

VIEWPOINT

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CREATING VALUE: PART II UNDERSTANDING RISK

By Elliot Williams, President

When potential buyers look at your company, they view the value of your business through the dual lenses of perceived opportunity and perceived risk. As discussed in the March Viewpoint, understanding the value-creation factors that make up the buyer mindset assists you in building value into your company. In essence, knowing what factors drive the decision making of potential buyers gives you a blueprint of how to build the most valuable company possible.

Last month, we talked about the perceived opportunity side—the factors about your company that make its future look bright. This month, we look at perceived risk—the factors that might cause potential buyers to worry that some dark clouds are on the horizon for your business.

WHY THIS MATTERS:

- Thoroughly understanding the risk factors buyers consider when acquiring a company helps you develop a roadmap for maximizing your business's value.
- Learning what risks potential buyers perceive in your company may turn up risks you're taking on every day in your business that you may have overlooked.
- Being thoroughly familiar with the factors that build value can help you understand which buyers are the best match for your business.

COMPONENTS OF PERCEIVED RISK

Entrepreneurs are risk takers by nature, so it is not uncommon for us to find that many of our sell-side clients tend to focus on the opportunity side of their business while ignoring or downplaying the risk side. In fact, you may be taking risks every day without even realizing it.

As shown on the right side of Exhibit 1, there are five broad areas where buyers can perceive potential risk: financial visibility, performance, operational excellence, barriers, and size. Let's look at each of these in depth.

Exhibit 1

FACTORS THAT AFFECT PERCEIVED OPPORTUNITY	FACTORS THAT AFFECT PERCEIVED RISK
SYNERGIES STRATEGY INNOVATION SCALABILITY MARKET CHARACTERISTICS	FINANCIAL VISIBILITY PERFORMANCE OPERATIONAL EXCELLENCE BARRIERS SIZE

- **Financial Visibility**

Buyers like to have visibility into future earnings and profits. They can pay more for a business when they have a high level of confidence in future earnings streams. Factors that help provide this confidence include having a revenue model that involves recurring, long-term contracts and having a business model that is "sticky" or differentiated. In other words, do you provide a mission-critical service or product to your customers? If so, this increases the likelihood that they will stick with you.

Revenue mix is another key component of financial visibility. Do you have a heavy concentration of your business with a particular customer or industry? Do a lot of sales come from one sales person (or key owners)? Answering yes to either of these questions may raise a red flag with a buyer; perhaps too many of your eggs are in one basket.

Buyers will inquire about your pipeline. What is your average sales cycle? This has implications on growth rates and necessary investments to generate new sales. How big is your backlog of orders? How big is the pipeline? Buyers feel more confident about companies that can provide a detailed pipeline analysis that covers all angles of potential future sales, including probability, timing, type, expected dollar amount and margin.

- **Performance**

History will repeat itself, or at least buyers believe it will. So they look at current and past financial performance to gauge likely future performance. Are revenues trending up or down or are they flat? Is your margin improving or weakening? How do you stack up versus your peers in terms of margin, growth and balance sheet stats? Are revenues with current customers growing or have they stalled out? How much will you have to invest in capital expenditures to generate future growth?

Nervous about providing such in-depth financial information to potential buyers? "Loosen up a little bit," is the advice of Robert Zurek, former vice president of Advanced Technology and Product Strategy for Ascential Software, a Westborough, MA, firm that was acquired by IBM in 2005. "When CEOs of private companies tell us 'We don't share our revenue numbers' they need to recognize that there are half a dozen other companies that will share

Naturally, any buyer is going to look very closely at your management team to determine its strengths and weaknesses and to decide whether team members have the potential to take the company further along its growth cycle. And they are going to look at key metrics that determine operational excellence.

their financial side of the business," said Zurek.

In addition, don't forget that you can't afford to take your eye off of your performance metrics at any time, especially when you're in the midst of negotiating the sale of your business. "Sometimes when sellers miss their numbers during the auction process, they're surprised by what a big deal that is to a buyer," said Jay

Jester, managing director at Audax Group, a Boston-based private equity firm. "They don't realize that these things flow through to the amount of the purchase price. The reality is that I can pay the price the seller wants because I can get good financing and I can get good financing because the seller's numbers are good. Sometimes people don't connect those dots."

- **Operational Excellence**

There are two sides to operational excellence: the way in which a business operates, including the quality of its management team, and the results it generates operationally (which, of course, ties back into financial results). Management teams that institutionalize best business processes and practices create value. Management teams that fail to do so create risk or at least perceived risk from buyers. This is true for several reasons. First, the future success of a business with strong systems and processes does not depend on a given person(s). Second, these systems become a leverage point for growth. When business processes are understood, documented and transferable, a company can grow more rapidly.

In addition, companies with strong operating systems are seen as being "cleaner," meaning they have less chance of unforeseen reporting or compliance problems. These systems create a "repeatable" experience internally that can be tested, measured and improved upon. They also ensure that a company is quicker to respond to market changes, which further decreases risk and increases opportunity. Finally, because information is easier to obtain in companies with operational excellence, buyers are impressed by response times on due diligence and perceive a much easier integration.

Naturally, any buyer is going to look very closely at your management team to determine its strengths and weaknesses and to decide whether team members have the potential to take the company further along its growth

cycle. And they are going to look at key metrics that determine operational excellence. These differ by industry and company type, so you need to understand the key operating metrics for your particular business and how your company stacks up competitively. To assure operational excellence and mitigate risk, put systems and best practices in place for every business function—sales, R&D, marketing, customer service, manufacturing, service delivery, training, compensation, career development, and so on.

- **Barriers**

Barriers come in many flavors and aren't always obvious to a potential buyer. Barriers can be absolute, such as regulatory barriers. Or they can be much more subtle, such as having an engineering team with very unique expertise.

In the latter case, while having a sensational engineering team in place can alleviate competitive pressures on sales

and margins, there are also risks that need to be mitigated to make a potential buyer feel safe. For example, do you have non-compete agreements in place so that if part of your engineering team walks out the door, they can't immediately walk in the door at a competitor?

Here are other things buyers look at when evaluating potential barriers: Do you have intellectual property that is proprietary or patented? Have you taken an inventory of your IP? If you have proprietary processes, do you have non-disclosure agreements with all employees?

Does your product or service involve high switching costs? In other words, does it cost a lot to move from your product to a competitor's in terms of financial outlay and/or other risk factors, such as potential downtime? If so, potential buyers may see this as a serious value driver that will minimize future downside pressure on sales. On

CASE STUDY: SIZE OPTAS, INC.

Here is an example of how focusing on opportunity, while minimizing the perceived risk of size, can result in a premium outcome. Last September, Mirus sold Optas, Inc., a provider of relationship marketing software and services targeting the pharmaceutical market, to Dendrite International, a publicly-traded provider of sales and marketing solutions to the pharmaceutical and life sciences industries. Optas generated approximately \$5 million in revenues, which, in our experience, is small when trying to attract very large industry acquirers due to reasons explained elsewhere in this article. Mirus offset this size issue and sold this company for a "multiple on revenues" valuation by focusing on opportunity and on areas of risk that Optas had mitigated.

HERE'S HOW THIS STRATEGY CAME TOGETHER:

Focus on the client's strong areas of perceived opportunity (See the March Viewpoint):

Market Characteristics – Mirus positioned Optas as a key component to providing marketing solutions in the rapidly changing pharmaceutical market. With marketing budgets moving away from mass market advertising and towards targeted, online, direct-to-consumer channels, Optas became a highly desirable asset for acquirers wanting to stay ahead of the trend towards relationship marketing.

Strategy – As I discussed in last month's Viewpoint, marketing your business' strategy and position to market analysts and key industry participants helps increase the value of your business. Optas' management team understood this and did a great job creating visibility with key industry players and industry experts like Forrester Research.

Innovation – Optas built innovative solutions that were tailored for pharmaceutical marketing and had a clear roadmap for additional functionality to continue their leadership position in the marketplace. Their solutions also guaranteed HIPAA compliance.

Focus on the client's areas of perceived risk that had been mitigated:

Operational Excellence – Optas has an incredibly strong management team with strong operational experience, unique domain expertise in marketing, proven experience building large businesses and a history of working within large enterprises. The strength of the management team helped acquirers see a path to future growth and profitability. Optas implemented "best practices" procedures for providing its services and solutions. These best practices gave acquirers a great degree of confidence in the company's ability to deliver consistent customer service.

Performance – Optas was growing rapidly and hit or surpassed financial objectives during the sale process. Acquirers experienced, first hand, the management team's ability to execute and hit its forecasts. Optas had also built a marquee customer base with significant growth with existing customers, which gave the buyer confidence that their customer base could grow given the right resources.

the other hand, if your businesses service or product has no switching costs, value could be lower given the ease at which customers can move and therefore drive down price and margin.

- **Size**

The size of your business has real bearing on its value. Big companies are worth more than smaller companies on a "multiples" basis. Buyers look at small businesses as riskier because any negative change in their business has a larger relative impact. Also, fewer economies of scale exist to impact the potential opportunity for synergy (discussed in the March Viewpoint).

Buying a smaller company is just as difficult and expensive as buying a larger one. When you allocate the cost and time spent to acquire them, larger companies make more sense. This lowers the number of potential buyers, which can ultimately lead to a lower price.

When evaluating size, buyers ask questions like these: Has this business grown to the point where management has proven an ability to build a very large business? Are there systems in place to adequately scale going forward? Often, smaller companies do not have scalable systems for growth, and therefore buyers must invest to solve this problem. Who are their customers? If you're primarily dealing with small to medium-sized customers, a large potential buyer might wonder how you'll cope if they try to take you into the Fortune 100 market they specialize in.

"The ability of a company to scale up is very important," said Zurek. "A buyer needs to make sure a company can respond to technical issues and to customer demands as it scales. If it's in a very specialized area, it might take six to nine months to recruit the right people to enable the company to scale. You have to focus on the people side besides the technology side and make sure you have a

retention program in place to keep people on board. And you have to communicate with these people to alleviate concerns when they begin to hear rumors of an acquisition. You don't want them to have their resumes out on the street when you're trying to convince a buyer that you have a solid team in place."

FIRST IMPRESSIONS COUNT

One significant risk factor doesn't fit neatly into any of these categories. It's the risk of not making a good first impression with potential buyers. "First impressions mean a lot," said Zurek. "If you've got that first meeting arranged by your investment bankers, put your best foot forward. Buyers are looking for people who have passion about their business. They want to see a fire in the belly. If you're excited about your business, that should be expressed.

"CEOs should have a profile of their company with key metrics in their hip pocket or be quickly able to assemble this when an inquiry comes in from a potential buyer," Zurek continued. "If someone says to me, 'I'm on the road next week' or are similarly unresponsive, that has an impact. Subtle assessments are going on all the time, and CEOs need to be aware of that right from the start."

Here's one final very important thing to understand about the perceived opportunity/perceived risk equation. When it comes down to setting a price, it's only natural that potential buyers will spend more time stressing the risk they will be taking by investing in your business. It, therefore, becomes the job of you and your investment banker to showcase the opportunity and to make it clear how minimal the risk is in comparison to the opportunity. In our July and August Viewpoints, we will discuss how to do just that with a two-part article on the keys to positioning your company for sale in a way that strongly highlights its full potential.

Elliot Williams is president of Mirus Capital Advisors, Inc. Mirus is a middle-market investment bank that specializes in advising companies in strategic mergers and acquisitions. By combining a proven process, industry and transactional expertise, creative thought, and personalized service, Mirus has completed hundreds of transactions for both public and private companies. Mirus is a registered broker-dealer and NASD/SIPC Member. For more information, visit www.merger.com.

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