Special Edition

MERGERS & ACQUISITIONS – Part 3

Last week, I discussed pricing variables for an asset based company. I discussed value challenges that asset based companies are facing in today's marketplace, and I discussed how to create additional value.

I also discussed, the risk involved when structuring an "earn out" overtime. This week, I want to focus on non-asset based transportation businesses. **Non-asset based businesses are normally classified as;**

- Third party logistics companies.
- Brokerage companies, and;
- Independent contractor companies.

The transportation industry, over the last several years, has been focusing on building non-asset based operating models;

- They believe, that they can create additional value and adjust to the marketplace quicker with less assets.
- Therefore, they're willing to review companies that offer opportunities to expand and cross sell their existing customer base.

What drives interest in a non-asset based business? – Opportunity! What creates interest for a buyer to pursue a non-asset based business? – Customers. Why are mid to large transportation companies focusing on logistics and brokerage opportunities? – **To diversify their transportation model.**

When dealing with a strategic buyer, they believe that success in the marketplace is increasingly linked to an organization's ability to manage and leverage its intellectual capital – the intangible and often invisible asset such as knowledge and confidence of people, **intellectual property and information systems that don't show up (directly) on the bottom line,** but are, in many instances, more valuable than financial assets.

A corporation is like a tree; there is a part that is visible; the fruit, and the part that is hidden – the roots. For a strategic buyer, he/she understands that if you concentrate only on the fruit and not on the roots, the tree will eventually die. **For a tree, or a company, to grow and continue to produce profits,** you have to make sure that the foundation is secure.

To concentrate only on the financial performance and ignore the hidden values, a company will not endure long term. Who are strategic buyers and how do you locate a strategic buyer?

A strategic buyer is normally a company that is looking to expand their business model and places emphasis on people, creativity and potential market growth;

- They usually have an existing customer base, but;

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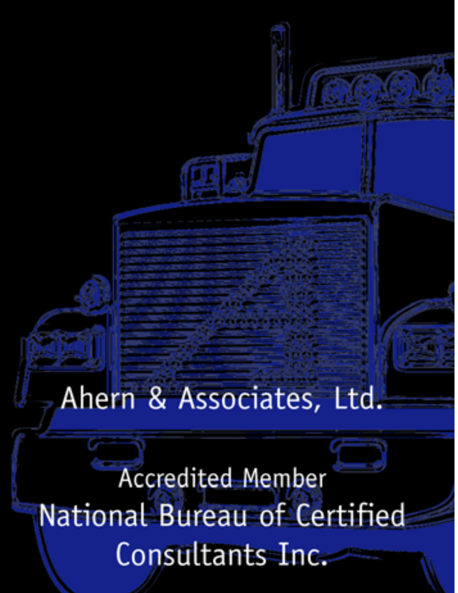

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- They need to secure the expertise to achieve the next phase of their growth.

- **They're looking for people/companies that can drive their business growth,** and;

- **They're looking to capitalize and cross sell their existing customers,** utilizing a 3PL, brokerage, or independent contractor component.

In essence, it's important to understand that for a non-asset based transportation business to receive maximum value, it must offer strong intellectual capital, knowledge, skill, and the capability to provide solutions to problems. Structural capital consists of everything that remains when all the employees go home. Data base file, software manuals, trademarks, organizational structures and so on.

To strategic buyers, intellectual capital is crucial to financial capital. As I discuss values, it's important to recognize that;

- If you don't have a "unique component to your business", or;

- You don't have strong "intellectual capital", then;

- You don't offer the opportunity that a strategic buyer is looking to obtain and the value of your business is worth less dollars.

If you are a 3PL or broker and do not offer a unique supply chain solution, your business is not as valuable as a company that is providing unique services. It's important to understand that the companies that have grown vertically and horizontally, such as CRST Logistics, C.R. England, Transplace, etc. leverage their people, customers, services, so they create the highest rate of return for their business.

The magic question; what price does one assign to creativity, service standards, alliances and unique computer systems? Obviously, traditional accounting methods don't reflect the work of such vital – yet intangible keys to sustained growth. **On the other hand, many companies that are in the market to sell their business don't have all the components,** that I've described that create the value that a strategic buyer desires.

Therefore, pricing values depend upon numerous variables. Let's make the following assumptions;

- **A small brokerage company,** whose revenues are between $3MM - $10MM of annual revenue.

- Historically, the company has generated gross profit margins of 18% - 20%.

- **The company's pre-tax profits** average 4% - 5% of earnings.

- **The company's pre-tax profits, for the first 6 months of 2009, are still trending at the same variables.**

- **This company will historically sell for 2 – 3 times average earnings, plus assets less debt, and/or;**

- **2 – 3 times EBITDA,** plus assets less debt.

It's important to understand that, in most instances, it will be an asset sale;

- If an owner wants to continue to be involved in the company going forward;

- There can be a separate negotiated contract, for employment and compensation going forward.

Let's assume that a seller is interested in assuming some risk. Let's also assume that a seller believes that by joining forces with a larger company, he/she can generate significant earnings and revenue, over the next 3 – 4 year period;

- In this scenario, a company may be valued as stated above, but;

- **There might be an additional "earn out" provision, based upon achieving specific goals and objectives.**

- Salary and compensation, going forward, is a separate negotiated item.

Approximately 7 or 8 years ago, I sold a brokerage company that was approximately $35MM to a public company;

- The owner wanted to stay for 5 years.

- **At that time, the seller received approximately 3 ½ times EBITDA,** but;

- **A deal was structured that, if he could achieve specific performance goals, he would receive additional value for his business when he retired.**

In other words, in order to create more value than the market was willing to pay, the seller needed to assume a certain amount of risk.

Let's assume that you're a larger company and provide supply chain solutions; let's also assume that the revenue is in the vicinity of $50MM - $250MM; what should you expect to receive? **Let's also assume;**

- Earnings are strong;

- Historically, they've been strong.

- **The company is providing supply chain movements for customers,** and;

- The company has a very strong infrastructure; you can expect to receive **3 – 4 times EBITDA, possibly 5, in today's market.**

Many times, when I speak to owners of businesses, they indicate that;

- They want 8 – 9 times EBITDA.

- **"I was offered 7 times EBITDA two years ago and I wasn't ready to sell",** and;

- "When the market changes and I can obtain 8 – 9 times EBITDA, I will be interested."

That market is gone! That market is not coming back! It's like the stock market;

- If you're willing to assume a certain amount of risk, you may receive a higher rate of return, ("down the road");

- When private equity entered the transportation sector, they had a lot of "free money".

- **They were willing to pay higher than industry average, because trucking was substantially less costly to get into than their traditional investments.** Those opportunities are gone.

- **There are very few private equity firms (today), that are still active in trucking; unless you are a strategically "special niche" company, the multiples that I provided are the maximum** that buyer's are willing to pay, in the current market;

In closing, I continue to receive comments stating that based upon my market analysis, "I'm better off waiting, a couple of years". My point; when somebody makes a statement like that, it tells me they're not prepared to sell or their expectations are not realistic.

The time to sell is when you're ready to sell and you're trying to accomplish something specifically;

- Whatever your goals and objectives are, they directly dictate when you go to the marketplace to sell.

- **For example, if you're in your 50's and 60's, and you want to protect your retirement account, sell now!**

However, if you're in your 30's and 40's and can't obtain growth, there are ways to structure a component of a sale, so that if you achieve specific goals, you can receive a higher "earn out". However, if you expect to wait 2 or 3 years and expect to achieve 2006 and 2007 values, it's not going to happen. **I wish it would, because those were years that were astounding years for my firm.** Those were times that were once in a lifetime opportunities.

When I spoke to sellers during that time period, I told to them;

- Sell!

- **Their company's would never provide better shareholder return,** and;

- They should take advantage of a unique market – many did not listen to me.

Today, I receive telephone calls from numerous sellers indicating "I wish I would have listened to your advice; boy what a fool I was".

In closing, in order to make a decision, you should;

- Review your 3 – 5 year business "plan";
- **Based upon that plan, make your decision!**
- If you're young and your business is growing and making substantial profits, you probably don't want to sell.
- **If you're young and your business is stagnant and your numbers are down, there is safety in numbers!**
- If you are older, you should protect your retirement account; the market will get worse before it gets better.

If you believe that you can obtain explosive growth, over the next several years, and you need additional capital, you should sell!

What you have to consider, as you're going through "your" process, is where is the market going to be in the next 18 – 24 months. Based upon your observations, make a decision that you will believe to be in the best interest of you and your family. **My personal and professional opinion is the economy is going to be struggle for at least 18 months, if not longer.**

Next week, I will discuss the process of selling your business, once you've made that important decision.

QUOTE OF THE WEEK:

"Anyone who has achieved excellence in any form, knows that it comes as a result of ceaseless concentration."