SELLING THE SHOP:

A COLLECTION OF THOUGHTS FROM THOSE WHO HAVE BOUGHT AND SOLD THEIR BUSINESSES.

NEW ENGLAND FOUNDRY TECHNOLOGIES

WILLIAM SHAMBLEY
President
New England Foundry Technologies

ARTICLE TAKEAWAYS:

- Getting your shop in order from accounting through marketing
- Exiting on your terms

One of the coolest examples of sustainability in American enterprise is the longevity of the family-owned business.

In the foundry industry, as with so many other industries, the lifespan of the business frequently mirrors the preparedness of the family ownership. In the rare occasion, a foundry can pass from one family to another through a sale of the business.

There are many methods of exiting a business. The worst for the economic community is an unplanned death in a business unprepared for sale. Less damaging but still generally unprofitable for the owner is a planned winding down and liquidation of assets. Working with legal and tax advisors, ownership of the business can be inherited, gifted, sold as shares to an individual or multiple family members. The business can also be sold to the employees through Employee Stock Ownership Programs (ESOP). The most straight forward exit, and potentially the best long term for the health of the company is a well-planned sale of the entity. This article will focus on this last case, with notes from buyers and sellers. The contributors have been kept anonymous.

Family-owned business, especially single owner-operator scale ventures, can be excellent wealth management solutions, with many tax saving benefits. As time passes, eventually the owner-operator wants to retire, or the family runs out of heirs apparent who want to keep working with the zeal required to run a successful business. Keeping an eye on the future, the owners should plan on running the business as cleanly as possible for two, but preferably three years. A new owner with the potential for acquiring the business is going to use a bank, and banks like strong financial statements.

To get the most value at the sale, you'll want monthly or quarterly statements for the balance sheet, income, and cash flow. A good CPA can make sure these are accurate. Other data can help increase the amount a buyer is willing to pay. A list of customers, (anonymous customer names are fine) with corresponding revenue, shows the "Customer Concentration" of your business. Actual customer names might not be revealed until closing.

One evaluation used during the due diligence process is the QOE, or Quality of Earnings report. The QOE reports digs deeper into the income statement, qualifying positive or negative income with information about the transaction history. This may include analyzing the last three years of revenue for the top ten customers. Buyers need to know if all the revenue come from one or two large accounts, or is it well distributed across several accounts. Are all the customers good for one or two transactions, or do they have long recurring revenue streams? Being able to show and explain a three-year revenue history will increase the value of your business to a buyer. While you're at it, take a hard look at your accounts receivables, and your customer list overall. Consider retiring customers

who are low margin or are constantly late with payments. Weeding the garden will help your appraisal value.

Operations like an advertising agency, technical consultancy, or legal firm where the owner is the business can be harder to valuate, but generally rely on the same strategies.

Putting the value on the business goes far beyond the old "1x revenue" or "3x profits" methodology for educated buyers. One metric used is the Seller's Discretionary Earnings (SDE), which is the "Seller's Value". The Seller's Value is the net income (EBITDA) of the business plus "add backs" such as operator's salary, frequently used assets that are in the name of the business but are not necessarily part of the sale. i.e., company cars, planes, season tickets, and other fringe benefits. These expenses are items that the buyer can forgo and reinvest if they choose.

The value paid may also be adjusted down to account for replacement salaries for team members that the buyer will have to hire. Owner Operators who are also the President/VP of Sales/GM/Maintenance manager may fully justify the amount that they take home at the end of the day – but a buyer will need to hire people to fill the current owner's shoes. These replacement salaries get deducted from the business value, since the buyer must hire staff for the business to succeed.

Hiring and training professional managers and team member to replace the owners is a valuable investment. These team members can ensure the future value of the company is uninterrupted after the owners exit. Taking the burden of finding and training critical staff off the buyer will increase the business value. Buyers will want to see what your team looks like as well. What percentage is about to retire, how much of the staff is well experienced and in their prime, and who's still wet behind the years. A buyer doesn't' want to see a thirty-year-old company with no employees having more than a couple year tenure. That's a sign that they may end up being owner-fork truck operators themselves.

Assets such as real estate, inventory, and supplementary (in-house) product lines can increase the value of the business – however be prepared for the fact that they may be handled as separate transactions. A buyer may want to hold them as separate entities or may want to split them out and only buy the business but not the facility, or the product line. Some buyers advise running the product line either as a discrete P&L center or as an independent entity to maximize the amount that they will pay for the total package. If you have good clean financial and environmental documents on a building, the buyer can make a clear decision on whether to buy the facility, lease it from the seller, or just move out completely – leaving the seller with a building to either rent out or sell to someone else. Disposing of twenty years' worth of unused patterns may let you lease out a warehouse or two in advance of selling the foundry.

Buyers, and their banks, frequently will look for the seller to hold some of the value of the sale as a personal note. While the seller may frequently want to cash out, and be done with it, loan payments, milestone based earnouts, and royalties can allow the buyer to pay a higher price and have some insurance that everything bought will continue to perform as promised. Promissory notes to the seller, like bank notes, need to be paid on a schedule or there are enforceable consequences.

Milestone based earnout payments are fraught with loopholes and can be risky for the seller. Legally enforcing such agreements can be challenging, or completely impossible depending on the terms of the agreement, and disingenuous buyers can walk away from a substantial portion of the purchase price without consequence. Sellers should use extreme caution in entering earnout agreements.

Royalty payments, or earnout payments based on future incomes, are a safer bet for the seller. Paying 5% of future income for 5 years, or similar terms, allows the buyer

Continued on next page

to defray upfront costs and can be good for both parties. Some buyers will use this kind of seller financing to be more flexible on the price.

Housekeeping measures elsewhere in the business will also help to increase the price a buyer will pay. Taking time to "5S" the facility, workflows, and company procedures not only increases the curb appeal when a buyer does a walk through, but the investment in organization will make it easier for a buyer to understand what he is buying and what future investments will be necessary. The five main principles of 5S are Sort, Set in order, Shine, Standardize, and Sustain. The goal of "5S'ing" is to eliminate the seven wastes of manufacturing (Overproduction, Inventory, Time/Waiting, Transportation, Processing, Motion, Defects). Also make sure that your processes are clear, concise, and have up-to-date documentation for all aspects of the business, not just manufacturing. Don't neglect maintenance, safety, HR, cost estimating, sales logs, marketing logs, etc.

From the moment a foundry owner decides to sell the entity, they should immediately start the 5S process, if they haven't already adopted it. Eliminating the clutter of old patterns, piles of WIP castings, mountains of waste sand and organizing the workflow in the foundry won't just increase the value to a seller, it will increase profitability and safety of the business while you still own it. Safety, in some circles, is the "6th S" - a safe clean operation will have a higher value than a sketchy apocalyptic building full of items of unknown origin or destination. Make sure that your safety plans and procedures are practiced, not just documented.

While you start cleaning up your production floor, don't forget about your digital presence. Just as you will clean up the floor, paint the front door, and ensure your BOMS are easily located, you need to make sure your web is current, mobile pages are responsive, and that your address is ranked well in the search engines. Ensure that there are no broken links, old photos, or pictures of employees that are no longer there. If your email administration is outsourced, ensure your IT department understands the DNS settings and email structure, and where the web is hosted along with domain credentials, as these will be passed onto the new buyer.

Once you've tackled the punch list, the big question is, what's it worth?

The simple valuation formula is:

Value = (SDE-Replacement Salaries)*Multiple + Inventory + Other Assets + Real Estate – Liabilities.

Multiples are highly subjective, and they are the subject of seller fantasies in all industries. High growth companies with a chance at IPO may have multiples of 10 or higher, but most healthy businesses will have a multiple between 1-3. Multiples are higher for businesses with predictable recurring revenue, increasing revenue, and those with solid long term customer contracts. Being good at using new technology in house, and being and industry leader, will also increase the value.

If you are planning to transition from owner-operator or family held business to a state where you can sell the business to another owner, you'll get the highest value by putting in some work upfront. Getting the financials in order is step one. Hiring and training a team to keep the business running after it is sold is a solid step two. Putting that team to work on the 5S process, eliminating waste and disorder to increase profitability and safety is a great step three. Take a hard look at the real estate and decide if it will be worth more to sell separately or lease to the buyer. Deal with all environmental hang-ups that may be lurking in the history. And if you're one of the many foundries who has an inhouse product catalog business, consider isolating that as a P&L or even incorporating that business separately. While you're at it, make sure that the online face of the company is adding value instead of detracting from it. Once you think you have your organization in good shape, it would be time to seek out a business broker that can help market and negotiate on your behalf. I suggest seeking a professional with experience specific to metal casting or heavy-duty manufacturing and can provide references.

Don't just show up dead to work one day only to leave your family and the industry hanging in the lurch. A business that nobody knows how to run or value, tons of WIP inventory without clear routing, and customers clamoring for castings and tooling is not an attractive inheritance. Who knows, once you've done all the prep, you might decide that you want to keep running the business for a while longer yourself!

The end game is to allow you to exit on your terms. Getting your house in order and keeping it that way is not only good for business – most importantly it will allow you to exit with the highest payout.

Contact:
WILL SHAMBLEY
will@nefoundrytech.com