From the Desk of...

Minimize Business Risks for Higher Valuation

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Tom Cavanagh
Director
BCC Advisers
tom@bccadvisers.com

When buyers value a potential acquisition target, they most often look at projected future cash flows and discount them based on the likelihood of achieving those levels of earnings to develop a present value. Put another way, they discount the projections based upon perceived risk, with riskier cash flows being discounted at a higher rate. The discount rate accounts for risk factors that business owners cannot control, such as general economic and industry risks or changes in Treasury rates. However, many risk factors directly attributed to the business are assessed and included in the discount rate through what is called specific risk. Many of these factors are well within the control of the business owner.

Customer Concentration – Having a few customers (or just one) make up a significant portion of your sales will increase the riskiness of earnings, as the loss of any of these could have a significant impact on your business (although this doesn't mean you should turn away additional business from these customers). Your best bet is to do anything you can to solidify your relationship, including updating customer contracts and/or spreading the relationship to other members of your team so it doesn't all lie with you. Ideally, you would acquire new customers, which will diversify your client base and help reduce your company's risk profile in this area.

Management Depth – Actively preparing current employees to be future leaders is an important aspect of reducing business risk. If an executive leaves, whether voluntarily or involuntarily, your company could suffer if no one is capable of filling their role. A potential acquirer may or may not have the internal resources to fill this gap. At a minimum, proper leadership structure and processes should be put in place to aid in any transition should a key person depart.

Intellectual Property Protection – Many companies have valuable brand names or key internally developed products and technology. Be sure these are properly protected through valid (and current) patents and trademarks.

Financial Statements – How your company's financial statements are prepared affects a buyer's confidence level in the earnings you present. Buyers will have more confidence in reviewed financial statements, which provide limited assurance that there are no material misstatements, compared to compiled statements, which provide no assurances. Likewise, audited financial statements instill even more confidence than reviewed financials. Although there are higher costs associated with a greater level of financial assurance, we are seeing more audits and quality of earnings assessments being required to build buyer confidence.

Non-Compete Agreements – A significant concern among buyers is whether key employees will leave and take customers with them following a transaction. Having employees sign noncompete agreements will reduce this risk. If a buyer must factor in the possibility of losing customers by way of former employees, their valuation analysis of your business could be negatively impacted. All things being equal, business owners that can put the necessary pieces in place to minimize these risks will create more certainty, and ultimately a higher valuation.

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* denotes a required field.