Gulfstream Mergers & Acquisitions

solutions brief

WHY NET EARNINGS ARE MORE IMPORTANT THAN REVENUE IN M&A TRANSACTIONS

Business Challenge-

Business owners do not understand that buyers normally base valuation multiples on total net earnings not total sales revenue.

There is a famous joke about two business partners talking at the golf course.

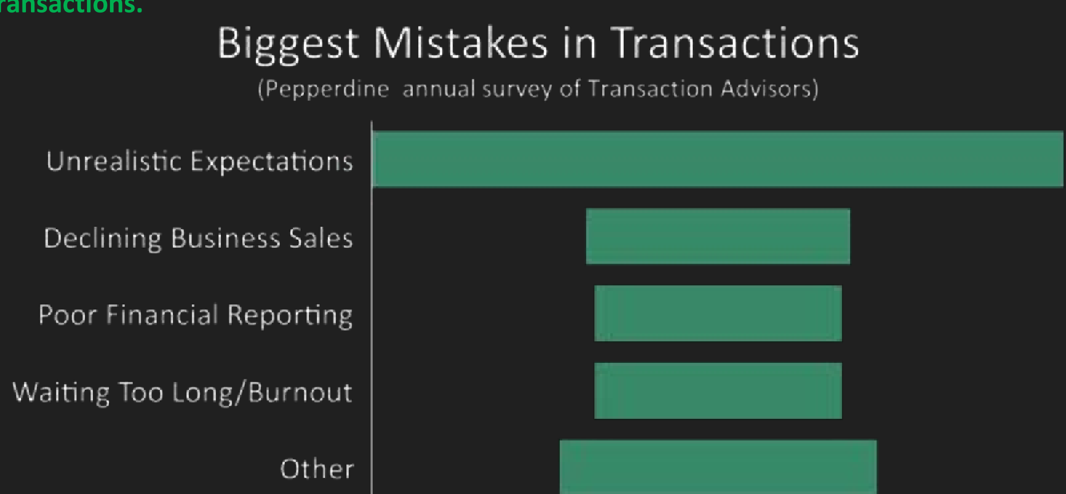
One owner turns to the other and says,
"Our business is doing great, our sales increase every month."

His friend turns to him and asks,
"How can we be doing great when we are losing money on each sale? "

The other replies,
"We make it up on volume!"

Sadly,many business owners apply this type of logic when trying to ascertain the value of their business. The 19th hole of golf course has been responsible for many misguided armchair valuations. Invariably some owner overhears someone who received a high multiple for their business, and they compute that multiple against their last year sales and determine they are rich.

Unfortunately, the rationale for this analysis is often fatally flawed due to the fact they are applying an incorrect basis for the multiple to be applied. They believe the multiple is based upon total revenue rather than net earnings. Naturally, this can result in a vastly different expectation of value.
This is dangerous because unrealistic price expectations by owners is the number one deal killers in M&A transactions.



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What this Means To Owners

There are many hazards to this type of miscalculation for the owner. It is human nature that once a price becomes anchored into your head (even if it was incorrectly calculated) , receiving anything less is perceived as a painful loss. This means they may turn down a favorable offer because they were unable to recognize it as a good deal.

As M&A advisors invariably it is the businesses with high margins not just high volume of sales that attract higher price points. Put yourself in the buyers' shoes. Most buying decisions are based on identifying and mitigating risk as well as predicting future cash flow. A company with large sales but showing minimum profits is actually a greater risk because they generally require more resources to operate and are most aversely affected by a sudden downturn in the market. Like the company in the joke more sales may just mean more money lost.

Exceptions

It is true that some businesses will peg a purchase based on a multiple of revenue. This particularly happens if a large publicly traded company or a company on the verge of seeking a buyout themselves are involved. For some publics they figure once the company integrated into their system the numbers will fall in line with their ratios not those of the selling company. Others maybe just looking to accumulate larger numbers before putting together their own selling package and they can benefit from aggregating. *But in both these case they are unlikely to apply the full multiples they intend to receive on revenue to the transaction*.

Some industries tend to pay on revenue more then others(think some early stage tech stocks) but often these deals will require a form of deal structure where the payout is not fully given at close such as an earnout or installment sale.

Most importantly even if the multiple is attributed to revenue that multiple will almost always be much smaller than the multiple paid for earnings. For example; a business receiving four to six times earnings may only receive .5 to 1 times the gross sales.

Actions

Find out from an M&A professional what the deal multiples are for your type of business. They have data and experience that can let you truly know which numbers you should follow.

Of course increased sales is often a worthy objective but not growth for growth sake. Why deploy excess resources and capital if you are not going to get the proper return? Focus on actions that will increase your net earnings. In some case you may actually be better served eliminating sections of your business and their corresponding revenue to increase your margins. Talk to your advisors on the best path forward.

Next Steps

Contact us to schedule a confidential no obligation meeting to discuss how we can design a program to perform your ideal exit or acquisition .

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