

Potential Buyers – Who Are They?



CORPORATE FINANCE ASSOCIATES

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The Primary Mission in marketing a company is to locate a buyer who likes you and who can afford you.

Categories of Buyers

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|----------------|--------------------|
| 1) Competitors | 6) IPO's |
| 2) Suppliers | 7) Corporations |
| 3) Customers | 8) Individuals |
| 4) Employees | 9) Venture Capital |
| 5) Creditors | 10) ESOP's |

Buyer Motivation

Buyers buy for one of three reasons: 1) ego trip, 2) buying a job, and 3) investment.

In the companies where sales are \$5 million and up, buying a job or an ego trip is a rarity. Buyers are interested in return on their investment.

Buyers purchase to enjoy a future benefit. What a buyer is willing to pay is dependent upon the perceived future earnings and the perceived risk. And, each buyer rates these factors differently.

Seller Motivation

Conceivably you could charm most any type of buyer into liking your business. Obviously, at some price and terms, sellers could be matched with buyers irrespective of seller motivation.

There are a minimum of six reasons why owners sell their businesses:

1. Estate planning
2. Family pressure
3. Right price
4. Need money to expand
5. Retirement
6. Illness

Caveat:

Competitors may feign interest just to learn how to better compete with you.

Tread carefully

Let's explore the relationship between seller motivation and categories of buyers. In the table on page two, is an indication if the deal has good or poor potential for the seller.

We must qualify this table to exclude service businesses because they are usually sold to employees or competitors. Also, even though the table would point to an IPO or a large corporation as the highest potential for your business, we must remember that these have minimum limits on size and profits.

Categories of Buyers

1. **Competitors:** Your business may be attractive for gaining market share, which allows for better control of the market price.

There may be synergism in production and marketing which could reduce unit costs. Possibly a plant could be shut down or the total sales force reduced. It may be cheaper to buy your facility than to build a new one.

Maybe the competitor's motivation is to expand into your geographical marketing area.

A competitor is already in the business: he knows the markets and the business. The basic value of your business to him is the replacement costs of any assets he would need plus the marketing costs to acquire your customers. Such a valuation by the competitor is unlikely to pay the seller very much for goodwill.

<i>Buyer Category</i>	<i>Estate Planning</i>	<i>Family Pressure</i>	<i>Right Price</i>	<i>Need \$ to Expand</i>	<i>Retirement</i>	<i>Illness</i>
Competitors			P			
Suppliers						
Customers						
Employees	P	G	P	P	G	G
Creditors				G		
IPO	G	P	G	G	P	P
Corporations						
a. Large	G		G	G	P	P
b. Small			P		G	G
c. Shell			G			
Individual Buyers		G	P		G	G
Venture Capital	P	P	P	G	P	P
ESOP's	G		G		G	G

P = Poor, G = Good

2. Suppliers: Vertical integration may appeal to some suppliers. However, they have to worry about how their other customers will react. Their customers may not relish competing with their suppliers. However, if the seller is a substantial portion of the suppliers business, it makes good sense.

3. Customers: Vertical integration may appeal to some customers. Again, they would have to worry about the reaction of other customers. If a substantial portion of your business is to one customer, then he may be a good candidate.

We've all heard the story about the big department store that cultivated their supplier until his business depended on the big store - and then they were cut off only to sell out to the big store just short of bankruptcy. The message is: Don't cultivate that big customer until he owns you, all in the hope he'll buy you out at a big price. He holds all the cards.

4. Employees: We're talking about a direct sale not an ESOP. Employees are excellent candidates to buy your business. Most don't have the money or the collateral to do the deal. Sometimes the seller is willing to make a favorable loan to a loyal employee, friend, son, daughter, or relative.

You've heard of the theory of relativity in business: What good is a business if it can't take care of a few relatives?

About 30% of the country's family businesses are passed on to second generation family members, and only 15% make it to the third generation says Nancy Drodow, project manager for the Family Business Program at Wharton School of Business.

Each family situation that we've run across has been different, making it difficult to generalize. Sometimes the emotional stress of the family situation is the real reason for selling. And, sometimes, the organization is so professional that the only hint of a family situation is the common surnames.

So it depends upon the situation. If you have confidence in the family member-buyer's ability to run the business and pay you, then sell it to him/her: If no, look elsewhere.

5. Creditors: Sometimes businesses are sold to the creditors without the consent of the seller. It's called bankruptcy.

Credit can be granted with convertible debentures and warrants. And that, in the final analysis is selling part of the business. As a matter of fact most any creditor has a call on the equity of the business whether or not it shows as equity on the balance sheet.

6. Initial Public Offering (IPO). The investing public may buy your company through an IPO. You sell shares to the public. While this concept is simple, the execution is complex due to government regulations. The normal IPO will take six to nine months to prepare and cost \$200,000 to \$500,000. This includes the prospectus, SEC registration, professional services, etc., but does not include the underwriting costs that will be another 6-12% of the proceeds of the offering.

The advantage of the IPO is "instant" cash and "instant" liquidity. The disadvantages are cost (initial plus ongoing reporting) and loss of control. After you go public, you have government rules telling you how to run your business, you have investors to please, and you have to operate in a fish bowl climate.

From a practical standpoint, a company has to be making \$1 million after tax to go public. In a hot market with a hot product, occasionally, a company will pull off a successful public offering with no earnings track record.

There are other techniques that may be used to speed up and simplify the IPO. You can merge with a shell company - a public company with no business and maybe no assets.

7. Corporations: There are several kinds of investor corporations varying in size from conglomerates like Gulf&Western and Littons to tiny fly-by-night entrepreneurial companies.

The objectives of conglomerates can be widely different.

A company like Litton might buy your company as a straight investment, intending to hold it and make it grow with new capital and existing management. The deal would probably be a stock swap or cash and stock.

The stock you receive would be tax deferred. You get instant diversification of your estate.

The stock, typically, is legended such that you can't trade it for two or more years.

Trading stock for stock defers taxes in most cases.

You could trade your stock for the stock of a lesser-known company. There are plenty of them willing to give you their paper for your paper. Each case has to be decided by the seller on its merits. Most deals like this involve substantial risks for the seller.

A publicly traded corporation tends to look at the value of a target company in terms of impact on its own price/earnings ratio. This doesn't mean that the buyer wouldn't bargain for a lower price/earnings ratio in the acquisition: it means that the seller has the potential to bargain for a price/earnings ratio up to the price/earnings ratio of the buyer without diluting the buyer's earnings. One publicly traded conglomerate that we work with has a target price/earnings ratio of 5 on a pre-tax basis for their acquisition candidates. Their own publicly traded stock has a ratio of 9. This means that every acquisition they achieve at 5 enhances the value of their stock. And it is surprising how many takers they get at 5. We suspect that when other buyers are looking for a 25 to 35% return (equivalent to a P/E of 4 to 3) that 5 looks pretty good.

Small private corporations will also trade you their stock, but they don't get many takers. A minority stock position (less than control) in a private corporation is worth nothing until the corporation is liquidated - and it may never be liquidated!

Most small corporations are merely legal extensions of an individual buyer. They look at acquisitions through the eyes of an individual buyer.

8. Individual Buyers: There is a broad group of individuals looking for four things: a safe place to put their money, a tax break on earnings, a chance for capital gains, and a rate of return in excess of 25% pre-tax.

Individual buyers with proper financial and technical qualifications are excellent candidates to buy medium-sized businesses. Individual buyers base their buying decision on the cash earning power of the business and the risk to their investment, as they perceive it. A person who has experience in the business has a lower risk threshold and usually will value the business higher than an inexperienced person.

Our experience is that many of these individual buyers turn out to be "tire kickers." It isn't that they aren't sincere: it's that they don't have the financial clout to do the deal.

This brings up another point somewhat off the subject. How does one qualify a buyer financially? Ask him/her for their financial statement, up front. You can bet that they are going to ask for your business statement.

If a person has a strong statement, there will be no hesitancy in presenting it. If there is a weak statement, there will be some lame excuse such as, "I'll produce it at the proper time," or "I assure you that I am qualified to do the deal." You shouldn't waste your time and risk the breach of confidentiality to a person or company that won't produce their statement up front.

An intermediary can help: He/she has no reservations about talking about financial qualifications, up front.

9. Venture Capital. Venture capital groups (VC's) will put cash in your business to let you build to a greater business value in 3 to 5 years. They want to achieve a 50% compounded return on their investment. Over 5 years this works out to about \$10 for each dollar invested.

On going in, they plan how they are going to get out. Usually it's by an IPO or merger with a bigger company. Venture Capitalists consider the management team as important as the profit idea. If your objective is to retire or leave the business, then venture capital is not a viable alternative.

Venture capital does have a place for a growing company in a large market. You get a smaller piece of a larger pie - or you may find yourself outside looking in.

However, more and more, venture capitalists are doing leveraged buy-outs (LBO's) of mundane businesses. This is more of the type of deal that an individual investor or a corporate conglomerate would do and, as such, is not a venture capital deal in the conventional sense of the term.

Nevertheless, if your business has a large asset base and has the cash flow to support the payoff of substantial new debt, a LBO through a venture capital group may work. If there is strong second tier management; the selling owner may leave, since it is an on-going business.

10. Employee Stock Ownership Plans (ESOP's): Each potential seller of a closely held business should evaluate selling to an ESOP. ESOP valuations tend to be higher than individual buyer offers. So, even if the situation is not right to sell to an ESOP, the ESOP valuations may be a useful negotiating tool.

Hundreds of Buyers

There are hundreds of buyers out there, and, in our experience, probably at least a hundred for each company that is seriously for sale. The information in this article is intended to help you narrow the search.