10 ways to increase the value of your company

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Are you thinking about selling your company in a few years? If you are, now is the time to consider how you can optimize its value so that you can get the price you desire when it is finally the right time to sell. Determining the value drivers for a company is a complex issue and many issues are not only company, but even buyer specific. It is advisable that you consult an experienced business appraiser or business broker about 3-5 years before your desired exit date, to find out what might be the best ways to improve the value of your specific company. However, following are 10 strategies to improve company value, which will apply to almost every company.

1. Increase customer diversification

One of the key value drivers for any business is a low customer concentration. The rule of thumb is that no customer should account for more than 10% of your annual revenues and the top 3 customers combined should not account for more than 25%. Obviously, this is a complex issue, as large customers can sometimes be serviced more efficiently, and therefore at a higher profit margin. So having a profitable, long term customer account for 20 % of your revenues is not necessarily all bad. However, if you are in this situation, try to find ways to tie the customer to your company by, for example, offering special incentives in exchange for them agreeing to sign a multi-year contract with you. A while ago, I ran into a printing company that offered its largest customer free plates in exchange for a multi-year contract, and the customer agreed right away. More companies than you would think are willing to tie themselves to a supplier, in exchange for a good deal. Try to offer something that has real value to your customers but does not really generate significant costs for you. Another idea is to tie them to you by integrating yourself into their supply chain. A manufacturing company I represented a while ago developed an inventory management software and offered its use to its clients at a very low charge. Many customers signed on and it is now much more difficult for them to switch suppliers, as they would lose access to the inventory system. Creating barriers, other than price, that keep your customers from leaving, is always a good idea and you should think about what may make sense for you and your customers.

Also, increasing the diversification of your customer base does not just refer to their share of your total revenues. If feasible, you should also diversify your clients across several industries, and expand their geographical diversification. For example, post 9/11, a lot of companies that sold almost exclusively to the airline industry went out of business fairly quickly. You want to be in a situation where if one particular industry takes a hit, you still have enough other customers to fall back on. It is a global world these days, so if you can, try not to sell your products and services to just one corner. Few recessions hit worldwide at the same time and with the same intensity. Even the Great Recession that started in 2009 did not affect all global economies to the same degree. So once again, diversification, where it makes sense, is a good idea.

2. Develop Recurring Revenue Streams

Whether it is due to a multi-year contract or part of your business model, for example if you are a SAAS company, business buyers love recurring revenue. Recurring revenue is the segment of a company's revenue that is stable and likely to occur on a continuous basis.

Businesses are sold on multiples of revenue and earnings, and the more dollars come from recurring revenue, the more money you will get for your company. There are various types of recurring revenue and buyers value them differently. The strongest type of recurring revenue is "contract revenue", such as a 2-year contract you may have signed with your mobile phone provider at some point and cannot get out of without financial penalties.

The next level are revenues generated by monthly subscription services such as Apple iCloud, or other providers. While customers can often cancel such subscriptions at any time without a penalty, few actually do so.

Finally, there are recurring revenues generated from products like razor blades or ink. Gillette sells you the razor at a low price since what they really want is the recurring revenue from the blades. Hewlett Packard does the same with their printers and ink. While customers have no obligation to buy their blades or ink, most customers who purchased their razors or printers, will regularly do so.

A few years ago, we worked with a company in the home automation field. At some point, the owner realized that it made more sense for him to offer the installation of an alarm system at or below break-even pricing to his customers since that allowed him to sign them up for an alarm monitoring subscription which generates a steady monthly income. By switching his focus from making money from the installation of the systems, to the monitoring contracts, he ended up increasing his revenues and profitability dramatically in the mid to long term.

Potential buyers of your company will look at the renewal rates of those contracts, so make sure that you keep your customers happy. The higher the renewal rate, the higher the value of the recurring revenue in the event of a sale of the company. Another client of ours, a company that started out as a consulting firm that helped businesses "move into the cloud", developed a security monitoring system for the information that was stored in the cloud and over time, this recurring revenue ended up being by far the largest contributor to the company's revenue and profit. If you are a manufacturing company, think about ways to add maintenance/service plans to your portfolio. A company a client recently considered acquiring is a manufacturer of scientific instruments. Next to making money from manufacturing the instruments, they generate significant recurring revenues from servicing them throughout their lifetime.

3. Have assignment clauses in all key contracts

Up to about 90% of all small and mid-size businesses (businesses with a value below $10 million) are sold in so called asset-based transactions. In an asset-based transaction, the buyer acquires only those assets and liabilities that are specified in the Purchase &Sale Agreement. The seller keeps the "legal shell" of the company. There are a variety of reasons why this is happening but what is important to keep in mind is that you will significantly decrease the pool of potential buyers if you have a large amount of contracts that cannot be assigned. So, when negotiating any key contract, make sure that it

has a clause that allows you to assign the contract to anyone who buys the majority of your business assets. Consult your attorney on this issue. He or she will be able to provide you with a suitable clause.

4. Reduce discretionary earnings

Many owner-operated businesses have a significant amount of discretionary earnings in their P&L. Examples are travel, and meal & entertainment expenses that were not strictly for business purposes, above market rate compensation for the owner, or members of the owner's family.

The majority of business buyers will accept a certain amount of adjustments to the P&L to show the true profit potential of a company. But generally speaking, it can be difficult to get money for something that the IRS is unaware of. This is especially true for cash-rich businesses in which a significant amount of the cash income is not reported on the company books.

Businesses are valued at a multiple of earnings. During the sale of a small business, on average, you will be able to get about $3-5 for every dollar in earnings you generate. However, the maximum tax rate is 37%, equaling $0.37 cents per dollar. So, it only makes financial sense to report all income, and remove non-essential business expenses from the P&L, in the years leading up to a sale (at minimum 2 years). Look at it this way, for every dollar you report over the cause of 2 years, you may end up paying up to $0.74 in taxes, but you will get $3-5 from a buyer for showing it on the books.

5. Increase profit margins

Buyers love a positive trend and the earnings of a company typically have a higher impact on its value than its revenue. In the years leading up to the sale of your company, focus your attention on steadily increasing the profit margins. You can achieve this by taking a critical look at your P&L and deciding which expenses you might be able to trim, or even get rid of altogether.

You should also focus your sales efforts on clients with higher profit margins. Driving sales while at the same time recording decreasing profit margins will not do you any good. To most buyers, a company with $6 million in revenues and $1,200,000 in profit (20% margin) is more attractive than a company with $7.5 million in revenues and $900,000 in profit (12% margin). Make sure that the incentive program for your sales team rewards them for winning customers and orders with higher profit margins. Try to obtain financial benchmarking data for your company several years before the sale, for example by hiring a business appraiser. Knowing the average margins within your industry will tell you where you might be able to cut expenses.

6. Get organized and stage the business

Business buyers are like most home buyers: nobody wants to buy a mess, and if they do, they will pay less for it. You should literally clean house as the sale date approaches. I have walked into offices that looked like a tornado just went through... Receipts in a shoe box won't do, wires hanging from the ceiling, or a break room that looks like a total mess, won't do either.

Make sure that you get all your paperwork organized with a good and logical filing system. A buyer will ask many specific questions and will ask to see lots of different paperwork during the due diligence process, and you should be able to find any information quickly. A knowledgeable sell side broker will be able to advise you ahead of time what documents a buyer will likely request to see during due diligence.

As part of the process, make sure that you have posted all information required by the Department of Labor. And check that there are no offensive posters anywhere to be seen. I mention this because I have seen plenty of those during site visits. They should not be there to begin with, but I can assure you that most buyers won't think it is amusing if they see posters or calendars featuring (half-) naked people hanging on locker doors or as screen savers. Such things are simply unprofessional these days. Many buyers will look at a lack of compliance as an indication that you are not running a tight ship.

7. Clean up pending law suits

This goes hand in hand with getting organized for the sale process. You should not underestimate the impact pending or ongoing litigation has on potential buyers: They REALLY don't like it. Many will simply walk away from a potential deal if they find out that there is ongoing or pending litigation. At minimum, litigation will drag out the due diligence period and time is the enemy of any deal, as every business intermediary will tell you. So, if there are any open legal issues, try to clean them up before you put the company up for sale. If that is not possible, be upfront about the issue(s) and have all related documentation ready for review.

Trying to hide any legal issues, or any other material issues, is never a good idea! If a buyer finds out during due diligence that you have withheld material information, the relationship will sour immediately, and the buyer will become suspicious that this might not be the only issue you tried to hide. Few issues will automatically derail a deal, as long as you are open and upfront about them. Also, keep in mind that a typical Purchase & Sale Agreement gives the buyer the right to offset charges caused by undisclosed issues against the seller financing. So, you will get stuck with the bill anyways. Selling a business is not like selling a home, where the seller is "safe" once you passed the home inspection and 30-day post-closing period. Make sure that you consult your attorney before making any decisions!

8. Be a big fish in a small pond

A company that is a major player in a smaller market is typically more attractive to potential buyers than a company that is a small player in a larger market. This obviously contradicts the recommendation to diversify your customer base to some degree, but life is never simple, is it?

So yes, you should diversify your customer base, but at the same time, you should strive to define your market and make sure that you become a known and substantial entity within it. Strategic buyers tend to pay the highest multiples during the acquisition process, and they typically go after the known entities first.

Strategic buyers are also looking to acquire proprietary know-how, so the more of that you have, the better. Being highly specialized can make you vulnerable but ideally, you are in a position where you are a known specialist in a small field that is attractive to many different potential customers. For example, you might be a manufacturer of Ozone monitoring and controlling equipment. That is a narrow field (small pond) compared to the large pond of scientific instrument manufacturing. Ideally, you become the known expert in manufacturing Ozone manufacturing and controlling equipment and then try to expand your customer base by either geographical or industry diversification.

9. Spread know-how

This is crucial for any owner operated business. In many small businesses, most of the know-how and key customer relationships are focused on a few people. You don't want to be in a situation where the key asset of the company is leaving the building every evening, when you, the owner, is getting in the elevator. Remember that you will leave the company as part of the sale process and having all material know-how tied to just you or one or two other employees will make any buyer nervous.

Many sellers underestimate this issue. They think "Well there will be a transition period during which I can transfer that know-how". However, a buyer will think "What if the seller gets hit by a bus the week after I bought the business? What if he/she is not cooperative during the transition period? What if key customers simply don't like me and will move on once the seller has left". It is really important that in the years leading up to a sale, you start spreading know-how and key customer contacts across a group of employees. The more you spread the know-how, the better, since a buyer knows that realistically a few employees may leave, but it is unlikely that an entire group leaves at the same time. Or in other words, the less the success of the company is tied to the owner/seller, the better.

10. Create golden handcuffs for key employees

Many business sellers will try to keep the sale process a secret from their employees. However, realistically, you will have to involve at least your key employees, as the buyers may require that they can talk to them as part of their due diligence. Oftentimes, your key employees will have a high value to a buyer and there might be concerns on the buyer’s side that they might leave during, or right after, the sale of the company. Many buyers will use this as an argument to pay less for your company.

You want your key employees to be good ambassadors for your business during the sale process and the most effective way to do that is by giving them a financial incentive. This helps to assure that the sale and transition period go through without a hitch. You should also brief the employees on the process and coach them on what to say, or not to say. Everyone on your team should speak with one voice. One way of assuring their support during the sale process and creating golden handcuffs, is to put a small percentage of the proceeds from the sale of the company into a fund as bonuses for key employees. Structure it so that they will only become eligible to receive their share if they are still with the company 12 or 18 months after the closing. Such arrangements can very effectively alleviate the fears of potential buyers that key employees might be leaving soon after the sale. Think about it this way, motivated, supportive key employees will have a significant contribution to the chances that the deal goes through without the buyers trying to negotiate the price down. So, allocating 5-10% of the proceeds to ensure the support of your key people, will most likely be a good investment for you.

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