20 Critical Factors That Influence Valuation

Preparing a business for sale is hard work. To streamline this process, AllianceOne Enterprises ("AOE") has leveraged its decades of expertise to derive a handful of critical factors that shape valuation. We sit down with owners and take inventory of these elements, with the goal of staging the firm for a strategic transaction and maximizing its enterprise value. For more information, please contact us at **(301) 768-8198**.

1 Willingness of owner(s) to stay for a transition period

The vast majority of institutional investors (e.g., venture capital, private equity, family offices) are not looking to operate the companies they buy on a day-to-day basis. Many times, acquirers are looking for executive managers who are committed to taking the company to the next level. When businesses are sold, buyers generally want to keep key managers for their invaluable inside knowledge using a combination of compensation packages and non-compete agreements.

2 Presence of successor to run the business

Institutional acquirers would always prefer a well-groomed successor in the exact position when the seller is finally ready to exit. In the absence of a successor, new ownership can and will bring somebody in from the outside prior to the seller leaving; however, this will factor into the corporate valuation.

3 Importance of owner(s) to company's success

How reliant is the company on its ownership? While a proprietor's willingness to stay on for a while certainly matters, enterprises that are vastly dependent on one principal have a higher risk profile. For example, if sales are totally attributed to an owner, that is problematic. Sellers who want to maximize their valuation need to begin considering how to delegate their responsibilities before initiating a sale.

4 Age of business

Buyers generally assume that the longer a business has operated, the greater its chances for future survival. A longer lifespan implies that a firm possesses varies positive attributes, including higher profitability, greater expertise, more tenured staff, and time-tested processes.

5 Company’s competitive position

A company’s competitive position is reflected in the changes to its total sales and gross margins year over year. Are you losing or gaining market share? Sometimes it may be necessary to diversify products/services in sectors with a lower competitive profile. Hyper competitive sectors with lower gross margins and profitability are far less attractive to acquirers. Owners can mitigate this issue by, e.g., adding a service to accompany or complement a high-competition product, thereby enhancing uniqueness.

6 Company’s corporate scalability

Institutional acquirers infuse companies with both financial and intellectual capital in the hopes of realizing growth opportunities. Firms with a new concept that can easily be duplicated in other locations (i.e., scaled up) hold a big valuation advantage. Relatedly, a common and important question that many buyers ask is: “How much does it cost to add a new customer?”

7 Company’s accounting & accountability

Maintaining accurate and consistent financial records may seem simple, but is too often absent in lower- to middle-market companies. All accounting entries (balance sheet, profit & loss and cashflow statement) need to be fully documented and explainable to prospective buyers. Institutional investors often require accounting on an accrual basis, while most small businesses use the cash accounting methodology. Owners are advised to not be penny wise and pound foolish: Unreported sales may save on taxes, but that approach could lead to lower multiples of earnings or EBITDA, driving down the overall valuation.

8 Real estate (location & lease)

Location, Location, Location remains an important principle, especially for companies where street exposure matters. For those investors buying businesses that are location-dependent, the elements of a lease (e.g., duration) are very important. A long-term lease with favorable tenant conditions can represent a substantive valuation enhancement.

9 Operational efficiencies

Companies with effective operations achieve higher earnings margins, which command higher valuations. Do you have matrices in place for measuring and optimizing output? If not, then your production costs/labor might be higher than necessary and reducing profits. Are you over/understaffed? Have you looked at the law of diminishing returns when evaluating different components of your operation? For instance, do you ship orders at 95% complete (i.e., you are in stock 95% of the time), when you could ship 93% while maintaining 75% as much inventory?

10 Company’s customer concentration

High concentration means that a small group of customers represents a large percentage of total revenue. Some companies have one or a select few customers that account for 25%-75% of their total sales volume. The loss of one or more of these customers can severely impact profitability and, by extension, the valuation. Owners can mitigate this issue prior to a sale in various ways, such as securing long-term contracts with larger revenue-producing clients.

11 Supplier/vendor diversification

Just like with customers, a significant concentration of suppliers/vendors also raises red flag for buyers. What would be the impact of losing one or two major suppliers? In most cases, owners can mitigate this risk by having secondary sources that offer similar products/services. For example, companies can have at least two shipping accounts and use their less-preferred carrier for a smaller portion of deliveries until there is an issue with the more-preferred carrier (e.g., major price increase, driver strike, etc.).

12 Brand equity/industry standing

Companies create brand equity by making their products/services more memorable, easily recognizable, and superior in quality and reliability. The resulting equity translates directly into higher margins and valuation premiums. Customers are generally willing to pay a premium for products and services that have garnered respect and admiration. Companies can bolster their brand equity through advertising campaigns that articulate a brand image and value proposition.

13 Core earnings (quality/predictability)

Cash flow is king to any acquirer. While top line revenues are important, it is the bottom line—the net earnings—that really matters. Owners can make short-term operational changes to increase their attractiveness as an “add-on/bolt-on” (i.e., intended to achieve economies of scales), but acquirers generally base valuation on stability and a long-term earnings profile. Thus, core earnings reflect not only sector cyclicality, industry profitability, diversification of earnings, and contractual relationships, but most importantly, future earnings potential. Companies that post high-quality and predictable double-digit sales increases while maintaining or bolstering net income receive higher valuations.

14 Core competencies

Core competencies generally determine how well a company can grow in the future. These are the key differentiating abilities or strengths that a company has turned into competitive advantages over its peers, which are difficult to replicate and thus underlie its long-term success.

15 Industry profit margins

While profit margins vary between industries, companies that consistently outperform industry averages for gross margins, net margins, EBITDA to sales, EBITDA to SG&A command higher valuations. Gross profit margins can change drastically based on competitive pricing; thus, it is important to consider barriers to entry and strategic relationships.

16 Condition of hard assets

In asset-intensive businesses, buyers focus on the need to repair/replace equipment and other hard assets because of their condition, age or technological obsolescence. Depreciated hard assets can still be valuable, especially to a new owner who can recapitalize them. Nonetheless, firms should be aware that the age and condition of their assets will be factored into the overall sales price.

17 Internet vulnerability

Is the business or product/service sufficiently safeguarded against online competitors (e.g., Amazon) and aggressive pricing strategies? A firm's commodity product(s) may be safer if, e.g., backed up by knowledgeable salespeople. Granted, margins can get so small on some products that only an Amazon-type business can afford to sell them.

18 Barriers to entry

How hard or easy is it for newcomers to enter an industry? For acquirers, higher barriers generally reflect more profitable pricing, competition, margins, etc. The money and/or expertise required to successfully gain traction in an industry is typically what defines the barrier. For instance, an auto parts store may have a high barrier to entry due to the necessary upfront investment in a large inventory.

19 Product/service differentiation

Extending from barriers to entry, acquirers will consider the legal/regulatory elements that can restrict competition, which would be a plus for the corporate valuation. These elements include things such as patents, trademarks, etc.—any special aspect that customers can readily identify with is valuable.

20 Volatility/cyclicality

Having a diversified portfolio of products/services that are not economically correlated (i.e., one is up when the other is down) is the best hedge against wide swings in sales, margins and profitability.

Supplementary Considerations

- **Do not make significant investments in the business if you are selling within 2 years.** Obviously, make investments that are necessary, but be aware that you are unlikely to get your money out of these investments over that short of a period. Buyers are typically paying based on a multiple of earnings; thus, any investments that cannot increase your earnings in the short term will not help bolster the sales price.

- **Have non-competes and non-solicitation agreements with key employees.** If these are not in place with current important employees, it is not too late to implement them. A potential buyer will be more inclined to pay top dollar if they can be assured that they will not lose a key salesman to the competition or to entrepreneurship.

- **Be mindful of your products and services' obsolescence.** Industries do change over time. Many evolve and improve, but some truly disappear. Owning a newspaper company was considered great and powerful not too long ago, but many had to morph into media companies in order to survive in today's market. Take stock of your future customer contracts, as guaranteed business can be a huge valuation factor and help mitigate industry concerns.

- **The size of your company will affect valuation**. In this case, size typically means sales and profitability. Larger businesses normally command a higher multiple of earnings in their valuation due to their greater ability to satisfy demand. Private equity and family offices typically want a minimum level of adjusted EBITDA: If they have $500 million to invest, they would prefer to spend that on 10-15 larger companies than on 50 smaller companies.

As always, AOE wants to be your go-to resource. Please contact us today at (301) 768-8198 for a no-obligation consultation about your company and the marketplace.