FINANCIAL POST

FP ENTREPRENEUR

Avoid today's valuation black hole

Brad Cherniak | Feb 11, 2013 10:10 AM ET

More from Brad Cherniak

{University of Toronto} Falling into the valuation black hole in today's market can be confusing, unpredictable and costly.

Black holes are those fascinating and mysterious distant formations in our universe — big, dark and dangerous, and you shouldn't go near them. Which is exactly how owners of private companies looking to sell should view the valuation black hole in the market today. Falling into this black hole can be confusing, unpredictable and costly.

The world of private companies and mergers and acquisitions transactions can be broken down into the following value levels:

> **A** Companies considered "leaders" in their space, with strong historical and forecast sales and operating margins, and few to no perceived weaknesses.
>
> **B** Companies considered "good." They may have suffered a bit in the economic downturn post-2008, but their performance has rebounded and their outlook is good overall, with few critical weaknesses.
>
> **C** Those considered "average" companies. Their historical performance has its ups and downs, and their results may not have bounced back fully post-2008. They may have material, even critical, weaknesses, but are still relatively good companies overall.
>
> **D** Companies that are the turnarounds, or "challenged" and may be labouring under a flawed business model or weak balance sheet.

About now, you may be thinking, "this doesn't seem to be a big problem for me and my company. Sure we have our flaws, but overall, I would place us as a solid B. That would suggest there is significant buyer demand for my company. And valuations being volatile for B companies suggests upside as well as downside."

But the crux is whether the buyer universe rates your company the same as you do. In part due to the state of the global economy, the moneyholders are in a position of unprecedented power.

Interestingly, for A companies, the opposite is true. They often experience buyer feeding frenzies that can result in crazily high valuations. In a dangerous, volatile world, but with lots of capital to invest, there is no better place to put it than with the market leaders. Right? These tend to be larger companies, whether private or publicly listed.

But back to the more typical small to mid-sized business, and the valuation black hole. Risk-averse and generally stressed about everything, buyers are having a difficult time finding what they consider to be B companies.

To make matters worse, the criteria to distinguish between B and C companies is amorphous and subjective. Often, the same set of facts with the same buyer will result in a different assessment. That might be due to the smallest thing in discussions with the prospective buyer or in due diligence.

What it really means is buyers are looking for reasons to make you a C at the least provocation. This is self-serving, as the valuation of a B company can be twice that of a C, all else being equal. The result is a large number of B companies have been painted as Cs by prospective buyers, so while buyer demand for Bs is high, deal activity in this segment is low. At the C level, buyer interest and deal activity are both very low, although the segment is very large. This is the black hole.

Much of what you need to do to avoid the black hole is pretty traditional stuff, but it is surprising how many companies fail to check these boxes. It is also surprising how long it takes and how costly it is to do so if you leave it too late.

In a nutshell, they are:

— Clean up your balance sheet, don't force the buyer to do it. This can take time and involve some cost.

— Get rid of extraneous investments or lines of business that complicate the assessment of your company and its fundamentals — also time consuming and costly.

— Craft the message of the opportunity your company represents carefully. Don't just lay out the facts and hope the buyer gets the core message.

— Find ways to create the pattern of growth in sales and profit margins that buyers look for. Be ruthless and obsessive about it.

— Have a good process for identifying and approaching buyers.

— Assess your team and fix any holes now.

— Have several years of financial statements, ideally audited or reviewed.

— Tidy up your contracts and records. Be ready for buyer due diligence, don't scramble.

— Have a forecasting/budgeting process and show you can hit your targets and explain variances. This is a critical one for getting into the B category.

— Avoid being reactive to the buyer and being put on the defensive. Lead the agenda as much as you can.

Ensuring your company is a B can take years of preparation, so plan and act accordingly. The reward for doing so can be great.

Brad Cherniak has spent more than 20 years as a principal, advisor to and investor in private companies. He is co-founder and partner at Sapient Capital Partners, a Toronto-based advisory firm to companies from early stage to $50-million in revenues. His column appears monthly in the Financial Post. He can be reached at brad@sapientcap.com *and you can follow him on Twitter as @SapientCapital.*