CONSIDERATIONS WHEN BUYING OR SELLING A BUSINESS

By Peter C. King, CEO VR Business Sales / Mergers & Acquisitions

PETER C. KING
CEO

VR Business Sales
Mergers & Acquisitions

The single most important decision in making an acquisition (or completing a merger) is in determining the value or setting the price. In a traditional merger, where the acquired business' shareholders exchange their stock for stock in the acquiring business, the negotiation of price seems simple – what is each business' stock worth? Although this may sound simple, there are many considerations each must make in valuing the assets or stock of both businesses and/or the target business.

KEY CONSIDERATIONS

There are many considerations that should be made when estimating the value of a mid-market business. The most important are:

- Stability of historical earnings,
- Future projections,
- Verification of information,
- The actual assets included in the sale.

STABILITY OF HISTORICAL EARNINGS

A potential buyer of a business will first look at the stability of historical earnings when estimating the price for a target company. Excessive add-backs or adjustments and inconsistent profit margins decrease the overall marketability of a target business. When estimating the value of a business, usually the last full year, last 12 months (sometimes referred to as trailing 12 months), or projected earnings are used. Sometimes a weighted average of the last 3 to 5 years is used. What should be remembered is that the earnings used should best represent the short-term future earnings and financial picture of the business.

FUTURE PROJECTIONS

In developing an accurate discounted future cash flow analysis, it is critical that the pro forma income and cash flow projections be realistic and supportable. Aggressive growth projections, when not well supported by good market research and analysis of the company being valued, carry high-risk factors with them, which should prompt an increase in the discount rate (required rate of return) being used. Conservative, well-supported growth forecasts, on the other hand, result in highly credible cash flow projections deemed to be relatively low in risk.

VERIFICATION OF INFORMATION

Due diligence is one of the most important steps in accurately valuing a business. There are two areas that need attention when verifying information – financial and operational. Financial due diligence involves verifying add-backs or adjustments, accounts receivable/payables analysis, inventory audits, and fixed asset analysis. Operational due diligence is often overlooked and involves verifying customer relationships, reviewing supplier relationships, and management strength, and analyzing the market for potential customers as well as competition.

WHAT'S INCLUDED IN THE SALE

Also commonly overlooked are the actual items included in the sale. Key items are intangible assets such as patents or copyrights, personal vehicles or real estate, shareholder loans or receivables, third-party notes, and other liabilities. In estimating the value of a business, all assets and liabilities included in the sale should be noted.

VALUED REPRESENTATION