The Importance of Reasonableness When Selling Your Business

By David M. Kauppi, Managing Partner MidMarket Capital Advisors, LLC

We recently completed a survey of a broad cross section of business brokers and merger and acquisition professionals. One of the questions we posed was, “What is the biggest challenge you face in your practice?” We gave them eight choices including lack of financing, sell side deal flow, not enough buyers, etc. We asked our professionals to pick their top three. The top answer was Seller Value Expectations with a 68.9% response rate. The next closest answer was sell side deal flow at 55.3%. Why is this the biggest challenge that our industry faces? To me this translates into a great deal of wasted effort on the part of our buyers, our seller clients, and our profession.

This is further exacerbated by the business sellers that expect a full business sale engagement with no monthly fees and the only payment in the form of a contingent success fee. A true professional M&A engagement includes preparation of blind profiles, confidentiality agreements, memorandum authoring, preparing a database of buyers, buyer contact, conference calls, buyer visits and negotiations. A typical business sale takes between 4-12 months and often involves from 500-1,000 hours of Investment Banker work.

Because deal flow is the second largest problem that the industry faces, many business brokers and merger and acquisition professionals will agree to this success fee only seller demand. I believe it was Rockefeller that said, “If it seems too good to be true, it probably is.” One of the large industry players estimates that the average business sale closing ratio is less than 10%. This is so important that I am going to say it again. The business sale closing ratio is less than 10%. It fails 90% of the time.

Let’s look at the natural result of this dynamic. The business broker, if he is doing it the right way, is going through this very labor intensive process to contact buyers, get confidentiality agreements signed and bring qualified buyers to the table. Here is what typically happens. The owner is getting all of this work for free, has unreasonable value expectations and since he is not paying any fees, has no sense of urgency. The broker could bring in legitimate market offers that are fair and the owner says, “That is not nearly enough, you are doing fine, just keep going.”

Well it doesn't take a business broker too many situations like this before something has to change. The first thing that usually changes is that he now refuses to take on any engagements without an up-front payment or a monthly consulting fee to offset some of his costs in this low closing environment. What happens over the next year is that his deal flow totally dries up, because he is competing with those professionals that are still willing to operate with only a contingent success fee.

The next question is how do those brokers that operate on a contingency basis stay in business? The simple answer is that they can no longer afford to perform a true M&A process. They take on a large number of clients and try to sell their business through newspaper ads, industry publication ads, email blasts to private equity groups, email blasts to other brokers and the favorite – putting the business on several business for sale Web Sites.

All of these approaches, with the exception of contacting private equity firms (about 1 % of businesses for sale meet their rigorous buying criteria) invite individual buyers, not corporate buyers. Individual buyers are looking to buy a job and to the extent that business sellers have inflated value expectations, these buyers have equally deflated valuation expectations. It looks something like this. Do you have the $XXX minimum needed for the cash at closing? No but I have investors. These investors never show up.

The individual's analysis follows this logic. Well, at the height of my career, I was making $150,000, so I am going to have to get at least that out of the business each year. Also, because this is high risk, the equity I put in will command a 25% return, and I have to cover the 75% of transaction value debt at 10%. So, by my calculation I can afford a price of 60% of the true market value of the business.

This gap is almost never bridged between business seller and individual buyer. And yet the approach most of the business broker profession is forced to take based on the unreasonable expectations of the sellers invites this dynamic. This is often hugely damaging to the seller's business. No matter how much he tries to focus on running his business, this stream of bargain hunters is a big drain. The business often suffers a significant drop in performance during this period, and like an overpriced home, often becomes stale in the process.

As the owner of a Main Street Business - bar, restaurant, salon, convenience store, gas station, etc. the economics and the likely universe of buyers really dictate this approach.

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Just be prepared for this process and at least have your non-paid broker screen out the totally unqualified buyers.

For owners of B2B type businesses and larger businesses, your buyer will not be an individual, but rather a corporation or a private equity group. Let's focus here on the corporate buyer. If the potential buyer is under $50 - $100 million in revenue, the M&A contact is usually the president. If the company is larger, it usually will have the initial deal vetting completed by the head of strategy, business development or mergers and acquisitions. Those people are not visiting business for sale Web Sites or searching the business opportunities section of the newspaper.

The business owner's first reasonableness hurdle is whether he/she recognizes that to reach these corporate buyers is a very difficult and labor intensive process and a firm that specializes in reaching these targeted buyers is the right choice to hire. These professionals normally require either an up-front fee or a monthly fee in addition to the contingent success fee.

Well, you did it. You interviewed several firms, checked references, felt comfortable with their process and felt confident with them as you partner for the next 6-9 months. Your M&A firm takes you to the market and gets several companies interested. You arrange multiple conference calls and corporate visits and then the subject of value comes into focus. This is where deals usually break down. There is a natural valuation gap between buyer and seller and the challenge becomes how to bridge that gap with both valuation and deal structure. The seller's reasonableness will be put to the test as he tries to balance his emotions with the ultimate arbiter of value, the marketplace. But that is the subject of a future article.

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