

The buying process: preparing your firm for sale

By

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What *you* should be looking for

In contrast to the beginning of other chapters, this section focuses on what *you* should want - which is not always the same as what buyers want. If you have read the beginning of every previous chapter, you will have a good understanding of putting together a firm that is very attractive to buyers – this is the most important thing in a successful sale. However, the buying process itself introduces new risks and complexities that can damage the hard work that you have done. Two firms I interviewed had disastrous experiences of the buying process where a cycle of partners being distracted due to the sale, key employees leaving, and a stressful buying process resulted in a vicious cycle where much of the value of the firm dissipated. In my sample only 75% of firms successfully sold first time around, leaving 25% who had to renegotiate what was often a lower value deal.

Think of the selling process as akin to selling a house. You might have a wonderful property but when buyers come looking, you should probably have given it a lick of paint and fixed some of those things that you've been meaning to do for some time. Moreover, you can't assume that the buyer knows all the benefits of your house and there is a process of education that you or your intermediary need to undertake to ensure the buyer knows *all* the benefits of your firm, including why it is just right for *them*.

The big difference between selling a firm and selling a house, as Paul Collins told me, is that a house doesn't get damaged during its sale, whereas a firm is likely to. To this end, I would recommend trying to stick with an interested buyer, even if they're offering up to 15% less than you think the firm is worth. A good advisor will give you a price *range* for your firm which will be highly dependent on variables you cannot control, including luck. Over the years I've seen several founders become distraught when they turn down a buyer's price and incorrectly rely on the economy, their firm, and the interest of other buyers being roughly the same if not better in another six month's time.

For sellers, the ideal buying process is that is short, profitable and painless. Most would also like to keep the character, culture and essence of their firm alive and if an earn-out is necessary, it is important that the targets are realistic, and the dependencies and contingencies spelled out. The extent to which these are achievable is dependent in part on how well you have followed the advice in this book, but also how well you manage the buying process.

The ideal situation for a seller is one where there are several buyers interested in the firm, where the partners are not overly distracted from their job of filling the pipeline, and where the due-diligence process unearths no unpleasant surprises and is therefore quick. These minimise the risk, not only of a buyer pulling out but also of the purchasing process being lengthened (with the risk that sales drop during that period leading to a lower valuation next time around).

2-3 years prior to beginning the sale process

An early advisor

Depending on the economic cycle, between 150-300 consulting firms are sold each month. Selling a firm at a premium not only requires that it generates sustainable, predictable, and growing profits in a niche area, but also that it is packaged and communicated well to a trusted network of potential buyers. For this, there is no substitute for specialist advice. For this reason, I would recommend your consultancy has the advice

of an independent expert experienced in growing and selling professional service firms, and that this advice is sought at every stage of your firm's growth. If you leave external advice to the last year it is possible that you will have missed something that may take some time to build in and have achieved sub-optimal growth. The advice I give in this section is obviously no substitute for in-depth expertise tailored to your firm, but reflects insights from buyers and sellers, as well as studies that have reported on this process.

Advisors tend to fall into two groups. The first are those that advise on growth. The second are M&A specialists. Concerning the first group, I suggest avoiding online 'personalities' such as Sam Ovens or Russ Ruffino. As I said in the introduction, their services are more useful for coaches and tend to focus around building a sales funnel. I would also avoid people whose advice is based on their own experiences of one firm. Many clients of mine have received advice from people who sold their own firms fifteen years ago, only to find that it is completely unsuitable for today's market. Concerning the second group, there are many firms to choose from, but I would focus on a firm that specialises in professional service firms generally rather than your specific type of service firm, because potential buyers will often come from a different service sector. If you drop me a line, I'm always happy to give the low down on good and bad M&A firms (I don't provide M&A advice myself). Unless your firm is valued at over £100m, it is likely that your advisor for the sale will be an M&A professional or a broker. The former tend to focus on deals worth between £10-100m, whereas the smaller focus on deals less than £10m.

At least two years prior to selling, it is worth doing an in-depth audit of your firm with an external expert. This will achieve several things. First, it will give you an idea what the firm is worth. Secondly, it will give you an idea of the potential buyers that might be interested, and how you might tailor your value proposition to better fit their needs. Third, it should give you a prioritised list of activities that you should undertake in order to maximise the value of the company. Even if your firm is in prime condition, an M&A specialist will tell you much that will make that preparation period much more effective.

One thing an advisor will be able to help you with is creating a list of firms that are likely to be interested in buying. It is certainly too early to let any of them know that you are interested in selling, but you might be able to have a closer look at the firms and their previous acquisitions to see if you fit their profile: are you big enough for them to be interested? Do you fill gaps in their service or market proposition? What has happened with previous acquisitions? Would you fit with their culture? You might even start targeting key individuals with invitations to join your steering committee, or with communications about your services, awards and other successes.

Preparing the team

If you (or other partners) wish to have a minimal earn-out period then it is crucial that you have someone ready to take over, or already have someone in place. Succession planning takes time, but if you have put into place strong systems the whole process will be less fraught. Whether internal or external, the person in question will need to have strong incentives to stay with the firm at least during the earn-out period, and to have shadowed the leadership role for long enough to make the transition smooth.

If you wish to do this prior to a sale, then it should be done at least a year in advance so that the new person has a chance to show the financial results of their interventions. A communications plan around succession is also important, to reassure staff and other stakeholders.

In addition, about a year before the planned sale, you should ensure you have solid skills for the team that will be handling it. If you can't afford expensive advisors you must consider who you need for the team. It may be worth recruiting an experienced well-connected part-time chair and an M&A savvy part time finance director, and incentivise them on sale. When it comes to an external team, this may well be the most important decision you make. Use an independent lawyer and accountant who are experienced in this type of transaction.

Timing of sale

The question of when to sell has a strong personal element, especially if there are one or two majority shareholders that can force a sale. It will very much depend on what their ‘number’ is, if they are still happy in their work and often how close they are to retirement. However, this concerns when shareholders might *want* to sell, not when is *best* to sell. Smaller firms tend to attract lower multiples, but the difference is not great. However, it is likely that earn-outs will be longer as smaller firms often have less mature structures and processes that reassure buyers about forecasts. Greg Alexander founded and sold SBI, and then founded Capital 54 where he is one of the only investors that puts money into small firms. Greg told me *‘when you are buying into a small firm, you either buy the people or the idea. I buy the people because the idea will usually change’*. What he didn’t say is that he invests in the assets of the firm because there usually are very few.

Whilst some sell too early to maximise the value of their work, a few wait too long wanting to milk the value from their firm to the point where margins begin to reduce. Remember that the sales process can take at a year and you may have an earn-out of three years when your earnings will be dependent on growth targets. So ideally, you should be thinking about a sale up to five years before you think growth might peak. This is all very idealistic, and of course many other factors come into play. However, if your firm is following an S-curve, buyers will be less interested when the growth begins to flatten off. The exception is a bear market which, whilst deals decline across the board, buyers are also realistic about the impact of recessions. Even during COVID-19, M&A activity continued at a reasonable pace.

Preparing key information

As we saw in the chapter on firm design, most firms will have a shareholders/partners agreement and Articles of Association (or similar) which set out the rules by which you operate. Reviewing and potentially amending these long before the sale process is incredibly important as you may find yourself restricted in what you can do. For example, how you have dealt with minority shareholder rights might hold up the process of a sale indefinitely. If your legal documents are these are out of date or inappropriate, they may benefit from renegotiation or redrafting before considering a sale.

In addition, a year or two prior to a sale, get in the habit of preparing and maintaining a Confidential Information Memorandum which is almost a marketing brochure a seller provides to entice buyers. It will typically include:

1. Investment summary
2. Firm Summary
3. Market and competitor overviews
4. Client base, sales & contracts
5. Services & IP
6. People
7. Governance
8. Financial history & projections

Use this as a benchmark to track quarterly performance and as a running audit checklist of all the areas that are going to come under scrutiny during due diligence. Doing this early enough will allow you to identify and improve upon weakness that buyers might use to barter down the price. I have put a template CIM at www.joecomahoney.com – it is well worth looking at early on, so you have a clear idea what looks ‘good’ to a buyer.

Who buys, why and how?

Types of buyers

Two forms of buyers account for around 95% of all purchases: Private equity and strategic buyers and it is on these that I focus. Private equity (PE) buyers represent a wide array of individuals and companies that focus on the acquisition as both a stand-alone source of revenue growth and an asset that might be sold on again in the future. PE deals have grown significantly over the last 15-20 years and now account for between 30-50% of deals depending on the economic cycle and the cost of debt. One reason for this growth is that private equity firms are taking advantage of cheap debt to leverage purchases for higher returns. PE typically want a medium-term financial return on investment for their investors. They will typically buy a percentage of the firm (not always a majority) and maintain the firm's fundamental operating model. Typically, most of the original board will still be involved in governance (depending on the contract). This is attractive to founders who wish their company to remain intact, to seller boards where one or more partners wish to exit, but also to senior managers who may not have the cash to disappear after their earn-out and don't wish to be a middle-manager in a bigger, very different company.

Strategic buyers are typically other PSFs that wish to lever the target firm to improve their own performance¹. But this can happen in four different ways (Table 35). Regardless of the primary aim, there are usually a host of secondary benefits which can include acquiring: key individuals, technologies, methods, 'star' clients, and access to high growth markets, sectors and services. All this said, failure rates of M&A activity are estimated² around 70% in terms of failing to generate value of the price paid (my own experience is that this figure is much lower in PSFs).

Table 35 Why strategic buyers buy

Reason	Focus of performance improvement
Growing international reach	Selling existing services in new high-growth markets; Better serving international clients;
Increasing market share	Growth through acquisition; Buying up the competition;
Increasing range of services	Cross-selling services in existing clients; Vertical or horizontal integration of services;
Differentiating the buyer's existing services	Adding value and pulling-power of existing services by adding key individuals, technologies or services in the same area;

Strategic buyers may not come from your market. Management consultancies are frequently bought by HR consultancies, engineering consultancies, media agencies and IT companies (in order of frequency), usually to create the strategic leverage with their clients for larger projects downstream. Whilst founders and senior management may be promised otherwise, it is rare for a small firm to maintain its independence, culture or systems after a few years of being bought by a much larger firm. This eventuality can prove frustrating for those whose earn-out did not allow them to retire, and end up working in a more bureaucratic, less entrepreneurial culture. I have personally seen how disastrous this can be when a large consultancy for

¹ A third option is floating as a public company. Among my cases, only one did this. It is rare, not only because it is much more complex than other options, but also because it is usually pursued by leaders that want to continue to develop the company by generating investment capital. There are markets (e.g. UK's AIM market) which are less stringent on what types of firms can float and how, but the complexity of a floatation should not be under-estimated.

² Christensen, C. M., Alton, R., Rising, C., & Waldeck, A. (2011). The new M&A playbook. *Harvard business review*, 89(3), 48-57.

whom I was working (young, IT focused, commodified – the firm, not me) bought an expensive niche boutique (grey hair, individualized, strategy). Within 3 years, the entire workforce of the acquired firm had walked out the door and set up a competing firm.

For strategic buyers additional value for the purchase will ideally come from new synergies such as leveraging bigger or more valuable projects, cross-selling, entry into a new market, plugging a gap in the firm's competence, or capture of a strategic client. These requirements are different to each buyer, but the key point is that the firm for sale must know and articulate its strategic value to buyers as well as its financial position. What interests strategic buyers foremost, therefore, is the potential of a firm to add strategically to its specific offerings and it is this that will first get the buyers attention and will likely prompt their initial approach.

Management Buy-Outs (MBOs)

A management buy-out was undertaken in only one of the firms I interviewed, and the founder was well aware that he was sacrificing cash for maintaining the culture of the company.

'I am proud of what we've built together and there was no way that culture and energy was going to remain intact if we sold to a big corporate. I realised early on that there is no way they could match the price of a corporate buyer, but that is the price you pay.' [Anon].

The pros and cons of the management buy-out are well encapsulated in that sentence. As many of my interviewees moved out of their earn-out periods, it became clear that in most cases their firms was likely to be engulfed by the culture and processes of the larger firm. Whilst there were a few exceptions, where the firms were kept intact as a separate financial and operational entity to the buyers, many purchased consultancies enter a spiral where encroachments on working practices (often swapping long term investment for short-term reward) lead to people leaving, which weakens the culture, and so on.

A management buy-out is one alternative to this, but if you think that a minimum purchase for a small firm is typically £5m, a company where the senior team comprises ten people will generally struggle to raise anywhere near this amount, even if their (life) partner permits! It is of course possible to overcome this obstacle buy selling slowly, so that profits can be used to fund the sale, but often this period can lead to confusion and a struggle for succession. Not impossible, but often difficult.

There are alternative options here. Sometimes it is possible to convince a bank or other lender to pay the major shareholder(s) for their shares and this is then repaid as a loan over a period. Other times, the founder may agree to have their equity (plus interest) paid back from future profits. In addition to ensuring the firm is in great share, a good advisor should provide you with options that match your needs.

Initial Public Offerings (IPOs) and SPACs

As with MBOs, only one of the firms I studied floated on the stock-market. AIM Elixirr. The benefit to this is that it allows owners to realize equity whilst still maintaining directive control. An IPO can generate a lot of money, provide a relatively quick return for owners and allow those who wish to exit, to do so, and free up capital for investment in big projects. In addition, as publicly-traded companies have more stringent accounting and reporting requirements they can often benefit from a stronger reputation in the market which can lead to bigger clients and access to reduced-cost lending. A final benefit is that shares become liquid so that payments can be realised as soon as the shares are released, as opposed to previously when they are realised on the firms' sale.

On the down-side the preparation for IPO and day-to-day reporting of a publicly-listed company is much more work and expensive. The IPO itself typically loses 10% of its value of the funds raised on fees to auditors, underwriters, and advisors. You are also likely to need expanded governance, reporting and finance teams. Once floated, there are greater regulatory pressures and disclosure requirements and short-term performance targets often take precedence over long-term value. All this results in greater costs which can

have a knock-on effect on margins. More importantly, these pressures can affect the culture in the company which can prompt both employees and founders to leave. Finally, a founder/CEO can lose control of the company if they do not keep shareholders happy. There are exceptions to this type of stringency – alternative markets such as the FTSE AIM (upon which Elixirr floated) have less stringent requirements and so are more suited to more entrepreneurial ventures which still require flexibility.

None of the firms I have interviewed or advised have ever used a Special Purpose Acquisition Company to IPO – indeed, it is still quite rare in the consulting world, and deals tend to focus on medium-sized technology firms. However, if growth rates of SPAC deals continue, it may not be long before they are not uncommon in the professional service firm market. A SPAC is typically formed by ‘sponsors’ to raise IPO funds from investors with a purpose of acquiring a private company and taking the firm public. The investors have 2 years to find a target firm while the funds are placed in an interest-bearing trust account. If they cannot find a target company within the given period, the SPAC must be liquidated, and the funds returned to investors. SPACs are sometimes called ‘blank cheque’ companies because they are provided with funds to go and find a great investment. As the sponsors have already done the negotiations with investors, the target firm can get to market much faster.

The buying process

Many buyers of firms already have existing relationships with their targets, though this is less likely to be the case with firms that are buying up many companies (many buy three or more a year in pursuit of rapid expansion) and rarely the case with Private Equity (PE). With ‘serial purchasers’ and PE they are likely to use a third party. For firms that have existing relationships, this is most likely to be a firm that you have already been working with on projects or with which you have a reciprocal cross-selling arrangement. It is likely that this firm will be aligned either vertically (e.g. strategy to implementation) or horizontally (training to recruitment) and thus the fit is obvious.

I wrote above that the stages of selling a firm are similar to selling a house. Also, as with buying a house, they appear relatively simple but belie what is often a risky, complex and stressful experience, especially for the target. Table 36 shows the steps and the potential timelines. The stages don’t need to be done consecutively, although there is a critical path, and in reality, these phases often overlap and repeat. Sometimes, a buyer pulls out and timelines get extended, but more commonly something might change (e.g. partners leave, or profits fall) and the price must be renegotiated.

Table 36 Stages to sale (and beyond)

Stage	Details	Duration
1. Know what you want	It is not as simple as private equity vs. a strategic buyer. Do you want to retain control? Do you want the firm to still exist afterwards? Do your partners want different things (e.g. staying on, exit)? Would you rather sell to a private or public company? How long do you want the earn-out to be? What is your target price? Regarding the buyers, it is wise to build a list of the characteristics of buyers that you are looking for and begin building relationships with a short-list early on.	1-2 Workshops
2. Pre-diligence	When you are selling a house, you clean it and maybe paper over some minor cracks. The same is true of a consultancy. Having a great firm is one thing but making that presentable so to attract the most buyers is another.	0-6 months

	<p>If you have followed the advice in this book, your firm should be in a solid state, but making this presentable to a buyer means further work. Even when you sell a car, you ensure it is cleaned and polished! Is your share structure clear? Is your Intellectual Property registered? Have you settled your bad debts? Are key contracts, corporate records, and governance documents well organised? Have you optimised your sales and costs to maximise profits? Are your governance and management processes clear and readily available? Do you have three years of audited accounts?³</p> <p>It is also well worth preparing for the successful outcome: how will the change be managed? What is your communications strategy and plan? Who will know what and when?</p>	
3. Engage intermediary	If you have not been approached by a buyer (or even if you have) you may engage a third party to help you identify potential buyers and structure the deal.	1 month
4. Search for potential buyers	The seller or intermediary will search the market for suitable buyers. You should aim to find as many suitable buyers as possible so to maximise the odds of finding one that shares your values and culture (and a bidding war never hurts....).	1-2 months
5. Initial approaches	Initial conversations are often held with several interested buyers. Additional and clarifying information is typically exchanged. At this stage, an NDA will be signed.	1 month
6. Deeper dive	More substantial information is provided in response to the potential buyers' requests (sometimes called a Confidential Information Memorandum) and an approximate valuation will be generated by potential buyers. If this is on target, a Letter of Intent (LOI) will be signed with one potential buyer which is usually a mix of binding (typically, exclusivity of negotiations, non-solicitation of employees and confidentiality) and non-binding (e.g. the price, deal structure, parties, financing, contingencies and required approvals) terms.	1-2 months
7. M&A due diligence	After agreement on a price, the floorboards are lifted, and all aspects of the firm are examined in detail. What is found will inform the detailed negotiations.	1-3 months depending on ease and complexity
8. Negotiations	The buyer presents an offer based upon its valuation model(s). Sleeves are rolled up and pizzas are delivered. The intensity of this phase can mean that owners get distracted from the main business such that a deal failure can hurt the potential of a back-up deal. Bear in mind that buyers will often have conducted many purchases and you may not have experienced any. It is worth getting an M&A specialist on-side here.	1-3 months
9. Share Purchase Agreement	A final contract is drawn up for sale. This is often complicated through different partners' needs, conforming to different international laws, and preferences on the type of purchase (e.g.	1 month

³ There are several benefits to having all your key documents ready to go. Not least, the impression the buyer is given that you have done this before and there may be competition for their bid.

	assets, shares). This culminates in the share-purchase agreement (SPA).	
10. Completion	Similar to a house purchase there is a time lag between the signing of the contract and associated payment. This is especially true if the SPA was conditional on any further activities (usually called 'Conditions Precedent').	1-3 months
11. Post-sale	Now the hard work begins. The communication plan gets put into effect, the change management plan begins, and the earn-out (if included) will start.	Hopefully not too long.

Whilst the average period of sale is between 6-9 months, it can last anything from four months to eighteen months depending on how prepared you are (and how lucky). The former is usually when a buyer is already known to a seller and one of them approaches directly, which can save the first four stages. However, these types of deals are also inherently risky because there is no competitor for the deal and the buyer is likely to be much more experienced in these negotiations. Private equity deals are usually done quicker than trade deals because they are set-up to buy and do these types of deals routinely. In terms of timelines, the big contingencies are 'Pre-diligence' and the 'Due diligence' phases. However, a good PSA (Ch.7) that has been used consistently removes much of the organisation needed to demonstrate key metrics to a buyer.

Hopefully, this will help illuminate why many of the owners that contact me wanting to sell immediately are disappointed. Doing the most important things in this book (i.e. maximising the potential value of the firm) can take up to two or even three years for a firm that has grown in a haphazard manner. If a one-year sale process and a two-year earn-out are added to the equation, then it can sometimes be five years before the founder realises maximum value. Naturally, some leaders will want to compromise maximum value for a shorter journey to sale.

There may also be some stickiness when it comes to risk mitigation. Most buyers will want some form of risk management around individuals and future performance, so are likely to insist on some deferred payments, earn-out clauses, financial-metric payments, non-compete clauses, claw backs or payment in shares. Some of these may be more preferable than others, but to reiterate: the less the firm depends on you and the other share-holders to generate revenue and growth, the easier it is to negotiate a short earn-out.

For every hundred firms that are *considered* by frequent buyers only around eighteen get an NDA, ten get to the Letter Of Intent, and only one gets through due diligence⁴. This drop-out rate isn't necessarily due to buyer pickiness but can also be due to sellers dropping out of the funnel intentionally. The average deal will result in 55% of the sale price being paid up front and the rest acquired through earn-outs. Around 90% of acquisitions of consulting firms require earn-outs, where the founders are contracted to remain with the firm for a period and hit specific targets to earn the rest of the purchase price. The smaller the company, the greater the 'people risk' for the buyer and the lower percentage of upfront payments.

The most common targets for an earn-out contract are unsurprisingly profit margin and revenues. In cases where the firm has a unique and valuable skill-set (e.g. technology consulting), buyers also specify the retention of key employees (who will often, in turn, be offered bonuses to stay). Around three-quarters of earn-outs hit their targets, so a CEO should not see the earn-out as guaranteed income. If you wish to avoid a long earn-out, you will need to have a large, diversified management team with minimal dependencies on senior people.

⁴ Equiteq (2014) The Knowledge Economy Global Buyers Report 2014/2015

It should also be stressed that the buying process is a major distraction for the senior management team, and if this hits sales, it is likely that the sale will fall through. For this reason, it is usually a good idea to use third parties to support this process so the senior team can focus on continued growth.

When buyers don't necessarily want what is best

There are four areas where buyers tend to ask for things that many well-run firms might not deliver were they not selling. Neither of these are necessarily a problem, but potentially something an advisor will suggest that you prepare for in the 18 months prior to the sale.

The first concerns service specialisation. Buyers tend to ask for a more focused niche than many firms naturally possess. This is often because firms are looking for a specific service (or sector) offering to add to their portfolio, and a more diverse spread of services will overlap with their own.

The second concerns profit margins. Whilst buyers tend to prioritise growth over profit margins, the ideal seller will have both. However, firms that have grown quickly will often have invested their profits into people and have little margin to show potential buyers. This is something that can be addressed either in the form of an explanation (*'you can see we have invested heavily in people for the last five years; we are now in a position to reap the rewards of the investment we made'*) or by actually freeing up margins in the 18 months approaching the sale.

Thirdly, simplicity. As David Blois, founder of M&A Advisory told me, *'buyers like to keep things simple. If a seller is too complicated or has too many variables, this often scares buyers off'*. In other words, you may have a complex company that works for you and other partners but may be difficult to sell. An example that springs to mind is an organisation that is a recent meld of many independent consultants who do similar things.

Finally, is when buyers are not actually buyers. They may be larger competitors pretending to be interested in order to access details about your finances, your rates, your clients and your star employees. An NDA is of virtually no use and instead you will need to do your own due diligence on buyers prior to sending them the Confidential Information Memorandum and trust your gut instinct.

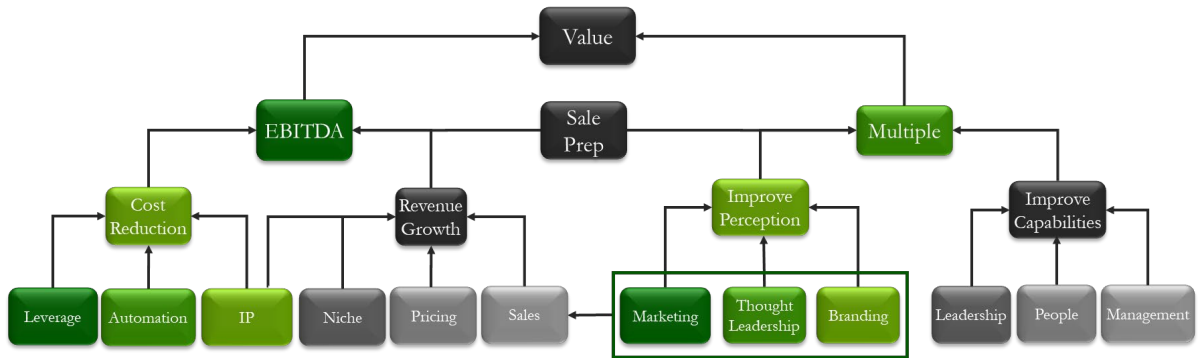
This all said, I would be cautious about changing the company too much in order to please a potential buyer. The majority of potential deals will fail, and several partners have reported taking their eye off the sales pipeline during due diligence and contracting process only to find the buyer pulls out and suddenly the finances don't look so impressive.

How buyers value your company

The foundation

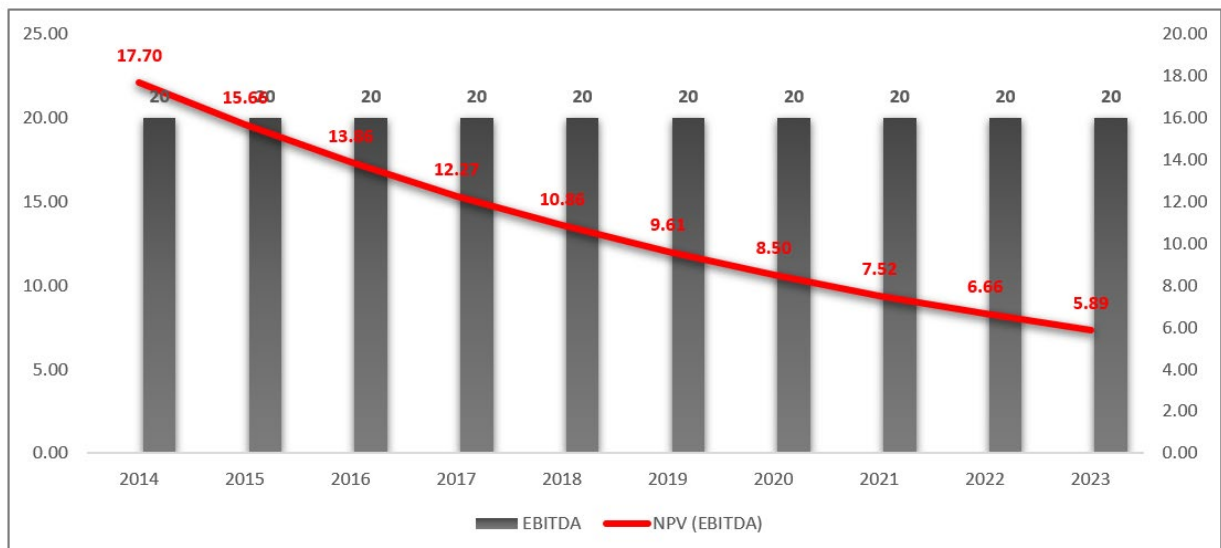
To illustrate the components of valuation, I have reproduced the diagram from the beginning of book (Figure 32). The firm's EBITDA provides the basis for calculating how quickly the sale price might be recouped by the buyer. This is used because it is seen as a more reliable estimate of the real profits generated by the firm because it excludes things (i.e. the 'TTDA') that vary depending on country, financing structure, or investment decisions. It is by no means perfect and can be depressed in many ways, perhaps the most common being partners taking out excessive bonuses. For this reason, not all multiples should be treated equally (many sellers get multiple envy when I bring up others'). The projected *growth* of EBITDA promises to shorten the expected recoup period, but if perceptions differ between the buyer and the seller then earn-out targets are a good way of settling the disagreement!

Figure 32 The Value Hierarchy



It is important to remember that buyers are buying the *promise* of future revenues which are diminished by inflation and risk. As the net present value of firm with static (but healthy) profit margins and revenues reduces considerably even over a ten-year period, it is important for the buyers that the firm is expected to grow. Figure 33 illustrates this with EBITDA of £20m discounted annually at 13% - as you will note, the value of a zero growth company rapidly diminishes for the prospective buyer. I have put the spreadsheet at www.joecomahoney.com so you can input your own figures. As detailed in Ch.3, buyers ideally want sustained, growing revenues for at least three years, and projections of the same for a subsequent 3 years. A minimum of 20% EBITDA and 20% growth for the previous three years is the basis for a good price.

Figure 33 Deteriorating purchase value with no growth.



I was told by several founders that their advisory firms told them that buyers aren't interested in firms with less than £5m revenue. This simply isn't true and may be prompted by advisors looking for bigger deal sizes to maximise their own earnings. In reality over a quarter of deals are for firms with less than £5m revenue, and around 15% are for less than £1m. Another 35% are for firms bringing in between £5-50m, and another 25% above £50m (Equiteq 2017). What is true though is that EBITDA purchase multiples are lower for firms earning less than £5m, then plateau between £5-50m, and then generally decline as the number of potential buyers diminishes. The reason for the low multiples at the smaller end is that buyers here are often simply buying in teams rather than businesses. As these firms have rarely built sufficient assets to reassure buyers, they typically attract long earn-out periods. Certainly, the smaller end of the market unsurprisingly tend to get deals which provide most of the payment for hitting future targets.

If you have a fast-growing firm advising on AI, robotics, data analytics or cyber security, it is likely that firms will be prepared to relax their requirements as competition for your company will be so high. In the case of fast growing firms, it is also likely that the buyer will value the firm on the last six months profits (multiplied by two) rather than the last year so as to give a more accurate reflection of value.

The multiple

To illustrate, consider a business that is making £1m EBITDA and advancing well at, say, 20% growth per annum. In terms of its business infrastructure, and qualitative assessment, let's just say a buyer would value it as a 5 x EBITDA company. Next year, therefore, if growth continues on track, the company could be worth £6m (£1.2m x 5). If the owner really works hard on the profit growth side (achieving 30% EBITDA growth), maybe they could get this to £6.5m (£1.3m x 5). Suppose, however, that growth rates were held and managerial effort focused more on improving the qualitative aspects of the firm – thus moving the buyer's multiple offer to 7 x EBITDA or an £8.4m business? My point is that once a solid EBITDA is achieved, it is usually more important to focus on the factors that will help generate a high multiple.

Understanding this point and having an awareness of the components that make up this qualitative multiple, is – therefore – critical to your future business success; certainly, an essential prerequisite to any deliberate 'build to exit journey. My advice pertaining to the right-hand side of Figure 32 is provided throughout this book.

I should also stress here that getting the narrative right during the sales process is a crucial part of managing buyer perceptions. The impact of the story about *why* you are right for them, *why* you have an exciting firm, and *why* your growth rates are likely to be high, should not be under-estimated. Central to this, as I detailed in Ch.3, is the category in which the buyer places you: consultancies tend to have a lower multiple than software firms but a higher multiple than training firms. Getting your positioning right is crucial.

Preparation for sale

Secrets, conflicts and hostages

By the time a typical firm gets to sale, it will typically have major shareholders (typically partners, less commonly investors), minor shareholders (typically employees), and a series of other stakeholders including clients, the buyers themselves, and the families of those most involved with the sale. It is important that these groups are managed and communicated with properly, especially those key individuals who need to be locked in for the earn-out. This can be especially complicated in a firm where partners are at different life-stages and thus want different things.

Partners generally keep the sale secret until the deal is done to avoid unnecessary worry, but mistakes often happen. One founder told me of a key document being left on a photocopier, whilst another said suspicions were first aroused when a cadre of suited analysts arrived at a dress-down firm for the due diligence. So, I would suggest assuming that the news will get out and having a contingency communications plan for this.

Generally speaking, only tell senior management who need to know about the plans. If you are planning a post-deal bonus then keeping the deal secret should be part of this. You may feel like a fraud not telling other employees, but if you do, be prepared for some to leave and for others to be distracted. These can affect your performance and lead to buyers pulling out.

Hopefully, you will have followed the advice in the section on governance and anticipated conflict in your partnership charter and communicated your exit strategy clearly to major stakeholders and shareholders. Unfortunately, this isn't always enough to prevent conflict which often happens when approaching a sale. Presented with a small purchase pay-out, minority shareholders often find themselves presented with a new job title, a three year earn-out, a new boss and a contract specifying non-compete and no solicitation clauses.

It is perhaps no surprise that they often refuse to sign and can hold the major shareholders hostage in hope of a better deal. I have experienced a few deals where such conflict was enough to dissuade a buyer.

The following good practices can help:

- Ensuring that the compensation and equity of influential individuals aligns their interests with those of the firm
- Winning buy-in and setting expectations of key stakeholders and shareholders concerning the plans of the majority shareholders
- Building excitement and motivation of the senior team towards the right exit
- Understanding the minimum requirements of shareholders for a sale, not just in terms of price, but also the type of buyer, terms and conditions
- Ensuring you have an experienced expert on hand to provide guidance where expectations might be out of alignment
- Having an independent arbitrator named for potential conflict situations, especially concerning the value of the firm for any unexpected exits
- Ensuring that the 'back-up' buyer is kept 'warm' when negotiations are progressing with the main buyer. When a deal falls through it can be shock enough for everyone to readjust their expectations second time around.
- Making sure you have a contingency plan for minority share-holders holding up a sale. Many owners take it very personally and feel they are being held hostage after creating jobs for these people. This thinking may or may not be true, but it won't help your cause to cancel the deal and sack them all. It might help more to think about what you are prepared to negotiate on, and whether you can act as their advocate in discussions with the buyers.

Peak performance: rhetoric and reality

In the two years prior to instigating the sell process the entire firm should be focused on maximising EBITDA. This may mean shifting the incentive structure in the firm and will certainly mean some crisp communications around accelerating sales. A six-month 'sprint' is a useful tactic here to focus minds and energy. It is equally important to attack costs wherever possible: ending subscriptions that are unnecessary, swapping associates for employees, closing offices that are unproductive, removing partners that are simply waiting for the pay-out, and trimming bonuses where possible.

Yet equally, a good advisor and accountant will help you portray your profit and loss accounts in the best light. Approaching sale it is normal practice to 'adjust' or 'normalise' EBITDA as there may have been additions or subtractions (e.g. payments through dividends or bonuses) which do not reflect normal day-to-day financial transactions. In addition, there may have been amortization or depreciation decisions some time ago which are better adjusted as a one-off cost rather than spread out to influence the current balance sheet.

Buyers recognise these 'add backs' and expect accounts to be adjusted (either way) in light of one-off payments that might not reflect market rates. It is better to err on the side of additional EBITDA and then have the debate with buyers later for two reasons. First, because the initial presentation of EBITDA puts a marker in the sand which sets buyer expectations. Second, because by the time a buyer comes to have that negotiation, they will have invested significant time and money and are more likely to progress with the deal. Many of us have continued with a house purchase that we've fallen in love with despite the fact that the survey has highlighted some problems with damp.

Negotiating a deal

Now, this isn't a book on negotiation skills⁵ but I'd like to highlight several things that sellers and buyers have told me to create the best deal for the seller:

- Really try to understand the buyer's motivation. How will you fit with them? Have their organic growth plans stalled? Are you a 'nice-to-have' buy or a 'must-have' buy? Be pushy and ask for their 5-year plan. Dig into them as much as they dig into you in other words: this is especially justified where there is an earn-out as they are asking you to back their future.
- Don't reveal too much, too early. Information is power in negotiations and you must be in control of what is revealed and when. To this end, try to avoid getting cosy with one buyer too early on. Don't go for dinner. Definitely don't go for drinks.
- More than one interested buyer is crucial to getting a fair price. If there is one buyer, and they know it, and know that you really need to sell, they are in control of the deal. Wherever possible get more than one buyer interested, even if you have to mix up PE and strategic buyers, or even if there is one clear preferred buyer.
- Once the Letter Of Intent is signed you are usually prevented from courting other potential buyers. It is crucial that before you sign the LOI you have the best possible terms. An experienced M&A advisor will help you a huge amount here, one of whom told me to always insist that they 'show you the money' before you sign, to ensure they actually have the funds ready to go.
- Once the LOI is signed, buyers have the upper hand. They will generally seek to renegotiate the price based on things they've discovered (a bit like renegotiating on a house after a survey has been done). One tactic is to draw out the due diligence until the seller is having a nervous break-down. This can be prevented by specifying a time limit prior to signing the LOI.
- Be open to earn-outs. Saying no upfront means turning your back on many potential buyers and potentially losing out on a higher total price for the firm. Earn-out payments tend to provide a higher return than upfront deals but have less guarantee of success.
- Quantify your value to them. Make a list of all the ways you will help them. For example, most buyers focus on how they will sell your services to their clients. Try to quantify this, but also quantify how you can sell more of their services to your clients.
- Don't start spending, or even planning the spending, of the money before the deal is done. You are more likely to accept last minute renegotiations by the client (which is a common phenomenon) if you've already told your family about the new yacht.

A universal piece of advice is to focus on the terms of the deal as much as the price. A lower price with better terms is usually preferable as bad terms will dent the price anyway. Terms are likely to include: the earn-out period; the percentage paid upfront; whether the price will be paid in cash or shares; whether assets are being purchased or shares; non-compete clauses; earn-out targets; earn-out conditions (e.g. resources); your role and power in the post-deal company.

Negotiating a good earn-out

Earn-outs tend to be used when there is a gap between the buyer's and seller's price expectations or when the business is still dependent on the owners (usually for sales). A good earn-out isn't necessarily (or just) a short one. It is one where there are no surprises and both parties end up happy because the goals of the earn-out are realistic, reasonable and supported. The details concerning the earn-out are usually hammered out in the negotiation. There are certain things interviewees tell me tend to go wrong during an earn-out, and these might focus your attention on the negotiations:

⁵ A good book on negotiation is Malhotra, D., & Bazerman, M. (2007). *Negotiation genius: How to overcome obstacles and achieve brilliant results at the bargaining table and beyond*. Bantam. Try to avoid books written by hostage negotiators.

The first is lack of financial resources. A few sellers have told me that once they joined they were disappointed with the amount of cash available for investment in their firm's (or more accurately, your department's) growth and that this had corresponding effects on their ability to hit targets. Whilst it is important to recognise that, as part of a bigger firm, you are one of many hustling for additional budget, this is something that should be covered in the negotiation. You should have a good idea what investment is required to hit your targets and seek to get this agreed.

The second is human, and other, resources. Often, a newly acquired firm will rely on the functions of the larger firm in order to succeed. From a buyer's perspective, this is crucial to achieving economies of scale. Yet, for the seller, it can mean that decisions take longer, bureaucracy slows things down, and the new team isn't as capable or doesn't understand your unique needs. A common complaint is when the firm needs to use the acquirer's sales team who don't really understand the new company.

A third challenge is central expenses being inserted into your P&L account. Frequently, the buying firm will add an expense line around 'Head Office Expenses' or similar. These can be significant and will eat into your reported profits, which is likely to impact your ability to hit earn-out targets. Again, this should be detailed in the contract, for what it is worth.

Fourth, is when the people who bought you leave (or worse the buyer is taken over themselves) and your political influence diminishes. One seller told me that he struggled to make the new owners of the company honour the original agreement.

A final challenge concerns your decision-making power. It is hard to hit targets if your ability to take and enforce decisions is highly circumscribed. Being as explicit as you can about this, your resources, and the central 'top-slice' of your revenues is important in making your earn-out successful.

Bear in mind that early missed targets have knock-on effects to later ones, and which can mean Year 3 targets are virtually impossible to hit by the end of year one. A very depressing scenario!

With all this in mind, my advice for negotiating a good earn-out is:

- Be clear on what you want. Not just the minimum price, but all the details from support, earn-out, the type of work you will be doing, and the decision-making power you will need.
- Don't just focus on the money. A match in values and chemistry makes the next 2-3 years much more likely to be enjoyable and successful.
- Get as much cash as you can up-front unless you are pretty certain that you are going to be hitting some high growth targets in future years and you think you'll enjoy the ride.
- Put a time delay on when the earn-out starts. This will give you a chance to recover from negotiations, settle in, educate the salesforce about your services, and execute your communications plan.
- Specify the details you expect concerning investment, access to decision-makers, and be clear on what processes of theirs you will expect to use (and the risks associated with these). If they want you to use their sales team, ensure that you have time to train and brief them.
- Insofar as possible, identify contingencies for specific scenarios. For example, a recession, the buyer being bought, or a personality clash.
- The greatest leverage you will have is by having several buyers interested. If you have chosen your niche well and grown your company sustainably, you should achieve this.
- Don't take your eye off the business. Get your team focused on business development and operations so that sales don't slip during negotiations. Your advisory firm and the founder should do the majority of the work for the sale.

Take-aways

- Prepare for a sale or large investment at least two years in advance
- At least two years in advance

- Ensure the shareholders are clear on what they want from an exit or investment. Discuss the minimums needed (e.g. cash, earn-outs, exits) with everyone that can hold up the event. Have this facilitated by an advisor.
- Seek to maximise recurring and non-headcount related revenues (see Ch. 5.)
- Ensure you have reduced the dependence on key individuals by having strong IP and processes in key areas
- Have a clear idea of what firms might be interested in buying or investing in the firm and the gaps that they would want you to fill. Align your strategy with these gaps.
- Ensure your Articles of Association and Partnership Agreement are not going to get in the way of a sale
- Set expectations of the senior team, and link sale targets to their reward structure
- Audit the firm from a perspective of a buyer and create a plan to deal with weaknesses
- Maximise EBITDA growth for 2-3 years before the sale.
- Anticipate and deal with any bad smells (court cases, debts, problem individuals)
- Ensure your accountant and lawyer are aligned with your goals.
- At least a year before a sale
 - Research and begin building your value proposition for buyers or investors. Why should they buy (or invest in) you and not a competitor?
 - Build a team of internals and externals to deal with the sale. Assess potential M&A advisors or brokers. Recruit fractionals or board members who can help with specialist skills, knowledge or connections.
 - Focus everyone not involved with the sale on business development. Shift rewards to ensure that sales are maximised during whilst the sale is progressing
 - Ensure that you have quick access to all the key data and facts that will be needed for the CIM and the due diligence process.
 - Assemble all the key documents, metrics, reports needed for the due diligence and CIM.