The time to sell

The economy's hot, and buyers are flush with cash. Here's how to get a top price for your business.

By Justin Martin, FSB Magazine
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(FSB Magazine) -- First came the waiting. James Richmond and four colleagues had been sitting around for nearly two hours in a lawyer's office in Plano, Texas, hoping that the last, crucial step in the sale of their company, eServ, to Perot Systems would go through.

Then came elation: an e-mail confirming a wire transfer into eServ's account of $21 million, to be divvied among CEO Richmond, 39, and his fellow founders. They raced to the airport and boarded a Citation 500 jet chartered especially for the occasion.

PHOTO: MARKHAM JOHNSON

Jon Carder sold his business, Client Shop, for more than $10 million. Carder, here surfing in San Diego, says you have to be willing to walk away if the buyer changes terms at the last minute.

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Flying home to Peoria, Ill., Richmond and his team drank toasts and traded war stories, recalling all the months they had worked without pay while launching their engineering-outsourcing firm and how, more recently, they had worked around the clock to close the deal. Now the entrepreneurs could relax. As of Feb. 28, 2006, eServ - a six-year-old company with $25 million in annual revenues - had become part of the giant computer-services corporation Perot Systems. (Richmond and his partners stand to make even more than $21 million if eServ continues to perform.) "People think about selling their company every day. But we really did it," says Richmond. "We started this company on a shoestring, built it, sold it, and became millionaires."

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What Richmond and many entrepreneurs like him have discovered is that now is a particularly good time to sell a business. The economy is, by many measures, in its best shape since the dot-com bubble burst in 2001. Banks are aggressively lending money for all kinds of acquisitions. Increasingly, corporate America views the purchase of small firms as a shortcut to growth and innovation. As a result, a small-business feeding frenzy is in progress. According to FactSet Mergerstat, there were 8,115 small-company acquisitions (deals valued at $100 million or less) in 2005, almost a 20% increase from 2002.

Yet another consideration: A growing legion of Americans, many of them refugees from corporate life, are itching to run a small business, and they make up a huge pool of potential buyers. Two-thirds of working Americans, in an April 2006 poll by Yahoo Small Business and Harris Interactive, confessed to having an entrepreneurial yen.

Many boomers are especially drawn to the idea of entrepreneurship as a kind of modified retirement; 55% of survey respondents select "own my own business" as a great way to spend their golden years. "There are so many reasons now is a great time to sell," says Alan Scharfstein, CEO of DAK Group (dakgroup.com), a Rochelle Park, N.J., investment bank that specializes in mergers and acquisitions. "When you add in private-equity firms flush with cash and a growing foreign appetite for U.S. small businesses, it's almost the perfect storm."

Perfect storms, however, eventually peter out. So while you're busy deliberating whether to sell your business, note that a growing number of economists now believe that rising interest rates and higher inflation will put the brakes on the U.S. economy. If that happens, getting a great price for your business will become harder and take longer. Not only that - a new study by Ernst & Young (ey.com) and Dow Jones (dowjones.com) warns of a huge backlog of private companies that venture capitalists funded during the boom years of 2000 and 2001 and which will soon be ready to sell. You might do well to unload your business before this onslaught hits.

While the timing today may be ideal, nothing about selling a business is ever easy. There's simply too much at stake. After all, a sale is usually a one-time opportunity for an entrepreneur to turn years of toil into a big payday. It often takes an emotional toll too, as owners get caught between not wanting to unload the business they worked so hard to build, and getting the best price in the shortest time.

(**What's your business worth - really?**)

To keep a deal alive, a small-business owner frequently finds himself catering to the buyer's every whim. "First there's the challenge of finding the right buyer," says Kevin Mulvaney, a professor in the entrepreneurship program at Babson College in Wellesley, Mass. "Then there are all the frustrations of constant negotiations and constant information flow. It can be really overwhelming." Those who have successfully sold their businesses have taken a systematic approach, planning the sale far in advance, getting their books in order, stirring up multiple bidders, and operating their business full bore until the day it was sold.

Not surprisingly, a very common scenario is that things go dreadfully wrong. There are no reliable statistics on botched deals involving small companies, because such transactions often involve businesses that are private. But according to Mulvaney, who also works as a consultant to sellers, 50% to 75% of those arrangements fall through.

Typically, an acquiring company is larger than the acquiree, often far larger, and that creates a serious mismatch. Big companies can drag out a transaction. Why? Because it's often to their advantage. They have lawyers and resources and time to spare, and where entrepreneurs are used to eye-blink decision-making, large companies tend to parse every choice endlessly. It's not unusual for a small company's results to slide south during this drawn-out process. A buyer can then use that as a pretext to negotiate a lower price.

Large companies sometimes have been unscrupulous, employing nasty tricks that allow them to drive down the purchase price. Meanwhile, the sellers of small businesses can aggravate matters by making mistakes of their own. "This is a very difficult dance. Entrepreneurs have to really look for ways to take charge," says Patrick Thean, president of Leadline, a Charlotte consulting firm (leadline.com) that helps small businesses through the selling process.

Staging a business for sale

Before putting your business on the market, experts strongly recommend that you spruce it up, much as you would a house before selling it. That's just what Charles Carroll, 50, did before selling his company, Integrated Biometric Technology (IBT), late last year. This Nashville startup scans job applicants' fingerprints and e-mails the images to the FBI. The service makes it possible for a company to do a criminal background check in a matter of minutes. Snail mail takes a minimum of several weeks. IBT had around $26 million in revenues in 2005, up 260% from 2004, and was "extremely profitable," according to Carroll. He sold to Viisage Technology, a Billerica, Mass., outfit that specializes in identity verification.

The third time around, Carroll hit the big time. The former police officer had started two previous businesses. His first company did special investigations on behalf of employers, gathering information on workers suspected of stealing, or using drugs. He sold the company in 1989 for what he feels was less than it was worth. Carroll still owns his second startup, which also performs investigations. With IBT, however, he started planning its sale a full two years before he put it on the block.

Carroll says that one of the most useful things he did was to switch from reviewed financial results to audited results, a far more stringent method of accounting. Of course, it cost more: $35,000 a year, vs. $10,000. Carroll also made some key hires in IBT's finance department. He knew from hard experience that buyers want a target company to have polished and reliable bookkeeping in place. He also gathered together various agreements with customers, vendors, and key employees and made certain they were transferable to a new owner. After all, who wants to buy a business if it's unclear whether certain pieces are included in the deal? "This time I looked at my company the way a buyer would look at it," he says. "I identified various weaknesses and made sure I had everything in order long before putting the company up for sale."

Getting the right price

While Carroll planned the sale of his business, he didn't set a target price ahead of time. That may seem counterintuitive. But being wed to a price can be a mistake. Too often such calculations have little to do with the value of the business and everything to do with how much an entrepreneur thinks he needs to retire in luxury. Or the target might be to beat what a friend or competitor reaped from a recent sale. "These are terrible numbers to hang your hat on," says Dolliver Frederick, a Newport Beach, Calif., business broker (frederickcapital.com). "The true valuation of a business is based on how much someone will pay for it. You can have a ballpark figure in mind. But then you have to allow the marketplace to work ."To calculate the estimated worth of your business, click here.

The game is to drum up multiple bidders. This is a proven technique: Animals use it to get the most desirable mates; auctioneers use it to drive the price of abstract expressionist paintings into the ether. Besides driving up the price, multiple bids provide an entrepreneur with options. Scratch the surface, and a $5 million deal laden with all kinds of deferred-payment clauses may be less attractive than a more straightforward $3 million pact.

Cash is king. But you probably won't get all cash, because most buyers want to make sure that some of the payout is tied to the future performance of your company. If possible, you want to avoid deals that are too heavy on variable payments. Getting paid in private-company paper can be especially risky. When Carroll sold his first company, he received 100,000 shares of stock in the buyer's private company. Those shares were valued at $300,000, representing 40% of Carroll's proceeds. But when the acquiring company faltered, Carroll was able to get only $25,000 for his shares.

To sell IBT, Carroll retained an investment bank that specializes in the sale of smaller companies. (For more on M&A firms, click here) The fee was $50,000 upfront to prepare his business for sale, plus 10% of the deal price. The bank contacted dozens of potential suitors, and the list was gradually winnowed to three serious prospects. Because the bank had drummed up multiple bidders, the offer came in surprisingly high, with Viisage at the top. Carroll and a business partner will split $35 million in cash, $25 million in Viisage stock, and an earn-out that could be worth another $10 million if IBT hits certain performance hurdles. The pair agreed to stay on with Viisage for a year.

Doing the homework

Once a deal gets moving, the wild ride really begins. Ask entrepreneurs who have been through the process, and two little words - "due diligence" - will send them down a painful memory lane. Buyers, especially big buyers with flocks of lawyers, can be relentless. They ask to see leases, patent filings, agreements with vendors, bonus plans for executives - and they want to see them yesterday. It helps to have planned for a sale, as Carroll did, and to have critical documents in order. But nothing can really prepare a seller for the sheer volume and variety of requests.

Fred Bidwell is CEO of Malone Advertising, an Akron firm just bought by the marketing conglomerate JWT, formerly known as J. Walter Thompson. "I wasn't ready for how much time it would take," says Bidwell, 54. "Anybody thinking about doing this - whatever the expectation, it will probably require 50% more work and take 50% longer. It was like doing two full-time jobs."

Start to finish, the deal took six months. While he was unfailingly polite, dutifully responding to all requests, Bidwell also managed a canny move. He didn't allow due diligence to become a one-way street. Sometimes entrepreneurs are so grateful to be acquired that they forget that a deal has to work for both parties. As JWT was checking on his company, Bidwell checked on JWT just as thoroughly. He talked to clients that both firms shared, such as Pfizer, to find out about JWT's

culture. To get a sense of what to expect in the future, he also interviewed the owners of small firms recently acquired by JWT. More than anything, Bidwell wanted to make certain that Malone Advertising (with $20 million in revenues in 2005) could successfully meld with giant JWT. Malone was founded in the 1940s, and many of the firm's 200 employees have worked there for decades. He wanted to ensure their jobs would be safe. "I felt a moral obligation to make the right move," he says. "I'm glad we checked around. It increased our comfort level that this was a good deal. What we learned is that JWT understands the importance of not meddling too much with companies it buys - that it wouldn't force us to adapt to its methods."

Now for the cardinal rule of selling a business: Until the check is cashed, run your company as if the deal is going to fall through. This requires intense focus. With a big payday imminent, there's a natural tendency to let up. Say the deal really does collapse (it happens). Suddenly a business that was a hairsbreadth from fetching millions can find itself in survival mode.

While being courted by Perot Systems, eServ's James Richmond kept running his business as if no deal existed. That demanded superhuman compartmentalization powers, and it was exhausting, requiring Richmond - like Fred Bidwell of Malone Advertising - to basically work two jobs. It was not unusual for Richmond - who is married with two kids - to come home from eServ at 8, only to focus on details of the pending sale until 2 A.M.

"Walking into a room and having Warren Buffett write you a big fat check is a nice fantasy," says Richmond. "But the reality is that to make a deal work is a hell of a lot of work." While the deal was being negotiated, Richmond spent several hundred thousand dollars to upgrade his computer servers. Never mind that the new servers would become obsolete once eServ joined Perot Systems. Richmond was focused on the downside possibility. Should the deal unravel, he wanted to make sure that eServ could keep growing without a hitch.

There are some solid reasons, say experts, for an entrepreneur to stay with his company after a deal is done. After all, no one understands a company better than the one who built it from scratch, so staying on can help ease the transition. The entrepreneur can provide guidance if new management encounters problems. When earn-out provisions are involved, sticking around gives an entrepreneur some control over his financial fate. Richmond stands to make another $1 million if eServ (now a division of Perot Systems) hits certain performance goals.

But don't overstay your welcome. The experts warn that entrepreneurs usually should not hang around for more than a few years, tops. "There's a potential for serious culture clash," says Mike Docherty, the CEO of Venture2 (venture2.net), a Delray Beach, Fla., consulting firm that sets up strategic relationships between large and small companies. "A founder usually has a particular vision. A buyer may have a very different vision. Guess what? The buyer is the owner now. If you are butting heads repeatedly, time to move on."

A buyer's bag of tricks

A common mistake many sellers make is getting caught up in the romance of the deal. Take the case of the founder of a medical services company in Maryland, a physician who asked not to be named. His company employs 12 doctors, and his typical client is a medical practice looking to outsource some of its services. Launched in 1999, it had $6 million in revenues last year.

Recently the doctor sold a controlling stake (54%) to a private-equity firm. He liked the idea of pulling some cash out of the business but still remaining involved. While three bidders emerged, the equity firm's offer was markedly higher. An offer that's an outlier can be cause for suspicion. You have to wonder, Is this buyer willing to pay more or is it simply throwing out a funny number that it has no intention of honoring?

The equity firm flew the doctor to California. Over a fancy dinner he was wooed with visions of how rich he was about to become. One particular phrase, repeated by the buyers throughout the dinner, now sticks in his mind: "The second bite of the apple is what really matters." This was a reference to how golden the doctor would be if the firm decided to buy the remaining 44% of his medical firm at some later date. "It's the buyer's job to sell you a vision," says consultant Thean. "They're going to spin out a tale of how beautiful life is going to be. As an entrepreneur, you can't help but taste the wine. But be careful not to get drunk."

After all, the doctor had only agreed to sell 56% of his company. That deal had not even closed yet. Talk about the remaining 44%, while enticing, was also just that - talk.

When the deal closed last November, the doctor received a wire transfer for millions. He won't disclose the exact amount but allows that it is certainly enough to retire on in high style. And he is just 38. The doctor used some of the money to buy a new house. The rest he invested. Early this year the private-equity firm demanded he return roughly 75% of the money. It trotted out a laundry list of "true-ups" and "impairments." Its overarching claim: All kinds of things are wrong with the business that the doctor failed to reveal during due diligence. For example, the premiums on his company's malpractice insurance just went up. The doctor says he informed the private-equity firm about this and other material issues.

He had planned a house-warming party and a business-sale party, but instead he began to battle the private-equity firm, which now owns most of the business he still runs. As for that apple, he's wondering whether the second bite is what he's experiencing now. "It was a horrible setup," he recalls. "The deal was finalized. I'd been paid, and they were trying to get back as much as possible. To my mind, they're trying to steal the company from me." Ultimately the private-equity buyer decided to let him keep almost all of the first payment for his business. The doctor believes the buyers were trying to bluff him into dropping the sale price of his company.

Another situation to be wary of: overly long or restrictive exclusivity periods. During an exclusivity period, a buyer asks a seller to refrain from talking to other potential suitors. That's eminently reasonable once a term sheet has been signed and a deal is underway. But many buyers are only too happy to lock down a seller early in the process. Philadelphia entrepreneur Scott Testa sold his software maker to a large company he cannot name under the terms of a litigation settlement. The ill-starred deal happened roughly a decade ago, but the details remain relevant in today's supercharged environment.

Early on, the acquiring company asked Testa, now 40, to sign an exclusivity agreement. He complied, not wanting to do anything that might annoy a potential meal ticket. Now he was locked in, unable to drum up any other bidders. The agreement also included some rather draconian measures. For example, Testa was barred from talking to a long list of companies, some of which were potential customers. The given reason: Certain potential customers are also potential buyers.

The deal dragged on for 11 months. During that time Testa says that his ability to prospect for new customers was severely hampered by the agreement he'd signed. Not surprisingly, his company's results faltered. The buyer used that as a pretext to cut the price by 40%. "They knew exactly what they were doing," says Testa. "It was a conscious strategy. They got us against the wall and beat the hell out of us."

He adds wistfully: "I was young and dumb. In retrospect, my mistake was agreeing to those terms. If I'd stirred up a full-fledged auction, I would have had leverage and the outcome might have been different."

Some buyers are even more brazen. After all, if you are the bigger party in a deal, you don't have to rely on subtle tactics to run an entrepreneur down. Jon Carder, 28, is the CEO of Client Shop, a San Diego online matchmaker that connects consumers looking for loans with banks. He started the company in 2002 with $2,000, built it into a 60-person outfit with $8.5 million in revenues, then sold it this February. But his deal had an especially bumpy finish.

The day before closing, Carder was enjoying a casual lunch with executives of the acquiring company, Los Angeles-based Internet Brands. Suddenly CEO Bob Brisco dropped a bombshell. According to Carder, Brisco said the deal could close that day, but that his board insisted the price would need to drop by 50%. (Brisco and his company refused to discuss the deal with FSB.)

Carder was aghast. He tried to negotiate with Brisco. But the more he pressed, he says, the more resolute Brisco grew. Brisco was in control, with nothing to lose and 50% to gain. Compounding matters, Client Shop had let another serious bidder slip away. Having nowhere else to turn, Carder felt as if a sense of urgency was emanating from his body, like an aura.

He decided his best option was to disengage. He asked his CFO to continue the negotiation with the CFO of Internet Brands. Carder then walked down to the parking garage and sat in his black Hummer. Irony of ironies, his girlfriend had recently bought him an audiobook called Effective Negotiating, by Chester Karrass. He cued up the first CD and sat there listening. Periodically the CFO came out to the parking garage with a progress report. The two would huddle together and strategize on how to push the price back up.

Seven hours passed. By this time Carder had worked his way through the entire audiobook. He tried to start his car, but playing the CDs had killed his battery. He had to call a towing service to get a jump-start. However, the story has a happy ending: The CFO - with input from the car-bound Carder and an assist from Effective Negotiating - managed to talk Internet Brands back to 90% of the original price. "It's tough for us entrepreneurs," says Carder. "Unless you have millions in the bank, buyers can really have their way with you. Well, now I have some financial security. Next deal, I'll be able to take a harder line."

Carder can now afford to be a tough negotiator. But there are still options for the average cash-strapped entrepreneur. If a deal is headed south, suggest a licensing agreement or other strategic partnership. That can bring in some money and keep the relationship intact for a possible future sale. You might also simply walk away. Doing so in a calm and decisive fashion may even send the buyer running after you, waving those magic dollars.

Would you sell your business if you were offered more than a million for it? Or do you enjoy running your company too much to give it up? Tell us what you think.