

## SELLING YOUR BUSINESS – WHO ARE THE PURCHASERS?

It is important for business owners who intend selling in the future to understand the motivations of prospective purchasers and the dynamics of the markets in which they operate.

Purchasers of businesses for more than \$1M have been grouped into broad categories according to their investment strategy and funding mechanism. Many investors are hybrids or combinations of these. Some investment criteria are common to all groups.

The categories are shown discretely to simplify this discussion.

### PUBLIC COMPANIES

The public company arena has industry consolidators in virtually every industry sector. These are strategic investors who are expanding through acquisition, usually in their core industry.

Public companies operate with a different set of business dynamics to private companies. Typically in private companies, profit is the driver of growth and investment and shareholder value is a secondary consideration. In contrast, public companies focus on increasing shareholder value.

As with private companies, acquisition is the fastest growth mechanism for a public company. However, the benefit is multiplied several times. Not only does the acquired business bring its profit into the public company as the primary benefit, but there is a much greater secondary effect.

The returns required by the shareholders of public companies are usually much lower than for equivalent private companies. The rigorous reporting requirements, greater share liquidity, increased availability of investors and access to them usually drives the price of the shares much higher than for a private company with an equivalent profit.

The capitalisation rate applicable to a business is also referred to as the Price/Earnings ratio (PE ratio). PE ratios vary widely, but could be in the range of 10-20. This is on after-tax earnings, which is important to shareholders. A PE ratio of 18 might be comparable to a pretax earnings multiple of 12.

Now is the interesting part. If a public company with a PE ratio of 18 acquires a private business earning \$1.4Mpa in pre-tax profit (EBIT) at 4 times multiple, it would acquire the business for \$5.6M. However, as soon as it does, the investment has a theoretical value to the public company of \$18M (\$1.4M less tax equals \$1M after tax, multiplied by 18), which is more than 3 times the investment price.

Assuming the public company can access substantial amounts of capital, it can dramatically increase shareholder value simply by making acquisitions. The profit of the acquired business does not need to increase for an acquisition to be successful.

It could even decline to some extent and the public company would still be able to 'create' significant shareholder value from the transaction.

The more successful acquisitions the public company makes, the faster shareholder value increases. Delighted shareholders continue to pour money into the company, providing a ready source of funds for further acquisitions, driving the PE ratio even higher and fuelling even faster growth and higher returns.

Public companies that adopt this business model may need to continue to make acquisitions to meet shareholder expectations; i.e. to maintain the growth rates shareholders expect and have already factored into the share price. This process can continue as long as the company can continue making acquisitions. Readers may know of organisations in their industry that have adopted this strategy.

It is important for prospective vendors to understand that public companies will not pay more for acquisitions than they believe they need to, as there may be a virtually limitless supply of acquisition targets. Although in some industries the voracious appetite of consolidators has driven the market price of targets higher, this does not occur in most industries.

## **PRIVATE EQUITY FUNDS**

A small but increasing proportion of the \$billions invested in super funds is allocated to private equity funds to pursue business opportunities.

Private equity funds understand the leverage mechanisms involved between private and public companies and often position themselves in the sweet spot, right between the two.

Private equity funds can access funds and become industry consolidators in much the same way as public companies can. Many are very good at making acquisitions of private companies in a target industry, combining or consolidating them and installing competent management and infrastructure, running them for a few years and then exiting through an IPO or a trade sale. Many work to a timeframe of 3-5 years in such an industry play.

Private equity firms are run by very capable people as a rule. If the strategy is right and it is executed skilfully, the returns to these firms and their investors are often astounding.

The typical private equity fund looks for investment opportunities with:

- Good team
- Proven and scalable business model
- Growth industry
- Financials:
  - Revenues over \$5M
  - EBIT over \$1M
- Ability to grow revenues to greater than \$50M in 3-5 years
- Exit strategy identified

## **MEDIUM AND LARGE PRIVATE CORPORATIONS - SAME OR RELATED INDUSTRY**

The main volume of industry acquisitions and consolidations takes place among medium and large private companies. Funds permitting, private companies are among those who will pay the most, as they have the most to gain and the least to risk.

Industry players can also grow much faster through acquisition than organically. They may want to expand into new geographic or strategic markets or bulk up for a future IPO, which may require them to increase sales to more than \$50M. Acquisitions can deliver fast track expansion geographically, vertically and horizontally.

Other reasons include acquisition of intellectual property, technology or entry to complementary markets, removal of a competitor or to gain access to key customers or supply contracts.

Most benefits of industry acquisition are in the form of market leverage:

- Leverage off target's customer base with existing products
- Leverage off existing customer base with target's products

The strategic and cultural fit will be important, as this will determine the amount of work required to merge the businesses and capitalise on the increased size and scale of operations.

If the strategic fit is good, it is usually quicker and cheaper to acquire a business already established and doing what the purchaser wants to be doing, complete with infrastructure, team and customers.

## **PRIVATE INVESTORS**

These are high net worth individuals or consortiums of successful business people with surplus cash to invest to earn higher returns than from other forms of investment.

Most private investors have a clear strategy for adding value and a mechanism for doing so.

They may seek businesses that are underperforming. The business may be undercapitalised, under-resourced or not well managed. It may have good management and sound growth plans but lack the funds to grow. They identify and provide the missing ingredients so the business can grow quickly.

Purchasers from the same industry would expect to leverage the business with others. If not, they may settle for a high, stable return. Accordingly, they can be very price-sensitive and adopt hurdle rates of return as their initial qualifier for business assessment. Often, ahead of strategic considerations, the first question is price vs profit.

Investors not from the same industry generally want the current owners/managers to continue to run the business. This may suit vendors who want to cash out and are prepared to stay involved.

