrepreneurs to grasp when it comes to their business. Our goal is to demystify the valuation process, help you understand the fundamental concepts of business valuation and arm you with the tools to create a plan that maximizes the value of your business.

Relative Value



Most entrepreneurs think the value of their business is based on an industry average tied to a standard-like multiple of earnings or percentage of revenue. Sometimes they hear stories of what similar companies sold for in their industry or ask their CPA for an opinion.

Basing an estimate of business value on averages, hearsay, or "market" comparable data points is extremely flawed. While this approach may work for assets like houses or cars, it does not work in business valuation. There are simply too many variables that go into each business's specific valuation. Without a thorough and detailed analysis of all the variables unique to the company and time, there is no way to accurately assess value.

Business valuation is the study of the variables and risks that impact the value of a company. When a business owner says the value of his or her company is based on the industry average or what a similar company sold for, valuation analysts cringe.

Let's take a minute to discuss averages, so we can understand how flawed this thinking really is.

Most anything dealing with numbers can be averaged and put into a bell curve. For example, you can average number of employees per company, number of children per family, number of shoes per person, price of a car, price of a house etc. If you can name it, most likely you can average it.

But averages can be quite deceiving. This picture was taken in February 2011, there was 6" of snow, and it was 5 degrees. If I told you it was taken in a US city, you would most likely guess somewhere in the north or even maybe somewhere in the mountains – right?

Wrong!

This picture was taken in Dallas, Texas where the average February temperature is 59 degrees. Travelers arriving to Dallas, dressed for an average temperature, would be in for a big surprise.

Just like temperatures, business valuations—even those within the same industry with similar size, revenue, and profit—will have a wide range of values.

The average value of a business in any industry is simply the middle point of a number of valuations. In order to have a middle point, there must be an equal number of values or data points on either side. Some points will be below average, others well above average, and some right near the middle. While you can't compare the value of a flower shop to one of a software or manufacturing company, the owner of the flower shop should strive for having the highest value possible when compared to other flower shops.

Many factors, each unique to the specific business, impact the value of a business and move the value either above or below average. Business valuation is the analysis of these factors and risks and their impact to a business's value.

An entrepreneur armed with the knowledge of these concepts can develop a long-term plan that can significantly increase the value of their business. With the knowledge of the valuation process, an entrepreneur can build a business that is worth significantly more than "average" and maximize the value of the business and years of work.

The objective of this book and to developing a long term exit strategy is to help entrepreneurs and their advisors understand what it takes to get a higher than average valuation when compared to other businesses in the same industry.

Risk Aversion

The initial concept that entrepreneurs must understand is that the risk—either real or perceived—within their business, and how that risk impacts the cash flow of the business, is the fundamental driver of business valuation and forms the basis. When this concept is thoroughly understood, an entrepreneur can build a strategy and tactical plan that will increase and maximize the value of their business.

This is the fundamental reason why businesses in the same industry of the same size can have a wide range of value. Take out risk, add clarity to the future expected cash flows, and the entrepreneur will increase value.

Risk is at the base of every valuation methodology and calculation. It is assessed from the basic, intuitive gut level through the most analytical, complex spreadsheets and due diligence. Risk, and perceived risk from an outside party looking in, is most often "over emphasized." This overemphasis has been the subject of many studies.

In his book *Trading to Win*, Ari Kiev says, "The fear of losing money has more influence over the investor than the desire to make money. Because of the pain of loss, people will do more to avoid loss than they will to maximize profit."

This could not be more evident than in business valuation. Investors, acquirers, and valuation analysts understand that running a business has both risk and opportunity. However, risks will always be magnified with a greater reduction in value than opportunity will be increased in upside value.

Entrepreneurs *must* internalize and understand this perspective. There is no escaping it. Any increased risk or uncertainty—perceived, real, or potential—that is not understood or mitigated will significantly decrease the value of a business.

Entrepreneurs must have answers and be able to show a plan to mitigate the risk and variables that buyers and investors fear. The optimistic, glass-half-full entrepreneur most often wrongly assumes that the upside potential is most important to a buyer.

Don't get me wrong, investors and buyers want and will pay a premium for a business with promise and exciting upside opportunity, but they will not do so without first understanding, quantifying, and discounting these opportunities for the downside risks.

Questions like:

- What will you do once you sell the business?
- Why are you selling the business?
- Will you stay involved with the business in some way?
- What do your employees think of the sale?
- Why is there an increase in inventory?

Are really fears of risk and mean:

- Why are you dumping the business?
- How far are you going to run?
- Don't you have any confidence in the future of the business?
- Are employees going to jump ship after the sale?
- Are you losing customers and sales?

Entrepreneurs who understand and minimize downside fears, both rational and irrational, will begin to significantly increase the value of their business.

Here is one of the biggest challenges to the entrepreneur. Having run the business for years, the entrepreneur becomes immune to the risks imbedded in the business. Over time, the owner accepts and becomes comfortable with them.

Here is a good example everyone can relate to. Let's say you've owned a car for a long time, and it has served you well for 50,000 miles. You probably view the car as dependable because it starts every time; you have no fear that it will break down. To you as the owner the time, miles and history are a comfort factor.

But the view point and perspective of a potential buyer or outside party is completely different. The car, or business, is an unknown, and the buyer will assume and fear the worst. Is it a lemon? What problems are there? Will it leave me stranded? 50,000 is a lot of miles!

A highly regarded 1979 study entitled "Prospect Theory," by Nobel Prize recipient Daniel Kahneman and his partner Amos Tversky, concludes that investors are indeed irrational when assessing the potential for loss over gain.

In order to avoid losing money, investors will seek odds that are many times greater than the risk of losing. For example, when flipping a coin, most people will only risk losing $20 if they have the opportunity to make at least $40.

Despite getting better than 50/50 probability, the pain of losing is much greater than the potential reward of making money even when given better odds.

As the overall impact of loss to the investor increases, so does this irrationality when compared to normal expectations and probability. The downside risk can completely offset any potential gain no matter how great the potential return and how good the odds when the stakes get higher.

To illustrate this point in my classroom, I take out a $5 bill from a bank envelope and ask students who is willing to flip a coin for the $5. At least half the class is always eager to take me up on this bet (while the other half always thinks there is some sort of trick).

I flip the coin and collect or pay off the winner. Next, I take out a $100 bill and offer the same bet. At this time, there are typically a couple gun-slingers who will step up to the plate. I then raise the odds by saying I will pay $150 to win and only $100 to lose. Despite increased expected returns, only a few, if any, take the bet.

Now add millions of dollars at risk in a business acquisition, and you can begin to understand why the downside risk of losing is magnified. This fundamental concept is always present and will drive investor decisions and ultimately the value of a business. Entrepreneurs must understand that risks, uncertainties, and unknown variables will result in significant decreases in business value. Investors and business buyers will not take on excess risk either real or perceived without a substantial reduction in value. They will either reduce the assessed value to a point of comfort or simply wait for another opportunity.

While this seems easy to understand from an intuitive standpoint, it is extremely difficult for the owner of a business to fully comprehend when it comes to his or her business.

Risks that are not considered by the entrepreneur running the business can become major destroyers of value to someone evaluating the business from the outside.

There are two sides to every story and two perspectives between the buyer and seller. As a seller, you have to anticipate the buyer's questions, concerns, and fears.

Seller: "Could one of my sales reps leave and start a new business? Well sure, but I have known him and his family for years. We have been through thick and thin. It's not a real risk."
Buyer: *Well, it is to a potential investor or buyer!*

Seller: "Could I lose that key supplier? No way. We play golf every week and have done business together for years."
Buyer: *Well you know what...I don't!*

Seller: "No one in our industry provides health insurance."
Buyer: *Yes, well, what about the impacts of the Affordable Healthcare Act?*

Buyer: *Aren't you in the Gulf Coast? Couldn't there be a Hurricane any year?*
Seller: Yes, so what!

Buyer: *You don't have a written employment guide?*
Seller: "Why should we?"
Buyer: *What about the Fair Labor and Standards Act?*

From the outside looking in, any fear is a reason to discount the business valuation.

Mitigating risk, anticipating questions, and answering fears increases value. Anyone from the outside looking in—be it an investor, banker, buyer or valuator—looks at risk and uncertainty with much more caution and skepticism than the entrepreneur.

Before any rosy projections or opportunities are considered, outside parties will look at the downside risk first. It is only after getting comfortable with the downside risk that they will consider the upside potential with more optimism.

Entrepreneurs most often lead with the upside potential, but outside investors always start with the downside risk first.

While all risks in a business cannot be mitigated, they must be clearly understood by the outside party evaluating the business. You can't put lipstick on the pig. All risks will come out eventually, especially after a thorough and exhaustive due diligence process. Even if they do not get uncovered, there is the potential of a lawsuit if not disclosed and discovered later.

Outside investors simply want to understand downside risk before they get excited and look at upside potential. Value is maximized by first decreasing downside risk and then by increasing the predictability and clarity of the future. It is only once this downside fear of loss is mitigated, that the potential upside will be fully considered.

<u>Don't ever forget this!</u>

Some risk factors are outside of the entrepreneur's control, but many more are within the control and influence of the entrepreneur. The objective of the entrepreneur and the exit strategy is to develop a plan to minimize internal, controllable risk factors and be aware of how outside risk factors can impact the business.

Internal risk factors are usually under the control and influence of the business owner especially when a long term plan can be put in place that allows adequate time for these strategies can be put in place. While external risk factors can't always be controlled or eliminated, decisions can be made in regard to timing and strategies put in place to help mitigate them.

A formal valuation follows a standard process that touches on most every potential risk factor that could impact a business and its cash flow. Analysts quantify these risks in complex formulas and ultimately value is determined by discounting the cash flow of the business by these risk factors.

Potential buyers and investors, who are putting their own money at risk without completing a formal valuation, will be cautious, thorough, and skeptical from an intuitive or gut-based process. Often these experienced buyers will be more in tune with undue risk than the most independent valuation analyst will be in a formal analysis.

Armed with the knowledge of this process and the understanding that investors will irrationally assess downside risk, entrepreneurs can get a step ahead by creating a long-term strategy to minimize risks and begin to maximize the value of their business and develop their exit strategy.

External Risk Factors: Timing

There are basically two main categories of risk: external and internal. External risks cannot be controlled by the entrepreneur while internal risks fall under the control and influence of the entrepreneur. In formal finance terms, external risks are referred to as systematic or aggregate risks. They are risks that impact every business and cannot be changed by the entrepreneur. Internal risks are called "Company Specific" and fall under the control and influence of the entrepreneur.

Think of external risk factors as the tide. When the tide comes in, all boats rise; when it goes out, all boats go down. While there is not much that can be done to stop an incoming or outgoing tide, entrepreneurs must realize that **the timing of these factors will impact value.**

These factors include:

- The National and Local Economy
- Industry Conditions
- Supply of businesses for sale
- Interest rates and available capital
- Miscellaneous external factors like Technology, Labor, Political, Civil Unrest, Weather

To understand external risks conceptually, think about the financial crisis of 2008–2009. This impacted most every business as it was impossible to escape the economic downturn and the impact to value. Business owners who had to sell during these times typically sold at much lower valuations than those that did before or after the downturn.

While these aggregate risks can't be changed or avoided by the entrepreneur, value is increased when these risks are at their lowest. The more comfortable investors are with the economy and reports regarding the employment situation and economic outlook, the more willing they are to spend their capital and make investments.

This is why reports such as consumer confidence and national employment numbers are so important. These reports have a clear and immediate impact on publicly traded shares of stock. Investors and analysts eagerly await their release and the results greatly impact the value of public company shares every day.

While not as immediate and evident, the same is true for small privately held businesses.

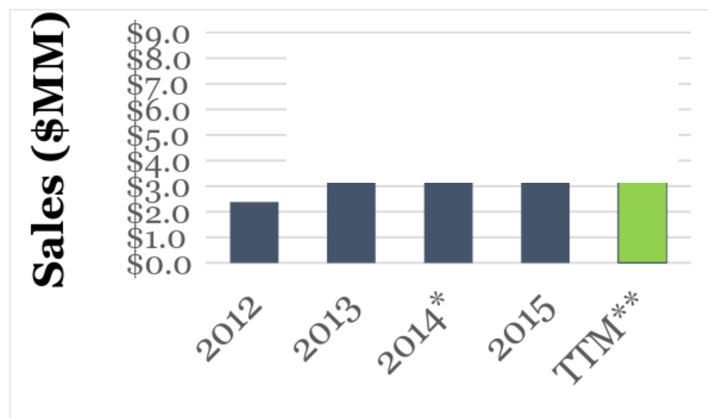
The rosier the outlook of the overall economic situation and forecasts (national, industry, and local) the more willing businesses are to increase hiring, make investments, and spend money. The tide is coming in, and most business values are rising.

An investor or buyer of a business simply has more confidence in better times. It is not difficult for the entrepreneur to understand that "perceived" value increases during good economic times. However, the challenge most often is to realize that this is typically the best time to exit the business and maximize value.

However, selling during good times is hard and especially challenging for the optimistic entrepreneur. Times are good, demand is high, and profits are growing, so why sell now? It is only going to get better.

Although counterintuitive, there are many reasons, from both an emotional and technical standpoint why selling during good economic times is the best time for an entrepreneur to exit the company.

From a technical valuation standpoint, trend lines are used to support projections for the future performance of a business. After a few good years in a rising economy, investors and business buyers will buy into the future with more confidence and reward the entrepreneur with a higher valuation.



While economic conditions impact all businesses to some degree, specific businesses are impacted more than others. For example, businesses providing products and services that are non-essential like luxury goods and services will be impacted even more. Their customers spend more in good times and a lot less in bad times.

Some businesses like auto repair companies may actually increase in value during tougher economic times**. Entrepreneurs must be aware and understand how overall economic situations will impact their business.**

I started buying printing companies in Houston during the mid 1980's. The Houston economy was extremely depressed. Many printing companies coming off the recent energy boom were now barely able to cover costs and keep their doors open.

These same companies, that only years before were running shifts around the clock and charging premium prices, were happy to take virtually any offer that would get them out of the business and the choking overhead that was built up during the preceding boom.

While I didn't understand the first thing about formal business valuation or the impact of economic conditions on business valuation, I figured out pretty quickly that I could pick up bargains during these tough economic times. Houston business owners who sold during the good times a few years earlier received substantially higher valuations then those who waited.

Industry Conditions

Like the national or local economy, an industry that is trending upwards is far more attractive than one that is trending downwards. At any given time, some industries are moving up while others are heading down. Popular industries are considered "Hot" and out of favor industries "Cold."

Entrepreneurs must understand how industry conditions are impacting the value of their businesses. Some industries are also considered more risky in nature due to a number of factors including regulations, fads, cyclicality, and other real and perceived issues. These industries are inherently more risky and will receive a lower relative valuation.

These can also have a positive impact like federal or state tax subsidies extended to energy efficient car makers to help reduce carbon emissions. The subsidies allow for these companies to benefit in a variety of ways, such as increasing profits, lowering prices to compete with the traditional car makes and models, and increasing R&D.

On the opposite end, anticipated industry regulatory changes can have significant negative effect on an industry. In the last election, certain candidates were in favor of radically simplifying the tax code. This would significantly impact the value of CPA firms and businesses such as H&R Block and other tax service companies.

Industry reports and their impact to company value are available through a variety of sources including IBIS, Trade Associations and Investment Banking firms. Entrepreneurs must stay current with their industry and how it is impacting valuation.

Supply of Businesses on the Market

The simple economics of supply and demand of businesses for sale in the market at any given time significantly impact value. It is a buyer's market, and values are typically lower, when there is a higher than average number of businesses available. It is a seller's market, and values are typically higher, when fewer are available.

There are many factors that influence the supply and demand of businesses on the market. One interesting concept that is often counterintuitive to many entrepreneurs is what happens when times are good in the economy, a specific geographic area, or a specific industry.

When times are good and prices are rising, sellers will hold out thinking that the good times will continue to get better. If they sell today, they give up the opportunity to sell at a higher price later. Conversely, when times are bad, they often want to sell to avoid a greater loss in the future.

Because of this concept, many entrepreneurs find it difficult to think about an exit during good times. This results in a tighter supply of businesses for sale in the market and can drive up valuations further resulting in a seller's market. Despite this fact, many rational entrepreneurs have a hard time letting go

and the result is an “irrational exuberance” among entrepreneurs during good times. The mindset is that things are good, I’m making a lot of money and it will only get better, so why sell now?

This creates a unique opportunity for the entrepreneur who understands this dynamic. In good economic times, buyers, investors, and lenders have an increased confidence to invest their capital. This coupled with a lower supply of businesses available often pushes valuations to extremely high levels.

Living in Houston, Texas for the last 30 years, I have witnessed this cycle several times in the energy industry. The most recent was in the years leading up to 2014. The proliferation of horizontal drilling and fracking, combined with high energy prices, resulted in “boom” times for not only the energy industry but others tied to it.

We completed valuations and consulted on a number of acquisition projects during this time period. One company we worked with was a trucking company that served the energy industry. They hauled off the water and fluids used by drilling companies in the fracking process. After several great years, their CPA called us in for a valuation of the company for the owner who was approaching a possible retirement age.

We came up with a high valuation that took into consideration the current growth rate and strong market conditions including a very limited number of these types of service companies for sale. Our conclusion showed that he would get a higher than average valuation and would have several companies competing to acquire his business. His irrational exuberance was evident in his confident opinion that it would only get better, and he was making too much money to sell now.

Less than a year later, oil prices plummeted, along with the demand for these services and the market value of his company. Now, he is in a very unfortunate situation that many entrepreneurs find themselves in when they miss the window to exit during market expansion.

As revenues and demand for his services ramped up, the owner increased resources and capital goods like trucks, equipment, and upgraded facilities. He also added staff and took on more debt to do this. Now, he is faced with increased overhead, additional debt payments, and decreasing sales—not a good combination. Instead of exiting at the peak of the market and enjoying a comfortable retirement, he is facing bankruptcy and very uncertain future.

When situations like this occur, the entrepreneur finds himself missing a window that can close very quickly. Instead of selling for a premium, putting money away that would gain interest, and transferring the risk of running the business to someone else, the entrepreneur soon realizes that he is no longer on top of the world.

A major factor that will greatly impact the supply of businesses on the market in the upcoming years is the Baby Boomer generation. These forty, fifty, and now sixty year old business owners will have a serious impact on the valuation of privately held businesses as they begin to exit and retire.

According to Biz Quest, we are now in the initial stages of what is expected to be the greatest wave of business transitions in U.S. history. At 83 million strong, baby boomers represent the largest single sustained growth of population in U.S. history. This generation started and grew hundreds of thousands of successful privately held businesses.

These Baby Boomers will vastly increase the supply of businesses available which is expected to lead to a glut of businesses in the market. This is expected to drive down valuations and give new leverage to buyers.

A survey by PricewaterhouseCoopers finds that one out of every two company owners plan to sell their business within the next 10 years, and people 55 or older own 30 percent of all businesses with employees. The simple fact is that this will result in an increased supply and drive down overall valuations.

Historically, most business owners exit their business with less than six months of advanced planning. Like any other market with increased competition, standing out from the crowd is crucial. Entrepreneurs must understand that there will be more options and choices available in the market for business buyers.

In a buyer's market, any issues problems or risks will have an even greater impact on valuation. Buyers and investors will have more choices and options to choose from in the market. If they don't like something about a specific business, they can move on to another one. Just like a homeowner selling in a buyer's market, who must take extra care to make sure his house stands out against other listings, business owners will have to take additional time and preparation to get their house in order before placing it on the market.

Interest Rates

Interest rates have perhaps the greatest overall impact on business valuation than any other external factor. Entrepreneurs must be aware of the current interest rate environment and which direction rates are expected to move. There are a couple critical reasons for this.

The first is that capital for an acquisition or investment comes in either the form of debt (borrowing from bank or other lender) or equity (from investors). Increased interest rates means the capital has to be paid back at a higher cost and acquisitions become more expensive to finance. This impacts both deal structure and valuations.

Lenders look at a ratio called the debt coverage ratio. The debt coverage ratio is the amount of profit above the payment (principal and interest) that must be paid back to the bank each payment. This is typically evaluated on an annual basis. Lenders want to ensure there is adequate profit in the business to pay back all principal and interest payments when they come due.

For example, if a bank is analyzing a loan of $1 million for the purchase of a business and interest rates are at 4%, there will be $40,000 due in interest alone. If interest rates are at 6%, that number increases to $60,000. A business with net annual cash flow of $80,000 would have a debt coverage ratio 2:1 with interest rates at 4% ($80,000 of profit divided by $40,000 of interest due). This is a more than adequate debt coverage ratio; for every $1 of interest that is due to the bank, there would be $2 of profit to cover it.

However, if interest rates were to rise to 6%, this ratio would drop to 1.3:1 which would be unacceptable to most lenders. **To make up this difference and create acceptable terms, lenders would require a lower valuation.**

The second reason is that investors will always seek the best return for the least amount of risk. In a higher interest rate environment, investors can put their money in other types of investments like bonds, real estate, dividend paying publicly traded stock or other less risky investments.

When compared to these options, owning a privately held business is much more risky. In a higher interest rate environment, they will receive a higher return on their money for taking less risk than investing or buying a business.

In order to compensate for this difference, investors will require a higher payback or a greater ownership of the company, either of which will result in a lower valuation.

Another dynamic to this is that, in a low interest rate environment such as today (early 2016), there is more capital available. When more capital is available, lenders are in a more competitive environment. Money is like any other commodity, and when the cost of the commodity is lower, there is more competition for it.

Other External Risks

Other external risks like the threat of new technology, labor, government regulations, political considerations, and other external risks and threats can significantly impact business valuation. In today's market, the uncertainty around healthcare regulation has had a serious effect on valuations impacted by these potential risks. We have valued several Urgent Care facilities over the years. Historically, these have been extremely profitable business models resulting in very high valuations. However, as insurance reimbursements rates decline and the uncertainty continues to increase around them, valuations and the demand for these businesses has been on a steady downward trend. In terms of valuation, these businesses peaked a few years ago and only time will tell if they will ever come back. In my opinion, I doubt it as there is long term downward pressure to reduce cost in all areas of healthcare.

I have been extremely fortunate to have exited two businesses near the peak of the market in both industries. The first was my printing company in 1999, and the other was an international nurse recruiting company in 2007. I exited the printing business just before significant technology changes disrupted the industry and the recruiting company just before the Visa and immigration laws severally impacted the supply chain.

How did I decide to exit these businesses at the right time?

In both cases, there were—in hindsight—very obvious signs of impending change. In every market peak, there are signs that a peak and impending decline or crash is on its way. However, the challenge is to interpret these signs and, the even more challenging part, is to act on them.

Fortunes are made and lost on catching these signs or missing them. I am extremely thankful that I did not miss the signals in deciding to exit the two main companies I started.

I will never forget when the light bulb went off for me with my printing company. The main product my printing sold were multi-part business forms that ran through a computer printer. We literally sold millions of these forms a year, and one of our biggest target markets was beverage distributors. The biggest was Anheuser-Busch beer. We sold our products to over 500 of their distributors around the country as well as other beverage distributors like Miller, Coors, Coca-Cola, and Pepsi.

We had sales reps and marketing campaigns geared to this industry as well as other industries like travel agencies, dry cleaners, and apartment complexes and others that used an abundance of these same types of business forms.

In early 1999, I attended a beverage wholesaler's conference with my sales rep in Las Vegas. Aisle after aisle was devoted to the latest and greatest in the industry. Most of it was geared around new software, the latest trucks, equipment, and new beverage products were introduced. As I walked down one aisle, I saw a very small booth that actually had one of our Budweiser logo forms on their display. It had a red circle and a line through it. Obviously, I had to check it out.

I walked up to the booth and asked them what products they sold. They said their product was a revolutionary electronic signature pad that would eliminate the need for printed business forms. As hard to believe as it is now, the thought of not having a "hard" copy of a signed business form with a record of the items purchased was totally unheard of at the time. Our business forms served as a proof of purchase and signed signatures, along with copies for both parties and their various departments, were a critical part of their operating process. This was a product that could never be replaced.

However, that night something resonated with me. This was just another sign of the disruptive technology that I had been seeing all around me—high speed color copiers, the Internet, and now the potential for electronic forms. While, at the time, none of these potential disruptors was practical or a competitive threat to our product, I could see a future where they would be. I decided that night it was time to sell the company.

Despite the fact that our business was growing rapidly, and we were adding customers both nationally and through acquisitions at an incredible rate, I sensed a shift was going to take place in our industry. The market was hot and the external conditions were right. I was on top, but it was time to get out.

I returned to Houston and engaged the services of a leading Merger and Acquisitions advisor in our industry. After reviewing our financials, diverse marquis customer base, and growth rate, he was a little shocked that I would be selling the company when conditions were so good. While I didn't tell him specifically about my fear of the disruption I predicted in the industry, I did tell him I wanted to get out while we were on top.

He said it would be no problem to sell the company and, due to the many factors that you are reading about in this book, we could sell it at a very high premium. In other words, we could exit for a price well above average. It was right in terms of timing and external conditions and, as you will read about in the next chapter, our internal house was also in order.

I entered into an agreement to sell the company in the late Fall of 1999, and in January of 2000, after making sure the world did not implode due to Y2K, sold the business for a price well above average in a virtual all cash offering. We sold the business to a group of executives from one of the world's largest business forms companies that was backed by private equity money.

I walked away with my family's financial future secure, and they purchased a growing business with a diverse customer base, pristine accounting records, great employees, and a stellar reputation. Within 5 years, the company went bankrupt as electronic signature pads, high speed copiers, and the Internet replaced business forms—a product that was never going to go away.

I often wonder how I "sensed" the industry was going to change when their team of industry executives, investment bankers and private equity firms staffed with the best and brightest MBA's from the top schools in the country didn't.

My guess is that the industry executives knew nothing else and buried their head in the sand at any talk of change, and the investment bankers were too technical with their complex financial models and growth rate calculations.

In hindsight, I sold in a seller’s market with external conditions aligned in my favor. The national and local economy was strong, the industry was growing, capital was readily available, and the supply of businesses on the market was low because business was good, and it was only going to get better. There was a lot of confidence in the market. The tide was rising. Armed with this irrational exuberance, the buyers missed the fact that we were approaching the top of the market and new technology that would disrupt the industry was right around the corner.

Business valuation is part art and part science. The art is the most critical. I know the private equity firm and their team of MBAs had detailed forecasts, projections, and complex spreadsheets calculations. If it were a finance project in an MBA class, I’m sure their team would have got an A+. However, what counts in the real world is the proper assessment of future risk and growth opportunities. My calculation included a large discount for the potential disruptive change that technology could bring about and theirs did not.

Internal "Company Specific" Risk Factors

While an entrepreneur cannot always control external factors, internal risks or "Company Specific" risks are the ones under the entrepreneur's control. This is especially true when given adequate time to develop a plan to eliminate or mitigate said risks.

These risk factors contribute the most to increasing relative value between similar businesses and are what form the basis of a plan to maximize value. In order to maximize value, strategies must be developed to mitigate internal risks such as:

- Business dependency on the owner
- Customer concentration
- Diversification of customer base
- Contracted vs. non-contracted revenue
- Supplier relationships / concentration
- Threats of technology
- Legislative impacts
- Incomplete financial records
- Online reputation
- Patents

Valuation analysts and investment professionals have formulas that attempt to incorporate and capture these risk factors in a process called discounted cash flow analysis. They discount overall company value for each risk factor identified and unmitigated.

Entire finance classes and valuation courses are dedicated to these formulas, financial models, and calculations. The good news for the entrepreneur is that the underlying concept and intuitiveness of these formulas are very easy to understand.

Finance professionals simply put a risk factor on impact of these potential risks to the business and its cash flows. At the end of the process, the total of these risk factors is added up to get a Discount Rate which is the expected or acceptable rate of return for the capital invested in the business. The Discount Rate is simply an estimate of the risk associated with the business.

The critical key for the entrepreneur to understand is that there will be a downward adjustment in value for each risk that is identified. These risk adjustments result in lower valuations and purchase offers.

While business buyers may not use a precise formula to discount these risks, they will all relate to the Risk Aversion theory discussed earlier. When it comes to the potential loss of their money, they will substantially lower an offer price for each real or perceived risk found in the business.

By the time an entrepreneur puts the business on the market for sale, it is usually too late to change any of these risk factors; they are simply embedded in the business. The entrepreneur must start working on these risk factors several years in advance of selling the business.

To an experienced purchaser of businesses, risk is like a 6th sense. When it pops up, confidence decreases, credibility is reduced and a lower offer if any is made. Attempting to put lipstick on the pig and cover up these risks at a later stage in the game simply does not work.

By the time a potential buyer goes through the research required to make an offer and complete the due diligence process, each potential internal risk will be identified, assessed, and an adjustment will be made in value.

The entrepreneur must understand that each one of these risks will impact the value of the company. When an entrepreneur cannot mitigate these risks, there is a substantial loss of value.

Companies that receive above average valuations are those that best minimize risk factors outside investors fear.

Here is an example of how this works:

Outside parties—especially bankers and debt providers—want clean financial records that tie historic cash flow numbers to verifiable sources. That source can be tax returns, audited or CPA prepared financials.

When these records are clean, professionally prepared, and accurate, outside parties gain confidence and will make a higher offer. When they are out of order, need to be explained, or can't be tied to a verifiable source, they lose confidence and they adjust purchase price downward for the risk that the cash flow represented is not accurate.

This is such a critical risk factor that it often becomes the first negotiating point to a lower offer and valuation. To a banker or lender, this risk can impact value so much that it can become a deal breaker. They will often only use tax returns or audited financial records as the amount of cash flow the business generates.

I made an offer on a husband and wife owned company that embroidered shirts and hats. When our CPA began due diligence, she uncovered a significant amount of unreported cash and personal expense write offs that were added back to the taxable income. She advised us to not go any further and that she actually had a duty to report this as illegal activity to the IRS.

We did not make an offer on the business and anyone else making an offer would certainly think twice after ascertaining the added risk and uncertainty of poor financial records.

While it is understood that business owners will take every deduction possible to minimize taxes, the entrepreneur approaching a sale must change this strategy and ensure that financial records are clean and reflect no aggressive tax deductions.

While a $10,000 aggressive tax deduction expense may save 35% ($3,500) in taxes, it can cost many times that in overall valuation and a much greater loss in credibility for "cheating" on taxes.

This is just one example of many Company Risk factors that impact value. The upcoming chapters discuss internal factors, their impact to business value, and how the entrepreneur can develop strategies to mitigate these risks and increase the value of their company.

Owner Dependency

Most entrepreneurs take pride in being hands on, meeting customers face to face, staying on top of every detail, and working long hours. They are extremely proud and often the business even has their name on the door. Their persistence, perseverance, and commitment are quite often the keys to the success of the business.

Unfortunately, owner dependency is one of the biggest and most common company risks and value destroyers of a business. Without ever knowing it, the entrepreneur who is the most hands on is often the biggest risk in the business. The dependency on the owner is typically the highest potential deduction on a business valuation.

To truly create value in a business, an entrepreneur must cross the bridge from "working in the business" to "working on the business." What that means is stepping away from the daily operations and looking at the business as an asset that generates cash separate from the entrepreneur. Businesses are valued based on the cash flow they generate.

If the owner or a few key employees are the engine that drives the business, what happens to the business when they are removed? In many cases, the value of the business is significantly diminished.

Investors and business buyers are not looking for a job; they want a business that generates income. If the entrepreneur or key managers can't be away from the business for an extended period of time, the engine can't be removed, and value is lost.

Of course no one knows more about the business, the industry, leading and motivating employees than the owner; however, when it comes to business value, no one cares. If the business can't survive without the owner, then the business has little value.

The best book written on this subject is "The E-Myth" by Michael Gerber. Gerber rightly states, "If you can't separate yourself from the business, then you have a job not a company." Buyers and investors will value a business that is not dependent on the owner or a few managers much higher than one that is.

Of course, to start and grow a business, the entrepreneur may have to handle all the day to day tasks, fight the alligators, and be a jack of all trades. However, when the time comes to create value and think about exiting, the entrepreneur has to be in a position to work *on* the business not *in* the business. What does this mean? Hire the right people, set up programs, and establish processes that enable others to run the business. The best test for this is to see how long you can be away from the business without an impact to sales and profits. If the entrepreneur can't be away from the business for a month without

just checking in or answering a few questions, then there is still a lot of work to do to build the right team and processes.

Highly Concentrated Customer Base

Customer concentration risk is a very common issue for even the most successful companies. It is not uncommon for a privately held company to have high levels of revenue from only a few customers. Many times a handful of customers account for over 50% of all revenues and often this number exceeds 70% – 80%.

Over time, many business owners get accustomed to customer concentration and don't perceive this as a risk. As long-term, stable relationships develop, both the company and the customer can become dependent upon each other.

This creates a dangerous trap and vicious cycle. As the relationship develops—and, in most cases, so do profitability and revenue—more company resources are used and added to serve the customer. As revenue and profits grow, it becomes easier to add additional resources to serve these critical customers. More often than not, this is done at the sacrifice of the only strategy that will help solve the problem—finding new customers!

The situation is akin to a frog boiling to death in water. While a business owner may not perceive this risk, it will not go unnoticed by any potential investor or buyer of the business. Overtime, management may become comfortable with the customer concentration, but the real risk of customer concentration is hard to ignore for an outside investor.

Even the best customers will be exposed to economic downturns, changes in management, new technology, changing market conditions, an acquisition, or any number of factors that could force them to change suppliers or reduce order volumes. This is a risk that most outside investors will not accept.

So what can be done to help mitigate the risk of customer concentration?

1. Continue to put resources into developing new customers and market share.
2. Build a "Rainy Day" savings account in case the day comes when you receive the phone call or email that your top customer is changing suppliers.
3. Have customers enter into Long Term Supply Contracts or Preferred Vendor Agreements. This makes switching more difficult.
4. Ensure that all employees who serve the account are under non-compete agreements.
5. Have a back-up plan: What will you do if you lose a key account? What expenses will be eliminated? What steps will you take?

Entrepreneurs must realize that valuation is significantly discounted for the risk of customer concentration. A plan to diversify and spread out this risk should be implemented to maximize value.

Poor Online Presence

Within the last decade, the internet has become a very vital and powerful tool in impacting business value. The web has not only changed the manner in which businesses operate and interact with customers but, perhaps more importantly, it has also changed how the business and brands are perceived.

As Winnie Hart of *Twin Engine Marketing*, a very successful Social Media consulting firm, describes, "The Internet gets to the Truth. A company that goes above and beyond to meet customer needs will be recognized with consistently strong reviews and ratings."

On the other hand, companies that fail to deliver excellence in their products and customer service will quickly develop poor online reviews and reputations. The "Truth" eventually comes out.

Sites like EBay, Yelp, VRBO.com (Vacation Rental by Owner), Trip Advisor, and Angie's List work because customers provide honest feedback and reviews. Readers of these reviews can easily tell when companies go above and beyond or provide poor service.

An occasional complaint can be washed away with over whelming positive feedback, but continual bad reviews will not be ignored and will significantly impact value.

Many business owners fail to realize that it's not always the search results that are the most important. What others say about them and their employees, and how the brand is perceived online, can matter even more.

While a company that has a business to business model may not depend on a good rating from Yelp to be successful, experience as an expert can shine through in LinkedIn articles and online discussions. You can bet that in today's world any outside valuation of your company will include a Google search and a thorough review of your Facebook, LinkedIn, and other social media sites.

Entrepreneurs must ensure that their company name, brand, and expertise come across strongly and portray them as an expert in the industry. Any bad comments from upset employees, customers, or vendors can tarnish your reputation. You must know what searches reveal about your company and your management team.

Like it or not, the first place potential customers, employees, investors and buyers will go to research your company is the Internet. With or without your approval, this will be their first impression.

Although it can take time, perseverance, and company resources, having a successful online presence can be one of the biggest increasers of company value. At the same time, it can destroy value as quick as the next Google search pulls up your name.

Revenue Model

Businesses generate revenue in a variety of ways. When teaching entrepreneurs and students about business valuation, the light bulb often turns on when we begin to discuss revenue models and their impact on value. They can easily see that two businesses, with the same amount of revenue, net income, and in the same industry and geographical area, can have a wide range of value just based on how their revenue is generated.

In the valuation process, revenue models are priced differently. Recurring or contract revenue will get a much higher valuation than project or bid type revenue. Entrepreneurs should strive to make as much revenue as possible recurring. This can be accomplished through contracts, subscriptions, supply agreements, annual purchase commitments, and a number of other ways to make revenue more consistent.

For example, $100,000 of net income from a company that has customers under a contract to provide annual maintenance, with a very low percentage of drop offs from year to year, will get a significantly higher value than a company that provides new construction and must find new clients every year. Project-based business revenue models are typically at the lower end of the spectrum.

While I was building my printing company, and going through a rapid growth period, I went to a Houston Aeros hockey game with Russell Vail. Russell and I were members the Houston Chapter of the Entrepreneurs' Organization (EO). Russell had recently sold his first company, an alarm monitoring business. The alarm monitoring revenue model typically receives a very high valuation because it has both contract and recurring revenue. I couldn't believe the valuation and purchase price Russell received for the company.

Until this point, I had been so caught up in the day to day of running, managing, and growing my business that I had never really thought about an end game. The conversation with Russell really opened my eyes to the possibility that I could one day sell my company. I asked Russell about the process and what advice he would give me.

After Russell described the sale, he followed up with a profound statement; "Al, the most important thing you can do is create a recurring, predictable revenue stream by eliminating the risk associated with it."

I said, "Russell, I own a printing company, and we are project-based. How can I do that?" His reply changed my life and fortunes forever when he said, "Find a way."

This was a turning point for the company and my life. The result of that conversation was the start of a strategy that became the focus for my remaining years in the printing business. I became obsessed with creating a more predictable, less risky revenue stream, so I could one day monetize its value like Russell did. Even though the printing industry revenue model was traditionally project and bid based, I looked for ways to make our revenue more consistent and predictable.

We moved from bidding on big projects to finding monthly newsletters, contracts to be the "supplier" to a franchise, partnerships with software companies (when they installed a system, we got the business forms and printing orders), contracts to be a preferred or approved vendor (we became the "preferred printing vendor" for Anheuser Busch wholesalers and ended up with over 500 as customers).

When we closed our sale and my wire transfer hit, one of my first calls was to Russell to let him know how his simple advice and inspiration years earlier changed my life. I sold the company for a valuation multiple many times higher than the industry average. The investment banker who worked on our deal and several others for the company that acquired us said he had never seen a valuation that high.

Lack of a Clear Vision and Direction

A good vision clearly describes what the company aspires to be in the future. A good vision has the end result in mind and provides the inspiration and reason for fulfilling the company's mission. As you have been learning, value ultimately comes down to the future potential of a business discounted for the risk. Without a clear vision and direction, there is an increase in uncertainty, and this creates additional risk. Entrepreneurs need to know and communicate where their company is going and how they will get there.

A good start is to be able to answer these questions:

1. Does your business have a vision and direction that creates a compelling image of the future?
2. Is your vision used as a guidepost for decision making by the people in your organization?
3. Can your vision be clearly communicated by your management team and employees?

If not, then it's time to develop a clear vision and direction for your business. It's pretty simple; if you don't know where you are going, how will you inspire others to help you on the path and get them excited?

A good vision should:

- Provide a guideline for decision making throughout the business
- Build alignment and commitment at all levels of the organization
- Facilitate desired change
- Serve as a roadmap for future decisions
- Inspire and motivate action
- Prepare the business for the future

A well executed vision becomes part of the organization's culture and comes to life in the everyday activities and actions of your management team. Investors and buyers will quickly be able to ascertain and evaluate if your business has a clear and compelling vision and direction. When the vision and plan is clear and compelling, there will be a significant increase in valuation.

Not Maintaining Good Financial and Corporate Records

We completed the valuation of a business that owned several franchise locations. Unfortunately, the owner ran two of the locations under one set of books and records. The owner now wants to value and sell one of the franchise locations. Since there is no way to validate the revenues and expenses for the location on a standalone basis, this muddied the waters and resulted in a significantly decreased valuation.

There are two lessons here. The first involves long-term strategy. If the vision and strategy was to diversify and build multiple locations that could be sold individually, then there should have been separate books, records, and tax returns. The second is that not maintaining good records will decrease value.

Not having clean financial records makes it difficult when a third party lender or investor needs supporting documents such as tax returns to evaluate the company and its ability to pay back debt. In our post-financial crisis environment, lenders are required to support every loan with detailed supporting documentation.

Not having clean financial records is ammunition for an acquirer to decrease the value of the business and will make it more challenging to get through due diligence. When financial records are not clean, audited, or reviewed by an outside CPA, due diligence can become a long and excruciating process. When there are poorly maintained financial records, it is not uncommon for due diligence to last months or to completely sabotage a transaction.

When it comes to outside investors and acquirers, every aspect of your business will be questioned, scrutinized, and all the skeletons will come out of the closet. Running a tight ship, documenting all processes, keeping all financial records up to date, closing the books on a monthly or quarterly basis, and having a competent and dedicated CPA who can keep you advised of all accounting, tax, legal, and HR regulations are critical.

Accurate and up-to-date records are an investment that will be paid back many times over when it comes to increasing value. The impact to value and credibility can be devastating if your financial house is not in order. Getting through the due diligence is challenging enough even with the best kept records; it can become a nightmare without them.

I am often asked if audited financials or a financial review is worth the investment. **Financial statement development falls into four basic levels:**

- **Internally Compiled**—Prepared internally
- **CPA Compiled**—Prepared by outside CPA
- **Reviewed**—Reviewed by an outside CPA to ensure they are reasonable
- **Audited**—Provides the highest level of scrutiny and acceptance

Audited financials provide the ultimate credibility to investors, lenders, and buyers. They are like an insurance policy and assure the evaluator that they accurately reflect the financial performance of the company. **I believe that audited financials will almost always pay for themselves in the sale of the business and will increase the value of the business in many ways well above their cost.** Again, increasing confidence is an overarching strategy and objective at all times. Providing audited financials is a powerful statement and will increase respect and confidence, as well as set you apart in the market place.

If it is too late to have your financials audited, then a financial statement review of your books, processes, and systems by an outside CPA is recommended. A financial statement review ensures that your books and records are prepared to Generally Accepted Accounting Principals, "GAAP," and are reasonably accurate. If the review is successful, then the CPA will state that they did not find anything material or obvious. A review will provide a higher level of comfort than internally prepared financials since they were reviewed by an outside, third party. A financial statement review can also catch any potential issues that could come up during negotiations or due diligence down the road.

Key Employees without Non-Compete or Non Solicitation Agreements

The potential of managers or key employees leaving to go with a competitor, start their own business, or divulge company information is a risk that can significantly impact value and cannot be ignored. This is especially true if the entrepreneur has been successful in removing himself from the day-to-day operations of the business like earlier suggested.

The existence of non-compete agreements helps address this concern. A well-written non-compete agreement can protect a business and increase value. These agreements help to protect the business from the risk of former employees leaving to compete in some form against the company. **A well written non-compete must conform to state and national employment regulations to be enforceable**.

In practically all acquisitions, the buyer and investors will require the seller to sign a non-compete agreement. You must expect and accept this, and it is usually not a problem. However, many times sellers are surprised to learn that this request will often include partners, managers, key employees, and even suppliers and other consultants at times. If this is not a part of standard operating procedures for the company, it can be extremely challenging to get them completed to meet the requirements of a buyer.

The seller is getting a substantial amount of money to sell the business; however, managers, employees, and even suppliers who are asked to sign a non-compete are not. They are signing away their rights to work for a competitor or another company in the industry. Signing a non-compete agreement can significantly limit their opportunities to work in perhaps the only industry or area they know. Most times they are rightfully thinking, "What happens if I don't like working for the new buyer and want to leave?"

We represented the sellers of a logistics company that had three key employees. The buyer and seller negotiated agreeable terms, and the buyer rightfully wanted to ensure employees had solid non-compete agreements. The buyer did not have them with the employees. The three key employees refused to sign non-competes when presented with documents by the seller's attorney. This created a blocking situation, and the buyer refused to go forward with the transaction. Not only did he back out, but he sued the seller for his time and expenses up until this point. The seller ended up paying for the buyer's expenses to avoid a potential lawsuit.

Be proactive by establishing strong and enforceable non-compete agreements with all critical employees, shareholders, and suppliers. Entrepreneurs can unknowingly destroy value when there is an open door for employees to go to work for a competitor. Perhaps more impactful, they can create a situation that can block a potential sale if the buyer insists on non-compete agreements and the key employees will not sign one.

Not Keeping up with Changes

Entrepreneurship and business has always been one of the greatest examples of Darwinism. Those that do not adapt to a changing world go extinct. Those that lead the change and are early adopters reap rewards that translate into additional business value.

Many business buyers seek to acquire companies that have not adapted or incorporated advances in technology, the Internet, or other ways to increase efficiency. The strategy is to purchase businesses at a discount and use them as a "platform" to incorporate changes and upgrades that quickly increase the value of the company.

They will literally come in with a scorecard that addresses inefficiencies and areas that can be improved. The wider the gap, the more "discount" they get in purchase price, and the more opportunity they have to make improvements and increase company value post purchase.

For example, the virtual office is creating a new paradigm that is enabling businesses to move to a whole new level of efficiency. Many established business owners, including myself, fight it and insist on downtown offices, staff, and in-person meetings.

It is the comfort zone, the way we always have run a company. However, like most disruptive technologies, taking advantage of opportunities that come with remote staff and going virtual can improve the quality of service, drive down cost, and create competitive advantages that all add to increased company value.

Business leaders who are not taking advantage of this are unknowingly driving down the value of their companies. As competition takes advantage of these opportunities, those who do not, fall behind.

Let me give a couple examples. We had a husband and wife team that ran a professional services firm as a client. They both graduated from top graduate schools in their field. They worked for leading companies in their industry and learned the business but, instead of climbing the corporate ladder, they stepped out from behind the curtain of a big corporate name and went out on their own.

Unlike startup firms of the past, in their field, they did not have office space and burdens of overhead. They took advantage of going virtual. The owners and employees work from home. Their employees are experienced, credentialed, highly respected, and their clients have no clue they all work from home. They don't waste time commuting to an office for endless meetings, and they don't need to be managed and babysat. Their firm can ramp up research projects with support staff from all over the world when needed.

When you work with their firm, you don't work with a freshly minted associate who is using a project as a classroom like many "big name" firms do. Your service fee doesn't include a downtown office, staff, or a "blended" fee that includes a partner that you seldom see but support their endless perks and boondoggles. You get experienced, proven professionals with no fixed overhead or imbedded resource costs. They are not alone.

I sit on an advisory board with the owner of a company who employs over 300 virtual customer and back office support. They work for a fraction of the cost and overhead. She can ramp up in busy times and scale back when business slows.

I have to admit I have overcome my reluctance, and our firm is now taking advantage of the opportunity. Our main financial analyst who graduated from a leading university works from home and uses support help and researchers from around the world. We utilize experienced and specialized valuation analysts in our field when needed to consult and review valuation reports.

The advantages of technology and a virtual world are all around. Early adapters are tapping into world-class talent creating companies, utilizing support staff, and eliminating traditional facility overhead to create lean, profitable, and more valuable businesses. They use technology, social media advertising, and many other new innovations to increase value.

Not Understanding Financial Ratios and Relative Performance

Financial ratios and other comparison metrics tell a lot about a company and its performance. They are also critical key tools in determining value.

In 2012, Miguel Cabrera of the Detroit Tigers won baseball's Triple Crown which was last won in 1967 by Carl Yastrzemski. Cabrera led the league in Home Runs, RBI's, and Batting Average. Knowing just those statistics, what do you think that says about his value as a baseball player?

I think you could safely deduce that he would be extremely valuable when compared to his peers. Financial Ratios are the statistics of business and are used by valuation analysts and investors to help determine the value of a business.

Financial Ratios help gauge a company's performance in many different areas including financial solvency, profitability, efficiency, return on investment, and even employee performance. Valuation analysts and investors compare a wide range of ratios to industry norms that are available through various service providers.

Companies that are performing better than average typically garner higher valuations and more interest by investors. In addition to their use in valuation analysis, business owners can use them as "Dashboards" to monitor company performance. For example, the Quick Ratio is used to evaluate the potential of cash flow issues. The Quick Ratio is Current Assets – Inventory divided by Current Liabilities. For most companies this is Accounts Receivable + Cash divided by Current Liabilities. While the average varies by industry, typically a ratio of 2:1 and higher is considered above average. As this number gets closer to 1:1 and below, the probability of cash flow issues increases and the value of the business would be lower.

While there are literally dozens of ratios that can be evaluated, a handful can give a solid insight to the relative performance of a company especially when compared to other businesses in the same industry.

Business owners should work with their financial advisors to understand financial ratios and how they can be used to help manage the business and increase value. While there is no Triple Crown for businesses, there are still above and below-average performers. Take the time to understand how your business stacks up!

Here is a link to a website that lists and explains many common ratios:
http://www.investopedia.com/university/ratios/#axzz28AiTxvz3

Overly Aggressive Expense Deductions

One of the biggest challenges with privately held companies is a lack of verifiable net income. Many businesses owners get in the habit of reducing taxable net income as much as possible. In some cases, deductions blatantly cross the line as they did with one business we valuated in which the owner deducted the family dog for "security" and trips to Greece to check out potential vendors.

In most cases, deductions, while pushing the line, do not cross it. These typically include family members on payroll, client entertainment, personal benefits, and timing issues like pushing revenue into the next tax year and accelerating expenses.

While these may be benefits to ownership and can reduce taxes, when the time comes to sell or value a business, over aggressive deductions can significantly impact valuation and damage credibility. Post the financial crisis, lenders, investors, and valuators have an entirely new standard of due diligence and income verification requirements.

Non-verifiable income, that is not on a tax return or GAP prepared financial statement, is typically not counted as net income. Let's look at an example:

If a business is valued at 4x (times) net cash flow and the company has $250,000 in taxable income, the valuation would be $1,000,000. If the business owner runs miscellaneous expenses and deductions of $50,000 to save on taxes, he would save about $17,500 on taxes at a 35% tax rate. However, he could lose 4x $50,000, or $200,000, in valuation.

In addition to losing potential value, business owners who push the limits on tax deductions also risk losing credibility with lenders, investors, and valuators. Personal trips and benefits, family members on the payroll, and other aggressive deductions that cross the line can be interpreted as unethical, in addition to actually being illegal.

While pushing the limits may be fine when running a business that is years off from a potential sale, there are many risks to valuation and credibility when it is close to a potential sale or transfer of ownership.

Impact of Taxes

Like anything else tax related, the best advice is to always have a competent tax CPA in your corner. Tax strategies are dependent upon the specific situation and parameters. It is important to start early and work with an advisor familiar with your industry, company, as well as all state and federal tax laws.

Most privately held business sales are structured as an asset sale. If the business is a C-Corporation, then the assets of the business are sold and first taxed at the corporate level. There is then an additional tax when the cash is distributed out to owners and shareholders. This can result in an effective tax rate of nearly 50%. Many business owners are shocked to realize this and, unfortunately, there is very little that can be done to change this situation at or near the time of a sale.

The future tax climate can best be characterized as extremely uncertain; this is brought on by the Supreme Court upholding the Affordable Care Act and a number of provisions in tax cuts that are set to expire. Capital gains and estate taxes, which can significantly cut into the proceeds from the sale of a business, are expected to only go up in the future.

When calculating the value of a business, most valuation models use "Free Cash" flow or after tax cash flow. Many business owners do not realize that there is a deduction for estimated taxes. Tax strategy and timing play an important part in determining the value of a business and an investor's returns. As tax rates increase, there is less cash flow to investors and owners.

Significant changes are forecasted in estate tax. This tax could increase from 35% this year to a potential maximum of 55%, and the lifetime exemption amount could go down as well. That might make for some unhappy kids.

The importance of taxes in business valuation cannot be underestimated and must be taken into consideration by the entrepreneur.

Assignability of Contracts

One simple but often overlooked risk factor is the assignability of contracts from both suppliers and customers. This often creates surprises and rears its head in the middle of due diligence. Not having assignable contracts can often be a major deal breaker or, at the least, a stumbling block. We've seen many transactions slam on the brakes while the seller is forced to scramble to ensure that supplier or customer contracts can be assigned.

Value is based on assumed future business results and achieving those results may depend on the continuation of a contract. If there is a risk that an agreement can be terminated with a change of control or new owner, then that risk will be taken into consideration when assessing value. Most acquisition agreements require that existing contracts will remain valid after a change of ownership.

The lack of an assignability clause may restrict a company's ability to assign or convey a contract to a new owner. It can also make a contract null and void if a sale, change of control, or merger takes place without the change being made. It is very important to note that this includes: leases, loans, liens, licenses, alliances, supply/service agreements, real estate contracts, employee agreements, and a myriad of other conditions.

We were involved in a transaction between an entrepreneur and a large publicly traded company several years ago. There was a great fit between two companies with good synergies and cross-selling opportunities. The acquiring company made a very strong offer that was accepted by the seller. However, when they got into due diligence, the seller found out the customer contracts were not assignable. Despite the fact that they were long-term contracts, there was an out if there was a change of ownership.

This created a very challenging situation. The buyer would not move forward until all the customers signed off on the change of ownership, but the seller did not want to let his customers know he was contemplating the sale of his business to this specific company.

This resulted in an irreconcilable difference and the break-up of the transaction. As an added note, market conditions changed dramatically the next year as we moved into the financial crisis of 2008-2009. The value of the seller's company dropped to a fraction of the pre-crisis offer, and he was not able to sell the business. To add insult to injury, the buyer decided to invest and create their own division. This not only removed them as a potential acquirer but also created another competitor in an already small market.

Not optimizing the use of capital

Many small business owners often shy away from debt or credit lines and actually end up with higher expenses in the short term and a lower business value in the long run. While this seems counterintuitive, companies with good cash flow and good credit can use debt and selective financing to improve both cash flow and business operations.

The challenge for entrepreneurs is to not abuse or "over-leverage" this opportunity by taking on too much debt. Needless debt for extravagance, covering up poor cost controls skills, shrinking margins, and a host of other bad business practices can mask short-term problems and evolve into significant long-term issues including bankruptcy.

This is when debt gets the entrepreneur in trouble.

However, proper debt strategies and management—such as a line of credit, short-term note payable, or other forms that that can be paid back out of normal cash flows—can be used to increase the overall value of the business. There can also be tax advantages as well.

When the benefits outweigh the costs, and the expense can be built into cash flows, interest expense can be looked at as just another expense of the business like salary, rent, or travel. Most entrepreneurs wouldn't think twice about hiring an entry level employee at $2,000/month but would never consider paying that in a monthly interest expense.

Using debt that can be easily repaid over time and out of cash flows for items like new equipment, supplier discounts, higher quality employees, training, and other improvements and efficiencies can be used to increase cash flow as well as the value of the business.

Another benefit of taking on a little debt is that it gets your foot in the door and can help establish a relationship with a lender. Although a large loan may not necessarily be needed today, somewhere down the line the business may require a loan to fund an acquisition, capital expansion, or hire additional personnel. Making payments on small loans can improve your business's credit rating, increase cash flow, and build credibility with lenders, so you can move quickly after an opportunity if needed.

Another added benefit is sending the message that both you and the business have been able to utilize financing and payback debt. This display of fiscal responsibility can be very powerful to would-be investors and potential buyers. Just remember to keep debt to equity ratios low and well within the capacity of the business to pay them back.

Currently, interest rates are at near historic lows, and it has never been less costly to borrow money. Obtaining a loan at a competitive rate and using it to fund additional growth and increased efficiency can increase profits and significantly increase the value of a business.

Not Protecting Intellectual Property

Many businesses possess some form of Intellectual Property (IP). It is categorized into two areas by The World Trade Organization: industrial property and copyright. Examples include inventions, trademarks and trade names, industrial design, literary, artistic, musical works, and more.

The most common ways to protect IP are through patents, copyrights, and registered trademarks (and trade names). Some IP, however, is not easily protectable or an entrepreneur may choose to not release information to the public through the patent process. This is often the case with trade secrets (a good example of this is the century-old recipe for Coca-Cola).

A simple way to gauge how vital certain IP is to your business is to imagine a scenario where that portion was removed or greatly infringed upon. Asking how this would impact sales, pricing strategy, or market awareness can help to give an idea of its value to the business. A valuation professional can help calculate the value of IP in a similar, but much more detailed manner.

When it comes to the overall valuation of a business, protected IP can significantly reduce the risk of competition and reduced margins and, to an investor, this can be critical.

My sister-in-law is the inventor of a very unique wheelchair cover. The covers can be custom printed with designs and graphics. The costs of the covers are even reimbursable by most insurance companies and Medicare because of the safety feature of protecting hands from the turning spokes.

She applied for a patent but was turned down because of a very similar patent in Japan. Even though no one was actively using the patent, she could not secure any patent protection on her design. She auditioned for the popular show *Shark Tank* and was turned down because the product was not patented. Although she has a fantastic and popular product, the risk of "copycat" products and increased competition impacts the value so much that she can't get investors.

I heard a great comment in regards to this; "The early bird may get the worm, but the second mouse to the trap gets the cheese." This is particularly true when it comes to new product innovations and ideas. Without IP protections, many fantastic first-to-market products can be easily copied and markets that were opened by the innovator can be entered by other competitors.

A difficult question is determining whether the cost of protecting IP is worth the risk and what is the likelihood it will be infringed upon. Hiring patent attorneys and other professionals can be very costly and extremely time-consuming for a patent to be granted, if at all. The decision to protect the risk is an important part of the long-term value creation strategy.

A recent client in the Oilfield service industry received a valuation of 1.5 times their most recent revenues and 9x earnings. The valuation was over double the industry average and over 3 times the

overall average for a business that size. In discussions with the buyer, they put a value on their patents of 50% of the total purchase price. Their patents added significant value to the buyer.

Supplier Dependency

An often overlooked risk is the excessive reliance on a major supplier or even employee. While maintaining a good relationship with a major supplier is valuable, the associated risk of dependency can impact the value of a business.

This is a very common occurrence and usually develops over a period of time. Suppliers are a critical key to most business's success. In many cases, one or two suppliers emerge as the "go-to" source for products and services. As these suppliers come through with rush deliveries, better terms, and a strong and trusting relationship develops, they tend to get the majority of business.

As I built my printing company, I developed a very long-standing relationship with a local paper supplier and over time became very dependent on them. I became great friends with the owners and, in addition to business, we supported each other's causes. They always took good care of us. They gave me favorable prices and terms and even referred several of their other clients to us for acquisitions. In turn, we gave them the vast majority of our paper business.

While this was a great relationship, it was unknowingly impacting the value of our company. When a national paper company bought them out, we became just another customer and did not have the "intangible relationship." As a result, prices, terms and even paper allocation during times of shortage were no longer based on the relationship. Not having a good relationship with other suppliers limited our ability to go to other sources.

There are a number of steps that entrepreneurs can take to mitigate single or major supplier reliance. These include having multiple suppliers, long-term contracts, and back-up sources.

Supplier relationships and their potential risks are an integral part of a business valuation and buyer due diligence. The dependence on suppliers, and the corresponding risk to valuation, will not get missed.

Entrepreneurial Burnout

One of the biggest and hidden impacts to value is entrepreneurial burnout. Successful entrepreneurs have a drive, passion and strong emotional connection to their business. They are forward looking, goal orientated and their greatest strength is working towards a fuzzy goal in an uncertain environment.

In the early and growing stages of the business, this is a great fit and strong elixir to the driven, passionate, creative entrepreneur. But when the bridge is crossed and the chaotic startup turns into an established business, the keys to success change to administration, processes, controls and systems. The joy of building and growing the business turns into the drudgery of managing it and the driven entrepreneur can start to lose interest and the emotional drive.

This is not typically a fast process, but instead occurs slowly over time. The joy of working a quiet Saturday morning or evening when the phones stop ringing turns into a burden and obligation. A long weekend with an extra day off becomes preferred over the excitement of getting into the office early Monday morning.

Creating and building turn into HR issues, IRS deadlines, legal issues, and constant administration. What was once passionate leadership is now the resented management of issues and problems. The late Harvard Medical School and Founder of the Levinson Institute for Leadership's Harry Levinson researched this concept extensively. His findings show how management resentment and burnout impacts the organization, employee performance, and ultimately company value.

Unfortunately, many entrepreneurs begin the process of exiting their business well after the impacts of their personal emotional state and business value begin to decline. We recently worked with the owner of a consulting company whose sales had decreased over 20% in the last year. He confided that he was enjoying his discretionary time out of the office much more than using it to entertain clients, network, and build the business.

He lost the "Eye of the Tiger," and there were many manifestations of this in his business including declining employee morale, increased turnover, loss of key customers, shareholder disputes, and many other tangible and intangible impacts.

Entrepreneurs must be extremely cognizant and self-aware of this issue as it is often the "Slow Burn" that has the most devastating consequences. It's ok to acknowledge that the joy and rewards of building the company are not found in administering and managing a company. The earlier this is recognized and dealt with, the less company and emotional value will be destroyed.

Below are links to articles with Harry Levinson's views on the topic. Take some time to understand this before you begin to destroy value that took so much time and energy to build.
http://wweb.uta.edu/management/Dr.Quick/spring2012/When%20executives%20burn%20out.pdf
http://www.leader.co.za/infocentrearticle.aspx?s=5&c=135&a=1407&p=2

Free Cash Flow

A business is ultimately valued based on the cash flow that the business will generate to its owners. All the efforts, strategies, decisions and years of work come down to this. While the business owner has a long history, emotional connection and sense that this is his / her baby, investors and business buyers are purchasing the business for the cash flow that will be generated. Terms such as EBIDTA, Net Income, EBIT, after tax income, free cash flow and many others are commonly used to describe this stream of cash flow. **It is critical to realize is that what matters most to the business buyer is Free Cash Flow or "FCF". Free Cash Flow is the amount of money that is available after paying all expenses including debt, interest, preferred shareholders, taxes, capital improvements and any cash that must be used or left in the business for increases in working capital.**

At the end of the day, Free Cash Flow is the money that is available for the owners and shareholders to do whatever they want with it. As Warren Buffet would say "cash is cash and all accounting is up to interpretation." FCF can be distributed, reinvested in unrequired improvements, set aside in retirement accounts, used for additional debt payments of any other manner the owners want. It is the cash that can be used once all obligations and required reinvestments in the business have been made.

Many times sellers, business brokers and even CPA's will use other forms of income in their calculations which can result in an over valuing of the business. The following formula is used to calculate Free Cash Flow:

Net Income (after paying all expenses including taxes)
\+ Non Cash Expenses (depreciation, amortization, deferred taxes & Revenue)
\- Capital Expenditures
\- Additions to Working Capital
\- Debt Repayment
\- Dividend Payments to Preferred Shareholders
= Net Cash Flow to Equity Owners

While past performance is often a good indicator of the future, it is important to note that the past does not always equal the future. You cannot simply extrapolate the future expected performance from the past performance of the company or value a business based on historical numbers. You can be sure that anyone valuing your company will be taking into consideration economic and industry conditions, changes in competition and technology, capital improvements, regulations and a number of other factors.

The calculation of Free Cash Flow and any forecasting should be left up to an experienced CPA and is outside the scope of the book. For now just understand that once Free Cash Flow is calculated, the expected return for the risk from all the factors that impact the business and its cash flow will determine the final value of the business.

As discussed earlier, the biggest misconception that business owners have when it comes to business valuation is that of simply applying some type of multiple to their earnings when in fact nothing could be further from the truth!

Pulling it All Together: Assessing Value

Once FCF is estimated, a risk factor or "Discount Rate" is applied to the estimated free cash flow that will come from the business and the value of the business can be estimated. While as much art as it is science the concept of close enough for "Horseshoes and Hand Grenades" applies to business valuation. The typical minimum required rate of return for taking the risk of owning a small privately held company is about 20% and it can go up from there to 50% or in some cases even higher.

This means that the range of value typically will range from 2x cash flow to 5x cash flow. Anything outside of this range is most often an anomaly or a special circumstance situation. Hence a business that is generating $500,000 a year in Free Cash Flow, will range in value from $1,000,000 to about $2.500,000 with the mid range being about 3 – 4x or $1,500,000 - $2,000,000 - quite a difference!!

As wide of a range as this may seem, it is not really that challenging to derive a fair market value once all the risk factors are understood.

When I started buying printing companies in my 20's, I was able to intuitively understand and assess the value of a business without any formal technical knowledge or understanding of the valuation process. It may not have been derived from applying the technical process that I eventually learned, but with my capital and bank loans on the line, I could not afford to miss any of the risks embedded in the business or overestimate the cash flow the business could generate.

In hindsight, I do not believe this was any special gift. Anyone standing on a high dive with or without diving experience assesses the risk of the dive. As the dive gets higher, the risk goes up and the consequences of failure increases. Risk is something that we all understand at a gut level. Over time and exposure to similar situations, we can become better at quantifying and processing it. However, no diver either novice or experienced would take the chance at a high dive into uncertain water.

Humans are programmed to both feel and quantify risk. When exposed to a situation such as buying or investing in a business, this same innate ability kicks in. When it comes to investing capital, the concept of risk aversion further exaggerates this principal as does the ability to walk away and either hold onto our money or wait for another deal.

Decreasing excess risk and uncertainty in a business is what increases value. All business buyers and investors are standing on a high dive assessing the risk of diving in. They will only go higher and invest more money as they more clearly understand, assess and mitigate the risk, uncertainty and potential of the downside.

I bought my first company Stewart and Sullivan printing in my late 20s. The company was one of our suppliers and the two remaining owners Howard and Guy Stewart were in their late 60's looking to sell the business. For a 28 year old looking at his first business acquisition, it was a big and intimidating decision.

How do I handle the production side? What about the legal issues? Is their equipment any good? Could I depend on the employees to run the business? Would the customers leave? Despite the fact that I had

known, trusted and worked with them for years, I was now making a decision to invest a substantial amount of my capital and a bank loan into the business. I had to assess the situation and place a value on the business. Without any knowledge or experience, I was completing my first business valuation.

The mid to late 1980's was a poor economic time in Houston. The oil boom had come to a screeching halt and the energy industry which drove Houston's economy was in a very depressed state. Just a few years earlier during the boom times, the economy was strong and printing companies thrived. The only thing that mattered was getting the job done and out the door as quickly as possible. Stewart and Sullivan had been running around the clock 7 days a week printing work for the major oil companies.

Despite the fact that the local economy and industry was in a down state, Guy and Howard tried to assure me that it would soon be back to the way it was and wanted to base the value of the business on this fact. However, during the strong economy a few years earlier printing companies began to sprout up in large numbers. With the downturn in the economy, competition increased and profits were getting squeezed. Despite their optimism, there was no sign of the industry recovering.

Without any knowledge, I had taken the first steps in the valuation process by assessing the external or timing issues of the valuation process. The local economy was depressed, interest rates were high and the industry had a lot of competition. In addition, there were a large number of printing companies for sale in the market place. In a formal valuation process, the assessment of external risks would have been one of the first steps in the process.

As I quickly found out, much of their revenue was derived from a few key customers with very strong personal relationships developed over the years with trips to Las Vegas. They became good friends with the print buyers and received the first shot at any business that came out. During the good times, they hit capacity by just taking care of these customers. They were too busy producing orders and counting the money from these customers to go out and market for new customers. This created an extremely risky and unpredictable revenue model that was based around a few relationships with print buyers.

A simple analysis of the financial statements revealed that the two brothers had been running a lot of questionable deductions through the business. Cars, lunches, trips to Las Vegas, family members on the payroll. Virtually any personal deduction that could be run through the business was run through leaving very little cash flow on the books. Not having clean financial records that tied to the tax returns hurt their valuation and became a major stumbling block to completing a transaction and getting bank financing.

In addition to having strong personal relationships with the key customers, they were doing all of the management and operational work required to run the business. They were quoting jobs, ordering materials, scheduling the work and putting out all the fires that came up. The business was dependent upon them.

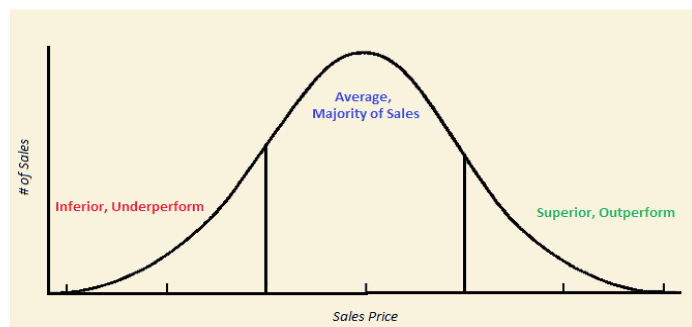
All kinds of other risks started to pop up. There were no employment contracts, a few key suppliers, no documented processes, they had outdated equipment and when separated the two brothers accused each other of not working hard enough. They were both tired and fed up with the business. They had reached the point of entrepreneurial burnout and were ready to get out.

Without any knowledge of the valuation process, I had estimated their cash flow and completed an analysis of the external and internal risk factors that impacted the company. I had walked through all the steps and completed my first business valuation. From that came an offer that was substantially below their asking price with terms that would protect my downside risk. The offer was 1/3rd cash upfront,

1/3rd in a note they would finance and 1/3rd based on the performance of the company paid out over time. Since the business was dependent upon them, one of them had to stay on for a least a year.

They didn't like our offer and tried to shop the business. In the end, they accepted my valuation and offer as the market confirmed my assessment of the company. Although they didn't like it, there was no getting around the risks embedded in the company and the external conditions / timing conditions were not favorable. We eventually completed a deal based on my terms. In hindsight, Guy and Howard Stewart had unknowingly built a business with a poor revenue model and excess risk that was valued well below its potential.

Buying companies like theirs became a large part of our strategy. I would look to find companies that were undervalued and make very low offers. The terms of 1/3rd down, 1/3rd in a note and 1/3rd based on performance never changed. It was more of a take it or leave it offer. Over the years I acquired about a dozen or so companies under this model.



While I did not know it at the time, I was buying companies that were under average in terms of relative valuation. Since I already had an established infrastructure, I could simply eliminate costs like rent, accounting and other overhead items and consolidate them into my location. The terms of the deal provided downside protection and created a mechanism to lower the purchase price further if business was lost after the sale.

While I was buying printing companies on the low side of average, there were several business brokers that brought me deals that were at the opposite end of the curve. These businesses had clean financial records, diverse / well established customer bases, systems and processes in place and other factors that increased their value. I was amazed at the prices these brokers were not only asking for but getting for these businesses.

The businesses I was purchasing were below average in terms of valuation, but the businesses they were selling were above average. The difference was all the risk factors we have been discussing. On a relative basis, there was much less risk in their businesses and revenue models and these companies sold for higher prices and better terms.

I would like to say that there was a big vision and masterplan behind what I was doing. In reality I was clueless from a formal strategy and business valuation standpoint. I was simply standing on the high dive and would not jump in unless I was comfortable with a value and deal structure that protected my downside.

As I told the story earlier in my discussion on revenue model, a lightbulb went off and my entire life changed after my conversation with Russell Vail during a Houston Aero's hockey game. Like most entrepreneurs, I had been heads down in building my company and running the business. Even though I had been purchasing companies for quite some time, I had never really thought of an exit for myself. This was the first time it ever entered my mind. After hearing Russell's story about the life changing event of selling his business and advice on building a more predictable, less risky revenue model, I had unknowingly started putting together a plan and exit strategy for the business.

Russell's story helped set my sites on an end game and gave me a north star to set my focus on. We began to focus on more predictable revenue models, that reduced the risk in the business and increased value. We moved away from traditional bid work that was inconsistent and unpredictable and started to get agreements and contracts to be the preferred printing vendor for franchises, software companies and other groups of affiliated companies. Our biggest break came when Anheuser – Busch gave us preferred vendor status.

Once that happened we had access to over 1,000 independently owned and operated distributors around the country. In time over 500 of them became customers. This model was copied with other franchises and national companies in a variety of industries including dry cleaning, travel agencies and other beverage distributors. It was a great cycle. The more business we got the better pricing and service we could provide.

Business boomed, profits increased and the less I had to be involved in the business. I focused my time and effort on strategies that included better pricing from vendors, acquisitions, and finding other ways to create a more predictable / less risky revenue stream. Life was great. The business grew through the 90's and was making nearly $1 million per year then a couple interesting things happened.

As the business grew, I remember walking through the shop one day and not knowing all the employees. As the number of employees increased, so did the problems. We had to fire an employee who was pregnant, one of the sales reps from an acquisition had a bipolar condition and threw a pair of scissors at a printing press operator when she didn't like the job, an employee with a series of DWI's got in an accident after a holiday party. Each one of these resulted in lawsuits.

Despite the fact that business was great and I could delegate the day to day, as the owner of the company, there was no escaping these challenges and their emotional toll. I had to work with lawyers, settle these issues and take them to bed every night. The fun was starting to go out of the business and then I saw a signal I could not ignore.

As I walked through the National Beer Wholesalers convention in 1998, I saw one of our Anheuser Busch business forms with a circle and a red line through it. The sales rep at the booth said they had an electronic signature pad that was going to replace the paper business form. I knew this represented that their software could replace our printed products. Later that night, I made the decision it was time to exit the business.

When I returned from the show, I put a phone call into an investment banker to represent me and sell the company. When he saw our financials, diverse customer base and profit margins he said there would be no problem in finding a buyer who would make a very strong offer. I ended up selling the company to a group of business forms executives who were backed by a large private equity company. They made an offer that was higher than any valuation the investment banker had seen in our industry. After the sale the buyers said they had never seen a company that such a solid, diverse base of highly profitable

customers. The simple conversation that took place at a hockey game several years started my quest to build a recurring predictable revenue stream and resulted in a record sales in our industry. The first phone call that I made after the wire transfer hit my bank account was to Russell Vail who had unknowingly gave me the best and most profitable business advice I ever received.

In turn, I now hope that this book will help you down the path to creating a plan that will one day maximize the value of your business.