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The Art of Running a Small Business

January 30, 2013, 7:00 am

Would You Pay $6.2 Million for This Business?

By JOSH PATRICK

From time to time, I intend to take a look at businesses for sale. We'll examine them from two perspectives - **how attractive the business is at the asking price and what lessons the business may hold for the owners of other businesses.**

The first business I want to look at is a **heating, ventilation and air conditioning** business in the southeastern United States. For obvious reasons, we cannot identify the specific business or owner. This listing was brought to my attention by the brokerage site, Bizbuysell.com. (Editor's note: The author has no current or potential financial stake in the sale of this business, nor does the author certify the accuracy of financial or other information provided by the seller and/or seller's broker.)

Normally construction companies are among the hardest businesses to sell. Buyers often look at them and pass. Why? If the buyer is a competing business, it will often think, "Let them go out of business, and I'll just take them over for free." If it's a financial buyer -- from outside the area or from a different industry -- **the lack of recurring cash flow may be the stumbling block.**

The seller of this particular business is being represented by a broker, Jim Dunmire, of the Murphy Business and Financial Corporation. Mr. Dunmire specializes in selling H.V.A.C. businesses, a subset of the construction industry that tends to be somewhat easier to sell than other construction businesses. Below is the basic listing information:

Type of Business: H.V.A.C**.**

Location: Southeastern United States.

Asking Price: $6.250 million, for the business and real estate.

Employees: 26 full-time, two part-time.

Furniture, Fixtures and Assets: $280,000.

Real Estate: 12,900 square feet, estimated value $800,000.

Intellectual Property: Training programs and a successfully developed niche.

Business Overview

The company has been in business for 14 years. Its founder is the owner and chief executive of the company, which services only homeowners. It does no commercial work and no new home construction work, which is unusual in the industry.

As a rule, the company says it does not bid for work. All of its projects have been negotiated with the customer, and the company policy is to not reduce prices to meet competition. **In addition, the company takes only jobs that fall within a radius of 20 minutes from the company offices.** There is a marketing plan in place that has been producing new business in a predictable manner.

The company trains all new employees in a training center at the main office. New employees aren't allowed into the field until they have been fully trained in the operations and service skills the owner believes they need.

My Take on This Company

According to Mr. Dunmire, this is a company that has strong profits that are more than **three times the industry average (it is *10 times* more profitable than the average H.V.A.C. company, according to Robert Morris Associates,** a database that analyzes company profitability). If I were a potential a buyer, I would be eager to look under the hood and find out how the company has produced those results.

The company appears to have a strong niche. **The owner has learned how to say no to business that doesn't fit his niche and only accepts jobs that work for his business model.** As a result, it seems the company has become very efficient at serving these customers.

In addition, the company has eliminated two significant forms of waste that are common to the industry. By staying within a 20-minute radius, the company **avoids having its personnel waste time driving around.** And by training its employees at its facility, and not in the field, the company allows trainers to focus on getting a new person acclimated - and not on getting a job done.

Challenges in This Deal

Mr. Dunmire told me the asking price for this business is **3.2 times its free cash flow. This is about a third higher than most companies in the industry ask.**

In addition, **it is likely that there is little chance for growth in the niche this company occupies.** This means a buyer looking to grow would have to either expand lines within the footprint -- which I would not recommend -- or find a way to clone the business in other geographic areas.

It's likely the owner has developed excellent systems and documentation for the results the company produces. During due diligence, it will be important to learn precisely how the profits are produced.

A first glance, this business looks like a great opportunity for a strategic buyer, such as a competitor. That said, some strategic buyers may be skeptical of the results - regardless of the documentation provided. For that reason, a financial buyer may be more likely to buy this high-margin business. (CSINVESTING EDITOR: WHO will run this business—keep owner in place?)

My Suggestions to a Buyer

Any buyer of this company should hold off on making any changes in operations, marketing or training until it has spent a significant amount of time understanding the secret sauce that has made it successful. But a buyer looking for growth should come with a plan to duplicate the operation in other areas. (Here's a guide to selling a business (See Appendix) that Barbara Taylor wrote, and here is one from Bizbuysell.com.)

What questions would you want to ask if you were the buyer? Do you think the business is priced right? What would you pay for this business?

Josh Patrick is a founder and principal at Stage 2 Planning Partners, where he works with private business owners on creating personal and business value.

1.
    - Warren Miller, CFA, CPA
    - Lexington, Virginia

(#3 of 3)

19. How accurately does the company keep track of its costs by job? (This is a key to tracking rework, employee productivity, and the efficacy of pricing.)

20. A buyer needs the real estate like it needs a lower IQ. Owning the land isn't required for the business to occupy it. Therefore, the buyer should conserve working capital and exclude the land. Besides, as we have seen of late, real estate investments are no sure thing. Owning a small business is risky enough. Also, having the seller keep the land might make the deal come together more easily because it gives the seller a post-closing annuity source of income.

The above items are the small tip of a huge iceberg. But they should be enough to stimulate the thinking of a smart buyer. And, by definition, smart buyers have good advisers. Lousy advisers and the absence of advisers have killed more deals than price issues ever could.

As for Mr. Patrick's 'daffy conclusion,' let me say this: the only time that a financial buyer will pay more than a strategic buyer (i.e., a competitor) is when the financial buyer has more money than brains. The very nature of the strategic buyer is that it brings knowledge to the transaction that a financial buyer doesn't; that knowledge enables it to grow revenues faster, reduce costs, or both, which allow it to pay more. It's simple economics, a phenomenon that is often absent in transactional goings-on.

Warren D. Miller, CFA, ASA, CPA
Beckmill Research, LLC
Lexington, Virginia

2.
- Jan. 31, 2013 at 7:44 a.m.
- Warren Miller, CFA, CPA
- Lexington, Virginia

(#2 of 3)

11. How does the company advertise and promote its business? Does it have a catchy tag line?

12. How is IT deployed in the business? (In my experience w/HVAC companies, they are often low-tech, and that is expensive. So there may be an opportunity for a savvy buyer to make some modest investments in IT and really drive down costs and increase productivity.)

13. Any buyer should be sure that compensation and perks for the owners and related parties are benchmarked against industry averages, adjusted for cost-of-living in the area where the business is based.

14. Approximately what share of the local market area did the business have in 2010? In 2011? In 2012? How is that share measured?

15. What is the average tenure with the company that the workforce in place has?

16. What assurance does the buyer have that the incumbent workers will remain with the company after it's sold? Are there 'stay bonuses,' deferred bonus payments, or similar incentives?

17. How is 'free cash flow' being defined in the above ratios?

18. Does the seller propose to sell the assets of the business or the common stock of the business? (There are major post-closing differences and economic implications of the two choices. Smart buyers buy assets; sellers prefer to sell stock because (a) the tax bite is lower for them, and (b) the liabilities of the business become the problem of the new stock owners, not the sellers.)

Warren D. Miller, CFA, ASA, CPA
Beckmill Research, LLC
Lexington, VA

3.
- Jan. 31, 2013 at 7:44 a.m.
- Warren Miller, CFA, CPA
- Lexington, Virginia

(Due to the 1,500-character size constraint, this is #1 of 3)

I value businesses for a living. Have done so since 1993. As journalists often do, Mr. Patrick has oversimplified a complex situation and, in the process, reached at least one daffy conclusion. Let me suggest some ways for potential buyers to determine whether the asking price is reasonable:

1. Are the numbers shown in the table above on the 'cash' basis or the 'accrual' basis? (The accrual basis is the only starting place for any savvy buyer.)

2. Why did revenues in 2011 decline 13% from 2010, when the U.S. economy itself grew?

3. What were 2012 revenues?

4. Have the financial statements been audited?

5. Does the business accept credit cards from customers?

6. What is the mix between revenues from residential work and those from commercial work?

7. What % of annual revenues come from 'maintenance agreements'?

8. Does the business survey its customers using either multiple regression analysis or factor analysis? If so, does it then align the incentives for its employees with what customers say they like and value about the work the HVAC company does?

9. Is the local economy diverse and strong? Is there a dominant employer or industry (which means more risk, which means lower value of the business)?

10. How is it handling the phase out of 'old' freon for 'old equipment that many of its repair-and-maintenance are bound to have?

Warren D. Miller, CFA, ASA, CPA
Beckmill Research, LLC
Lexington, Virginia

4.
- Jan. 31, 2013 at 7:44 a.m.
- gbosco13
- chester, ct

My bet is that a local competitor/strategic buyer purchases the company for $5.4 million.

5.
- Jan. 30, 2013 at 8:26 p.m.
- Fred T
- New York, NY

I doubt this business will be sold for the asking price. Margins have nowhere to go but down and a financial buyer will likely pay less, not more for this because there are no synergies. I'd love to hear how they have margins 3x their competitors and serve such a small geography. Better yet, tell me where they are so a competitor can come in and bust up the margins.

6.
- Jan. 30, 2013 at 8:26 p.m.
- Michael
- Spencer Iowa

I disagree with the observation that the customer is automatically getting ripped off just because the business is driving some serious profit. If someone cheaper was always going to win, there would be no upscale client base in anything - we'd all buy YUGOs and generic corn flakes.

At the end of the day, it appears the customer believes he/she is getting more VALUE from the business compared to the competition. (As a example, If the client base is a bit older and more affluent, and more "life experienced", they would gladly pay a bit more if there was no drama - no headaches - it's done right the first time.)

Whatever they have done, they have built a value proposition that works with their marketplace - and the customer is voting with his/or her dollars.

At the end of the day, if that's what has happened - so be it. Price doesn't drive everything. What you get for the price - and what you want/need - does.

- Jan. 30, 2013 at 4:38 p.m.
- Diane Menke
- Philadelphia

Why do some commenters assume this contractor's pricing/profitability is "too high". That they are ripping off clients because they are more profitable. Higher GP does not necessarily that they are over-priced.

This company values service + company culture (overhead). They have to perform to a very high standard if they limit their customer base to home owners.

This is where the in house training comes in. Mechanics need to be on time, work clean, wear booties in the house, explain what they did to the buyers, bill the buyers. The office needs to manage like a well oiled machine to keep clients and mechanics scheduled and keep accounts paid.

If this company is selling geo thermal HVAC systems, their average sale is going to be in the 30-60K range. Solar systems start around 15K-25K. Forced air systems are a few K

They can "resell" to the clients every 11-15 years + provide annual service agreement in between. With this info you can begin to understand how much they might sell in a restricted area, once you know their demographic.

Are there state or federal incentives to promote the sale of the type of equipment they are selling now or in the future? Many states are promoting the use of renewables.

Look to the owners/shareholders pay as a possible place where profits are being padded. The owner might not take a salary and instead takes draws on profit. This is a very common in construction companies.

Diane Menke
Myers Constructs Inc.
myersconstructs.com

7.
- Jan. 30, 2013 at 11:35 a.m.
- Jim Stauder
- St. Louis, MO

Josh,

I love this topic – discussions about real businesses that are on the market. What a great idea!

At 3.2 times cash flow, this business may be a bargain. I do not think a buyer should necessarily bring a negative bias that “something is fishy” because their profitability exceeds the industry’s norm. A well-run small business is rare and that depresses the gross margins of many small businesses – especially in the construction industry where competitive bidding is so common.

On the surface, it appears this business has developed an excellent reputation for providing great service at a fair value and that can lead to significant success, including the ability to negotiate project pricing. By serving residential customers, there is surely no customer concentration and that is a huge positive aspect. There may also be recurring revenues in the form of maintenance agreements. It would also seem with a diverse customer base that the business would not be dependent on the business owner, but I would want to understand and confirm the capabilities and quality of second level management.

Although all buyers should be leery of seller representations about their business and perform extensive due diligence, I see nothing in your description that sets off an internal warning alarm. I’ll bet this business is sold quickly – especially after the publication of this article. Please be sure to follow through with an update.

Jim Stauder

jimstauder.wordpress.com
@jlstauder
-

This is company where a deal structure that includes a substantial "earn out" component is necessary. Businesses do not earn profits at rates FAR, FAR above competitors.

- Jan. 30, 2013 at 10:11 a.m.

8.

The article does not mention which key employees will stay (or not) - that is likely the important ingredient in the secret sauce for this small business.

If the owner is getting out (to retire?) then perhaps key employees will also be retiring soon.

- Jan. 30, 2013 at 10:10 a.m.
- Recommended7

9.

- Diane Menke
- Philadelphia

NYT Pick

This is interesting. The margins shown are in the correct range (mid to high 30%s) if I am reading your graph correctly. They own the building. They have strong systems and staff.

In our industry sales is key. Who sells in this company? It is often the owner who sells in a construction business. Anyone buying this company would need to know the sales team can generate the same numbers and grow them after the sale of the business. That means sales can't be by the owner, who is leaving. The sales team has to come with the company.

What is the value of the average sale? How much of revenue is service, and how much is new product?

What is the owners salary? Is the GP boosted by the owner not paying himself enough? This is common in our industry.

What is the profit %?

In the south east employee pay rates and benefits are very low compared to other states. How will these 2 costs be effected in the future, as employees and the government change this condition?

What other changing costs might impact this company? Changes in insurance costs and regulatory compliance costs come to mind.

With more information, I could definitely see another construction business buy this business. It could be a big box store, a new construction developer, another HVAC company wanting to grow market share, A plumbing company, etc.

Please keep us posted.

Diane Menke
Myers Constructs Inc.
myersconstructs.com

- Jan. 30, 2013 at 10:10 a.m.
- Recommended4

10.

- Daniel
- New York, NY

NYT Pick

3.2x FCF is a very reasonable price relative to the public equities market. You didn't mention net cash, so let's assume that's zero and there aren't any outstanding lawsuits or other significant liabilities.

The big questions on my mind are about who could continue to run the company once it's sold and who else would leave; if the market is limited to the immediate area then what's the total addressable market - i.e. is it going to run out and then it will have to change its strategy; how predictable is its sales channel and how does that compare to pre-2009; how variable can its costs be; are there new laws or regulations coming due that impact the business; is there a concentration of customers or source of customers; and why are they selling now?

- Jan. 30, 2013 at 10:09 a.m.
- Recommended2

11.

- Fred T
- New York, NY

This business sounds too good to be true and I would ask the seller to finance a portion of the purchase price or have it structured as an earn out with the owner serving as a consultant for an agreed upon time. It’s difficult to believe the company can charge such a premium for a service in a limited geographic area. Every customer is getting ripped off and could do better elsewhere.

- Jan. 30, 2013 at 10:08 a.m.
- Recommended1

January 7, 2010

Small-Business Guide

How to Sell Your Business

By BARBARA TAYLOR

Quick Tips:

- Put yourself in the buyer’s shoes.
- Don’t go it alone. Assemble a team of professionals, most importantly an attorney and an accountant that you trust.
- Get a professional valuation of your business.
- Make sure your financial house is in order prior to sale.
- Familiarize yourself with the entire selling process, from start to finish.

Recommended Resources:

- Read a book on selling and valuing a business.
- Visit the online marketplaces: BizBuySell, BizQuest and BusinessesForSale.
- Learn about business valuation: BizEquity, Business Valuation Resources, or contact a Certified Business Appraiser in your area.

- Find an intermediary: International Business Brokers Association, Alliance of Merger & Acquisition Advisors, M&A Source
- Plan an exit strategy: Association for Corporate Growth, Exit Planning Institute

You only sell your business once.

That thought alone may be enough to keep you up at night when you decide it's time to cash in on your years of hard work — as if there isn't enough pressure associated with every step of the sale of a business. But there's much you can do to prepare for the sale, and it's not a bad idea to start thinking about it long before the day arrives.

While every transfer of business ownership is unique, there are some important questions that sellers should ask themselves and there is a common process that is used for the sale of most small businesses. The more you prepare, the more successful the outcome is likely to be. What follows is a brief outline of the process for small, closely held companies. Many of these principles apply to larger transactions as well. (You may also be interested in this blog post: Has the Economy Closed Your Exit Door?)

First, ask yourself three questions:

Can Your Business Be Sold?

Many elements of a business make it attractive to buyers. For example, does it have a solid history of profitability, a large and loyal base of customers, a competitive advantage (intellectual property rights, long-term contracts with clients, exclusive distributorships), opportunities for growth, a desirable location and a skilled work force?

Are You Ready to Sell?

Make sure you are ready, both financially and emotionally. Think about what life will be like after the sale. What will you do — not just for money but also with your time? Many business owners suffer real remorse after handing over their business to a new owner.

Here are a few indicators that it may be time to move on:

¶It's not fun anymore. Burnout is a very real issue for business owners, and an entirely legitimate reason to sell.

¶You're not inclined to invest in growth. You may be comfortable with the current size and profitability of your business and have no desire to make the capital expenditures necessary to take it to the next level.

¶You feel your management skills are overmatched. It is not uncommon for business owners to build their business to a certain point and then realize they lack the skill set required to go further.

What’s Your Business Worth?

Many owners have no idea. On one end of the spectrum, for example, was a client who owned a professional services firm. She felt the firm was worth more than $1 million. After a lengthy search, a buyer paid her less than half that amount. Then there was a client who was about to sell his I.T. company to an employee for $200,000. After advertising the business for sale nationwide, he sold it for one dollar shy of $1 million.

Selling a business is both art and science, and in no other area is this more evident than the valuation. While every seller wants to achieve maximum value, setting an asking price that is too high signals to buyers that you may not be serious about selling.

While there are a number of methods used to value a business, the most common formula for smaller transactions is a multiple of seller’s discretionary earnings (S.D.E.). This type of market-based valuation involves recasting profit-and-loss statements — adding back owner’s salary, perks and nonrecurring expenses — to find the S.D.E. of the business and then using comparable data for similar businesses to arrive at an appropriate multiple.

Prepare Your Business for Sale (Now!)

Another client owned a popular sports bar and grill. He’d made repairs to some of his kitchen equipment, brought his books current and determined a reasonable asking price. He got an inquiry from a serious buyer — an industry veteran on a nationwide buying spree with his partner. The buyer liked everything about the business, and asked for data from his point-of-sale system, which my client was unable to produce quickly. By the time he assembled the information, the buyer had made an offer on a similar business in another state.

There is no way to overstate the intensity with which buyers will scrutinize your business. But here are things you can do to put your best foot forward.

First, get your books in order. Not being able to provide accurate financial statements in a timely manner can cause a deal to unravel in short order. Be sure to have the following on hand before you go to market:

¶Last three years’ profit-and-loss statements.

¶Last three years’ balance sheets.

¶Year-to-date profit-and-loss statement.

¶Current balance sheet.

¶Last three years’ full tax returns.

¶List of furniture, fixtures end equipment.

¶List of inventories.

¶Commercial property appraisal or lease agreement.

Be ready to furnish other documentation — particularly during the due diligence phase — when you will probably be asked to produce insurance policies, employment agreements, customer contracts, lists of patents issued, equipment leases and bank statements.

You will also want to spruce up your business to make it attractive to buyers. Make any needed cosmetic improvements to the premises, get rid of outdated inventory and make sure that equipment is in good working order.

Spread the Word

Not surprisingly, most savvy buyers use the Internet to research available businesses for sale. The two largest Web sites are BizBuySell.com and BizQuest.com. Some sites specialize in selling certain kinds of businesses like franchises, Internet properties or restaurants. Most of these sites charge a monthly subscription fee to advertise your business for sale.

There are two primary marketing materials that are typically used to describe your business to potential buyers. The first is a one-page document that offers highlights of the business without revealing its identity and is sometimes referred to as a “blind profile.” The second is a comprehensive selling memorandum or prospectus to be sent to serious buyers who have signed a confidentiality agreement.

Make Sure Potential Buyers Are Qualified

There’s no bigger waste of time than working with a buyer who will not be able to complete a transaction. Ideally, you will want all interested buyers to sign a confidentiality agreement before sending out anything other than the “blind profile” for your business. In addition, you should require buyers to submit some basic information:

¶Name and all contact information.

¶Previous employment and business ownership.

¶Educational background.

¶Funds available to invest and sources of financing.

¶Minimum monthly income requirement.

¶Intended timeframe for completing a transaction.

¶Reason for interest in your business.

Negotiating the Deal

After you've found a qualified buyer, provided a selling memorandum and had an initial meeting, it will be time to stop the flow of information and ask that an offer be presented. This can take the form of a nonbinding letter of intent or a term sheet. It should spell out the primary terms of a deal so that all parties can move forward in good faith.

My client ended up receiving three offers on her professional services firm. One was from a competitor, one was from an industry expert residing out of the country and one was from a regional firm looking to extend its geographic footprint. While that last offer was the weakest from a financial standpoint, we knew that this buyer would be able to complete a seamless transition and build her business. We decided to negotiate with the regional firm.

The asking price was $500,000. The regional firm offered a disappointing $400,000, with $50,000 down and the balance financed by the seller over five years at 6 percent interest. My client planned to stay with the firm under new ownership and was relatively certain that gross sales would increase substantially when her company became part of a regional brand. She offered a counter proposal: In lieu of financing the balance of $350,000, she asked to receive 10 percent of gross monthly sales for five years. She conservatively estimated that she would realize an additional $108,000 -- over and above the selling price of $400,000 -- at the end of the five-year period using this deal structure. Both parties accepted.

All sellers hope to get a full-price cash offer for their business. But in the real world this rarely happens. More often buyers will make a down payment and then pay some or all of the remainder in installments to either you or a lender. Don't be dismayed by an offer that doesn't meet your original expectations. As this case illustrates, a willingness to be creative with the terms of a transaction can go a long way toward a successful sale. Be sure to enlist an accountant and a lawyer to help you assess the tax consequences of the terms you suggest or accept.

Selling a business is largely about setting realistic expectations, avoiding surprises and just plain hanging in there. It can be an arduous journey, but one with a very tangible (and rewarding) light at the end of the tunnel. Once you've successfully sold your business, savor an accomplishment that not every entrepreneur gets to enjoy. Whether you're lying on the beach, retiring by the lake or starting your next venture, you did it!

Barbara Taylor is co-owner of a business brokerage, Synergy Business Services, in Bentonville, Ark.