DE BELLAS & CO.

INVESTMENT BANKING

WHEN SHOULD I SELL MY STAFFING COMPANY?

It's understandable that owners would want to reap the rewards of recently signed clients. Often times, clients don't learn about your company one day and then hire you the next. It can take years of getting to know each other, office visits, travel, follow up calls, and most importantly, perseverance, before a client will trust you enough to hire your firm. Not to mention everything that went into building your company's reputation, all of which directly and indirectly goes into the decision to hire your company.

The fact is, at any given time, most successful businesses have a number of hot prospects that appear likely to sign up. Even if a client is already under contract, it may take months before that contract generates revenue. So when circumstances dictate that it's time to sell, owners are often puzzled about whether the timing is truly right. And they question whether they should move forward with a sale today or delay it until revenue starts flowing from recently signed clients and the hot prospects.

Don't make the mistake of delaying a sale for the wrong reasons! There are ways to get paid for seeds you've already planted.

So how can I get paid for new clients and hot prospects?

Buyers often seek to pay for the business you've created and the earnings stream that will be delivered to them at the time the deal is closed. However, because buyers are typically attracted to growing businesses (which may be one of the key selling points to your business), they may be willing to sweeten the pot for you. In that case, a "structured" deal may be used. This means that, in addition to possible cash paid upon closing, incentive-based payments may be paid to the seller if the company achieves performance hurdles over a designated period of time, usually 1-3 years. Referred to as an "earn-out" component, in some deals we've facilitated, it has actually doubled the amount our clients have made from the sale. An earn-out component gives owners an opportunity to bank a considerable amount of the value in their business today and still have another substantial payday down the road. This allows owners to feel comfortable that they are being paid for their established client base as well as new and soon-to-be clients.

Is that risky?

There are risks associated with earn-outs. The main risk is that sellers may not "hit their numbers" and achieve the payout they hoped for. Another concern is that after a sale, an owner may not have the same level of control within the business, and that meeting those performance hurdles may be out of their hands. A third concern is that the buyer may increase the expenses incurred by the business, thereby reducing the seller's ability to achieve the earn-out. That said, a seller needs to fully understand what his or her role and responsibilities will be post-sale and how the buyer intends to operate the business. If the seller is comfortable with this and has confidence in the growth of the business, then the risk is greatly minimized and the reward can be significant.

What's wrong with waiting?

We've talked to too many owners who have elected to wait it out and delay selling until prospects or recently-signed clients begin to generate revenue, only to find out that the client they expected to sign went to a competitor, or they lost a client, or their top manager left all of which can dramatically affect the sale-ability of a business. Owners can always make a case that there are better things around the corner, but in our experience, the risks associated with waiting are often not worth it. The simple fact is, any number of things can happen to your business in this "waiting period." Businesses do not operate in a static environment - rather they are constantly changing and reacting. To put it mildly, things happen!

The Bottom Line: If it's time to sell, it's time to sell. Hire an experienced advisor who understands your business and your goals and can structure a deal that works for you

On a daily basis, we discuss issues related to value. "What's my company worth?" and "I'm not selling for less than $___ million" (fill in the blank!) are things we commonly hear. For over 10 years, our firm has assisted buyers and sellers by performing business valuations. With well over 100 transactions completed, we have a clear understanding of the items that affect value in today's marketplace.
It's no wonder that owners want to know the value of their business and it's also easy to understand why they typically do not know the value. The reason, of course, is that if they have a well-run business, they are probably spending their time keeping it that way and not worrying about its perceived value! Situations arise, however, when it's necessary to determine the value of an enterprise. These can include thoughts of selling, divorce settlements, estate planning, partnership disputes, and more.
Following are the major items that affect value. Most important among the categories are financial performance, management and clients.

Financial Performance
Without question, the single most important factor that influences value is the financial performance of the company.

- *Earnings* -- Since service businesses are cash-flow oriented (unlike manufacturers which have considerable hard assets), values are often based upon adjusted EBITDA (Earnings Before Interest Taxes Depreciation and Amortization) generated over the past twelve months. Adjusted EBITDA is the profit number that the buyer can reasonably expect to generate if it owned the company. It takes into account the various "perks" that many owners enjoy and is often a point of considerable negotiation in transactions.
- *Trends* - Are revenues and adjusted EBITDA growing or declining over the past few years? Clearly, businesses with consistent and profitable growth are valued more aggressively than those with flat or declining revenue and/or profits.
- *Anticipated Growth* - If new clients recently came aboard or perhaps a proven salesperson has just been hired, the company's financial performance could improve and therefore these kinds of scenarios could certainly affect value. While buyers will rarely pay all cash for these, they may pay the seller based upon future performance, thus improving the overall purchase price. (See my previous article in the Fall '01 Kaulkin E-Bulletin for more information).

While financial performance is a major factor influencing valuation, this alone does not determine value. Other elements include:

How well established is the company?
Companies with a proven track record of stability provide buyers a level of comfort that can just isn't there with younger, start-up companies.

Client Base

- *National vs. Regional* - Are the clients blue chip, household names or are they local companies? Both could be attractive depending on the buyer. If the buyer seeks to be a regional player, the local clients may be a plus, whereas if the buyer seeks to be national in scope, it would likely value "name" clients more.
- *Industry specifics* - Some client sectors are known for having lower and higher profit margins. Lower margins are often the result of increased competition in those sectors. In the collection industry, for example, credit card companies have notoriously "squeezed" rates downward that they pay their agency vendors. Such clients may be less attractive to some buyers who seek higher margins from an acquisition.
- *Specialists* - Niche businesses can be attractive to buyers seeking to expand significantly in one particular area. Brand recognition and strong client relationships are two reasons that niche players are often attractive to buyers.
- *Client diversification* - Red flags are raised when a company generates the bulk of its revenue from only a handful of clients. This is the old 80/20 Rule. The issue is risk, but interested buyers may structure

deals to accommodate this. For most buyers, a well-diversified client base is preferred, because it eliminates significant risk elements.

- *Relationships* - Long-term client relationships are ideal. They are proof that your clients like what you've done for them.

Services

Certain services such as Outsourcing are growing in popularity and are considered "leading edge", while others are considered old-line (traditional). In the collection industry, for example, Outsourcing could include first party A/R management services as well as other services performed in the name of the client. Both new and traditional services could have value to the right buyer. Many also feel that if the company offers multiple services, it can entrench itself with its clients and strengthen those relationships. Providing an array of services is useful in attracting new clients and is understandably sought-after by potential buyers if the services generate significant profits.

Automation

Highly efficient systems improve operating margins -- and the reverse is also true. If buyers view a company's systems as outdated and in need of a major overhaul, the price will often be reduced by the expected amount of capital expenditures needed. This may, however, contribute to their interest level in the first place. In other words, if the company can be bought at a lower price because capital expenditures are necessary, buyers may see this as a good opportunity to acquire an otherwise attractive company. Another factor related to automation is whether clients are satisfied with the reporting capability, flexibility and response times of the company. All of these things lead to happy clients and happy clients lead to future revenue and stability.

Management

A big key for most buyers is whether or not a quality management team exists and whether it will remain in place after the deal. Will the shareholders stay? What does the management team look like beyond the current owners? This can affect a buyer's confidence level regarding the stability of the company, its client relationships, and its internal organization.

Legal and Accounting Affairs

Are there any accounting "irregularities"? If so, they could be early indicators of client loss and they need to be addressed. If the financial statements are not squeaky clean, they should be rectified prior to selling, or at the very least, fully disclosed to prospective buyers early in the selling process. Depending on the issue, it may not negatively affect value. In addition, certain types of lawsuits may be acceptable in some industries as "the cost of doing business". These should also be fully disclosed and depending on their nature, may or may not affect value.

Presentation

What impression does your office give when people arrive at the front door, and after they walk through it? Are your managers and employees working hard and chipper or do they appear to have a chip on their shoulder? I'm not saying that a business needs to resemble a 5 star hotel with fine china and turn-down service, but in order to "show" well, it should convey a clean, organized environment with people who like what they do and are good at it.

It's nearly impossible to cover all of the aspects that play a part in valuing a service business, but this discussion provides a basis for understanding the valuation items that matter to most of the buyers most of the time.

The Bottom Line

Businesses that excel across the majority of these areas receive top dollar when they sell. To truly understand the value of your business, hire an advisor that fully comprehends the marketplace in which you operate. True - your general accountant could probably get the job done for you, but if you're going to pay for a professional service and you plan to base life-changing decisions upon it, you should get the most informed analysis available. Call an advisor that understands valuations within the context of the current pricing climate for your industry.

Lately, owners of outsourced service businesses have become very interested in the answer to the title question. It's understandable, really. Having seen many of their friends and colleagues sell during the wellpublicized buying binges of the mid-late 1990s, over the past few years the announcements of done deals and the number of buyers knocking on their doors have cooled considerably. As a result, we've heard many owners ask the question,

"Are buyers still buying?"

The simple answer is "Yes"! The opportunity has always existed to sell their business, and it still does…if you know where to look.

So Who's Doing All The Deals?

Well, that depends on a number of factors. Typically speaking, it's fair to use the size of the business to be sold, as measured by revenue and earnings, as a primary indicator of what type of buyer might be interested. Let's understand, however, that we're speaking in generalities and that there are always exceptions, and that special characteristics of the selling company should also be factored in.

Sizing Things Up

Under $5 million. If your business generates up to $5 million in annual revenue, for example, it is not likely to be of interest to most financial buyers. That is, buyers formulated solely to make acquisitions using money raised from institutional investors, pension funds, high net worth individuals, and the like. For a business of this size, a buyer who is already in the industry will often realize the highest value (ie. Pay the highest price). This could be a company located in your region that would benefit by gaining your clients, services, staff and/or systems. Or it could be a buyer from another part of the country who wants those benefits and seeks geographic expansion. An industry buyer may also make sense for owners seeking retirement, where the buyer can assume client relationships and the owner can transition to retirement.

$5 million to $20 million. For businesses of this size, the buyer universe gets a little larger. These companies are large enough to attract both industry players and strategic buyers (companies that operate in allied industries). A strategic buyer could be, for example, a call center or a Customer Relationship Management (CRM) company that seeks to expand into a related industry such as ARM because it utilizes similar infrastructure and skills and therefore could lead to cost-saving opportunities, and because there is a distinct opportunity to cross-sell services among client bases. The ability to cross-sell is often attractive because the more reliant those clients are on their service providers, the less likely they are to take their business (and their money!) elsewhere.

Over $20 million. Lastly, all types of buyers, including financial buyers, may be interested in companies with more than $20 million in revenue. Most financial buyers have specific investment criteria, such as minimum requirements for revenue, profit and growth rates. Many of them also seek acquisitions of companies that are leaders in their field, with top-notch management, operating in growth industries. In fact, quality management is almost always one of the key components as they seek to invest in new industries. Because the financial buyer typically does not have operating expertise in the given industry, they rely more on management's experience and therefore look for managers that are among the best in their industry and who want to remain post-sale. This can be a great opportunity for both sides.

Exceptions apply to all three categories (of course!). While I've summarized their typical interests, buyers are known to step outside of these lines based on their specific interests. For example, strategic buyers could be interested in a $3 million company, as could a financial buyer perhaps as an add-on to its other investments, or in the case where its fund is on the small side (< $50 million). For that matter, industry players may also acquire companies with $20 million or more in revenue, but not without examining potential client overlap issues that could lead client erosion after the deal. The point is, deals happen in all shapes and sizes…there are no absolutes.

What To Expect

Buyers operate in a fairly predictable fashion, and therefore the motivations of each type of buyer should be clearly understood before entering into any transaction.

Industry: They are most likely to eliminate duplicated expenses, such as closing offices or laying-off certain staff after the transaction. This is because, by definition, they already have some of the functions covered, specifically things related to administration of the company like accounting and compliance. It's certainly not a given that employees will be let go, but keep in mind that their interest in making the acquisition in the first place is often predicated on their ability to combine operations, cut costs and increase profitability.

Strategic: This type of buyer may plan to initiate similar reductions as the industry buyer, or they may simply be focused on leveraging both client bases fully to provide a broader array of services. However, if they've already got an office in Houston, they probably don't need another in the region, so they'll fold the two together. The strategic buyer may also offer advancement opportunities for middle and senior management as they combine businesses, recognizing that they don't fully understand the complexities of the acquired business, the services they provide or the clients they service.

Financial: The approach of a financial buyer is simply different because they do not already operate in the same or related industry as the target and as a result, they're not likely to find ways to eliminate significant expenses or cross-sell services. They are, however, focused on finding the right management team that can continue to drive a bottom line that satisfies their investors. So there could be pressure from your new partner to produce expected results or suffer the consequences, which may mean a lower payday if you've entered into a transaction that includes an earn-out provision, or it could mean replacement. On the other hand, their reliance on senior management provides a certain level of freedom to continue producing the results that attracted them in the first place. As long as you're performing, they're going to love you and leave you (alone) to do your job.

You may deem some of the points above as pro's, some as con's, and some may not matter to you at all…depending on your point of view. With any buyer, you'll want to fully understand their post-sale integration plans to make sure it's the right deal for your organization.

The bottom line is that deals are happening with all types of buyers. As proof, our firm represents a number of deals that are expected to close over the next few months. One transaction involves a financial buyer, two are with strategic buyers, and two are with industry buyers. Deals are clearly being done. So the question really is, "Is the timing right for you?"