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Size Matters

Why small good businesses are valued differently than their larger counterparts.

by Michael T. Newsome

News regarding the high cash price multiples garnered in today's markets for many middle-market businesses does not elude the ears of small-business owners. Nevertheless, for valid reasons, lucrative valuation metrics and all-cash prices are not necessarily applicable to many successful small businesses (< $10MM enterprise value). Understanding the factors influencing this differential may help to moderate expectations and avoid disappointment at the end of a sales process. More importantly, it may set the stage for some actions that could improve the outcome.

Our focus in this article is on small service, distribution, and manufacturing firms that compete in narrow niche markets. Specifically, these are situations where competition is somehow limited and the market is relatively mature. Nestled in these niches are very good little businesses that consistently earn attractive returns on invested capital. These niche businesses often operate under the radar of larger competitors. In this environment, financial success frequently can be credited

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The reasons why good businesses like these are valued differently than their larger counterparts are several: lack of market depth for buyers, limited access to capital markets, lack

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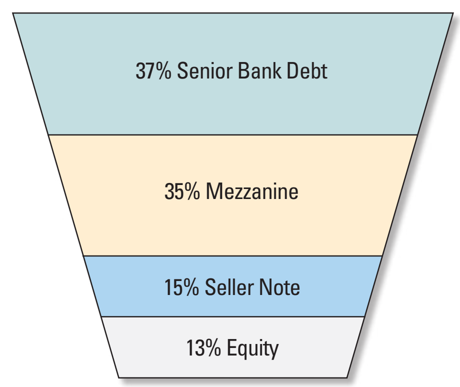
of growth opportunities, and management succession risk.

The sheer size of the business and its market can mean that it does not fit into any corporate entity's strategic vision. In other words, the lack of opportunity for growth does not warrant the acquisition effort. There is no perceived synergy.

At the same time, private equity investors, either as a buyer or as a financial supporter of management, find this type of business to be a challenge for several reasons:

- The owner is usually crucial to the success of the operation; and when that person is bought out, a replacement is necessary. That transition introduces risk to the buyer.
- The stable, but static, business leaves little opportunity to effect change that will increase value, either through growth or improved operations.
- The same transition issues are likely to exist when it comes time to exit from the business.

Since growth is not available to enhance the investment return, the only way to achieve an acceptable investment outcome is through financial leverage of a conservative acquisition price, which is difficult to achieve in the capital markets. The availability of borrowed money to support either a private equity or individual buyer is typically limited to the asset base that would serve as senior debt collateral and a thin market for small mezzanine financings. Business size matters to lenders because smaller firms are inherently more vulnerable to risks such as management turnover, competitive change, or economic cycles. Accordingly, financial leverage, if mezzanine lenders can be attracted, may not exceed 3x EBITDA. The end result is a valuation meaningfully below the premiums bandied about in the financial press. As an example, it would not be abnormal to see an acquisition price below 5x EBITDA having a capital structure as follows:



The owner of a small niche business can't change the market conditions in which the business operates, but can improve the outcome of a sale process by decreasing the risk to the buyer and all of the lenders, including the seller. Several actions can be taken to achieve these objectives:

- Groom replacement management. A succession plan that transitions day-to-day management to a competent team reduces risk

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from the perspective of buyers and lenders.

- Motivate managers to think like owners by permitting them to buy or earn (not be given)

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a piece of the equity. This spreads responsibility and represents a piece of the transaction financing that doesn't have to be raised by a financial buyer.

■ Develop borrowing relationships with lenders. Creating a history of borrowing money fosters lender confidence that management can succeed under leveraged conditions.

If these things have been accomplished, when the time comes to sell the business, several conditions will be different. The risk of management succession will have been eliminated and lenders will have confidence that the team can successfully operate the business with leverage. Whoever the prospective buyers, greater certainty in management and readily available debt can lead to a more competitive atmosphere, which can affect the purchase price and lessen the amount and risk of the seller financing. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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