

Modify Business Plan to Defend Valuation



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It's Friday afternoon. You get a call from your largest customer who tells you that she's interested in talking to you about potentially acquiring your company. She asks whether you can put together a valuation for your company: If the number is in the right range, then she'd like to take the conversation further.



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Of course, you agree to get back to her with a number. Now what?

Use your business plan, modified, to defend your valuation. Think full disclosure! Interested investors will request a business plan as part of the due diligence

process and it should include supporting data to outline your case and the assumptions underlying your methodology to defend valuation. Now, more than ever, investors are looking closely at the specifics you include. Be prepared to have your company's plans thoroughly reviewed and withstand intensified analysis.

For the purposes of merging or being acquired your plan should include the following.

Strategic Value

Mergers and acquisitions are almost always driven by the perceived strategic value. Your objective in preparing the business plan is to understand and reflect the sources of strategic value that could accrue to the acquiring company. Structure your plan to highlight how that strategic value will be realized, and include sufficiently detailed analysis to support your assertions of how value is created.

Financial Valuation

• *Ratios and Competitive Benchmarks.* Price-to-Sales (P/S) and Price-to-Earnings (PE) ratios are most frequently used in setting a company's val-

uation, particularly for high growth companies. However, Discounted Cash Flow is the most traditional form of valuation methodology. Chances are that the acquiring company will look at all three methods. You should also be aware that valuation methods will vary by industry sector. Understand which ratios analysts use to value companies in your industry and use those as your valuation method. Identify at least two to three public companies that are similar to your company in your industry or sector or both, and use them as a basis for comparison and for purposes of forecasting.

If information is available on private company transactions in your sector, incorporate these also, or at the very least, know what they are. If your company is private, an acquirer is most likely to give your valuation a "private company" discount. This will be at least 20 percent and will often run much higher, depending on how accessible the public markets may be to your company. Many investment banks and venture capital firms have access to private databases with this type of information.

• *Revenue Forecasting.* Consider both direct and indirect revenue. Direct revenue is based on sales of your company's products. Indirect revenue is an estimation of sales of the acquirer's products driven by sales of your company's products. Focus on recurring revenue as the basis of your forecast; a revenue forecast based on selling new/additional product to your existing customer base has less risk than revenue streams that are dependent on gaining new customers. Itemize separately the revenue that will be generated from existing clients and the revenue to be earned from new clients. Consider and include several scenarios, and state the assumptions behind your forecast.

• *Forecasting Cost Savings and Earnings.* Value may be created through cost savings that may come from eliminating redundant staff and facil-

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ities, avoiding the need for future R&D, or efficiencies in operations. Estimate what the proforma operations might look like with specific reference to savings on both sides.

Intellectual Property

A key asset of your company is the intellectual property that you have developed and owned or have licensed from other parties. Your plan should identify any trademarks, copyrights or patents held by your company. Information such as man-hours of research and development is very useful information and may place significant value on your IP even if you don't have patents.

If your company has developed intellectual property for which a patent disclosure could be filed, but has not yet, make note of that asset and how much time remains in the window for filing a technology disclosure/patent application. Also, be sure to put your IP in the context of barriers to entry: How easy or hard would it be for another company to duplicate your effort.

If you have licensed technology to or from other firms, itemize any contractual terms that may limit or enhance the value of the technology: exclusivity, non-competes, right to create/license back derivative works, maintenance requirements. In forming new vendor relationships or alliances, you need to put controls in place to ensure that the contractual terms of these relationships do not impede future mergers or acquisitions.

Key Management and Employees

Based on your understanding of the strategic value of your company to the potential acquirer, identify the key management and technical personnel who need to be retained in order for the deal to have merit. Include a brief biography of each, highlighting their unique qualifications and company responsibilities. It may be true that an acquirer is only interested in your company's customers or products, and does not care to retain any of the current management.

You need to assess whether the deal is interesting to you in light of the acquirer's intent. If you have management incentives that take effect in the event of a merger or acquisition, these should be described in the business plan.

If the acquirer is interested in retaining key management and personnel, compensation and

incentives should be considered prior to a transaction closing. No matter how good a transaction looks on paper, if the right people are not incentivized, it won't work.

Customers and Market

Your customer list is a critical element in the valuation of your business. Describe how your customer list creates value for a potential acquirer. Does it increase their market share? Provide the basis for entering a new market segment? Identify any trends in your customers' industries that might be relevant. For example, if their industry is experiencing high growth or consolidation, this trend will impact the size of the market opportunity.

Product

Include in the plan brief jargon-free descriptions of your product line and highlight the customer value. For products that are still in development, clearly state the stage of development: concept/design, development, alpha, beta or final test. If you have had early customer feedback on these products, you will want to reflect the results of your alpha or beta program. Even if your potential partner is familiar with the competitive market, you should describe your company and products' competitive positioning, particularly in terms of price, breadth of product line, and barriers to entry and other unique differentiators.

A company's business plan is a key document in creating a productive relationship with a potential partner or acquirer. Your business plan needs to be carefully constructed to sell the strengths of the relationship and accurately reflect the details of how your business operates. Strategic value, financial value, customers and market, key management, intellectual property and products are all elements of your business that your plan will need to address.

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