Assessing the Market: A Business Owner's Guide When Contemplating an Exit

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The state of the economy and attendant effects on a potential merger & acquisition (M&A) process is a typical question for business owners as they evaluate their options. Is the market hot? Will buyers pay the highest price? Or have buyers pulled back? Should I wait?

No One Has a Crystal Ball

Economic prognostication is an endeavor fraught with straight-line extrapolation and guesswork. What were the forecasts in, say, 1997? Did anyone forecast the precise timing of the dotcom meltdown? How about the early aughts, how prominent were the voices warning about a banking meltdown at the end of the decade? In December 2019, were you planning to lock yourself down and cower in your basement?

I have sat through enough "economic outlook" luncheons to know that today's forecasts likely have no bearing on tomorrow's reality, and as a result, my economic outlook tends to lean towards the "something else" school of thought. Something else, likely something no one saw coming, is what we will experience. History is replete with examples.

For the business owner contemplating a sale of the company, the vagaries of forward looking economic statements are compounded by the element of time. The decision to market the company in October means a closing will not happen until next summer. Instead of trying to time the market, business owners are wise to keep their focus on what they can control: Their company.

M&A is not Macroeconomic, it is Microeconomic

Valuation is a confluence of factors that include competition from an orderly process, honesty, the need/want of the buyer, seller motivation, the tenor of the times, the skill of the investment banker, and most importantly, the strength of the underlying company.

In good economies or bad, the demand from buyers will be strong. The question of a good deal for the seller, therefore, is largely depended on the quality of the company being sold. A strong, profitable, well-run company will be in demand, and likely command a premium, even in a weak economy. A weak, profit challenged, poorly run company will struggle to find suitors, even in a strong economy. Owners interested in selling their companies should focus more on what they can do to make their companies more valuable, and spend less time fretting about the future prospects of the economy.

M&A is Supply Side

This means demand follows supply. If a company is brought to market, it will almost certainly receive offers. The only question will be if the offers are of interest to the seller. High demand will not necessarily result in more supply, instead, it will likely increase what buyers are willing to pay.

The M&A Market Responds to Clarity

As a business owner, the first thing you should figure out is what do you want to accomplish? Do you want to retire and sell the entire company? Are you seeking a capital partner to help you grow? Would you like to create some personal liquidity by selling a portion of your company? Do you want to work for a few more years? Indefinitely? Or do you want to decamp to your next phase of life as soon as possible? In addition to your plans and your personal financial planning, how do the other constituents in your company factor into your M&A goals? These can include your family, employees, customers, vendors, and your legacy.

Clearly explaining to the market what you seek to do will increase the odds of receiving offers that you find acceptable. Numerous clients over the years have told me, "I'm flexible, I'll do whatever the buyer wants." I always provide the same reply: buyers cannot make an offer based on that. Provide guidance, without mentioning price, of course, and the business owner will have a far better chance of receiving offers that makes sense.

A Random Sample of One

A mistake many business owners make is to respond to an "over the transom" offer. This is not to suggest that an unsolicited offer should be summarily rejected – you should review it on its merits and respond accordingly – but that random sample of one offer might be acceptable for the buyer, but it may not be suitable for the seller. Sure, valuation is likely to be the main aspect considered by the seller, but the timing of the payments, the amount of the company acquired, the expectations for continued involvement, and tax ramifications are but a few of the considerations that may or may not line up with the seller's goals.

If the offer does not meet the seller's objectives, the seller should actively seek the right buyer. The question sellers need to ask themselves is: How do I define a successful outcome? Fitting a square peg into a round hole rarely works. A business owner has options, and therefore that owner would be wise to pursue as many of those options as possible. Proactively seeking the right partner will likely yield better results that reactively responding to a "random sample of one."

Role Reversal

The market for middle market M&A transitions is unlike most other markets. The features of a market include the role of the buyer, who buys, and countervailing role of the seller, who sells. Pretty simple, right? In the M&A market, the roles are reversed. The seller is the one who selects the buyer, so in that regards, buyers are the sellers, and the sellers are the buyers. The normal rules of buying and selling are reversed in M&A.

A Highly Demanded Limited Resource

Buyers are plentiful and offer a commodity (dollars), whereas a seller is a unique, limited resource. A dollar from buyer one is exactly the same as a dollar from buyer two. A company, especially one in the middle-market, is unique. Other companies might compete with it, but when customer mix, products, marketing strategies, pricing, geographies, margins, supply chains, and more are considered, most companies are unique. No other company is a perfect replacement for another. Multiple buyers therefore compete with each other for the attention of a single seller. That seller will be unable to meet demand – the company can only be sold one time to a single buyer – and therefore, that limited supply will put upward pressure on price. Therefore, one of the few ways buyers can differentiate themselves from the competition is by offering more of those dollars.

The seller, by simple virtue of being a limited resource, will be able to engender a better deal, not only in the amounts of those dollars, but with the terms of the deal, the timing of when those dollars will be received, and the conditions that are attached to the payment of those dollars. This is why, when buyers ask me, "what's special about this company," I reply, tongue-slightly-in-cheek, "it's a company. And it's for sale."

Conclusion

While systemic shocks to the economy can impact the demand from buyers, and while strong economic times might lead to frothier valuations, a decent company with an owner who has reasonable expectations will have a high probability of getting a good deal. In a strong economy or bad, a well-run, profitable company will be in demand. Instead of hoping to passively benefit from a "rising tide lifts all ships" mentality, the wise business owner is advised to focus on building a strong company and proactively seeking the right M&A partner.