CHAPTER 1

What Buyers Are Looking For

Buyers purchase information technology (IT) businesses for many reasons. Naturally, the central rationale behind every purchase is the buyer's belief that the business will generate value in the future greater than the purchase price.

Strategic Motivations for Potential Buyers

The best way to understand what your business looks like to a potential purchaser is to put yourself in his or her shoes, and in Chapter 3 we look in some detail at the different types of buyers and what motivates each of them. For now, let's take a general look at why someone might want to buy your IT business.

It may satisfy a strategic need. For example, acquiring your business may enable the buyer to operate with greater economies of scale. A buyer may also believe that your business would have good synergy with his or hers. For example, the acquirer may want to expand offerings to existing customers, and your business may provide a solution—a product, a service, or both. Solutions can take a variety of forms. Your offerings may enable the purchaser to conduct business more efficiently and/or attract more customers; your sales force, products, or services may attract more customers for the new entity. Or the acquirer may feel that the market is heading in a particular direction and your business will help achieve desired goals.

A buyer might also want to acquire your business to eliminate a competitor. (With the acquisition of one business by another, however, care should be taken that antitrust laws are not violated; the Hart-Scott-Rodino filing is one way the government, through the Federal Trade Commission and the Department of Justice, monitors acquisitions.) Purchasing a competitor does not necessarily ensure that the buyer will retain all of your customers. Some may have chosen you because they did not want to do business with your competitor. Not all acquisitions are positive. Some can be nonsynergistic, as expenses can mushroom, customers can defect, and revenue growth does not meet expectations. Furthermore, while some of the most likely potential buyers of your business are your competitors, discussions with them are potentially dangerous quite apart from antitrust concerns, since the exchange of information can result in the disclosure of confidential data.

Your business may be attractive to someone merely so they can prevent competitors from purchasing you.

As a result, you always need to analyze who will be helped the most if they purchase you and who will be hurt the most if they do not purchase you.

Your business also may offer a buyer extended geographical, market segment, or overall business expansion, and purchasing it may allow the acquirer to establish itself in a new territory or market altogether. It is true that as telephone and Internet bandwidth technology continues to improve and spread, physical distance is much less of a barrier for many kinds of businesses, but geographical and market reach still remain an important motivator in many purchase decisions.

Personal Motivations of Potential Buyers

Geography may also play a role in a buyer's personal interest in that he or she may want to live where your business operates. Your location may offer a pleasant environment, good schools, better climate, proximity to family and friends—any of a large number of compelling lifestyle or similar factors.

It could be that your company operates in a business area that interests the buyer. Perhaps the potential buyer is already involved in a related area and is looking to expand. Rather than developing an entirely new business unit or line, a businessperson will often opt to purchase a successful firm and merge it with existing operations.

During boom times, when it is difficult to attract and retain individuals with required skills, the acquisition of an IT business that already employs such people may be the compelling reason. Such acquisitions, however, do not occur only during times of talent shortages. They can also take place when a business wants to enter a market quickly, as this is more important than ever, and acquiring market share (with resulting economies of scale) continues to be a strong motivating factor.

Business Attributes That Are Attractive to Potential Buyers

Regardless of the attractiveness of your business and personal motives of the purchaser, the potential purchaser will be seeking some level of business security. Buyers want assurance that your business either is stable and likely to remain so after the sale or is projected to grow and evolve into a profitable enterprise. For many if not most buyers, this translates into concern about financial performance. Some may be wondering whether the new business will perform with the desired synergy. Still others will focus their attention on the status of product development schedules. This is where the particular strengths of your business enter into the decision.

Security for the potential buyer may come in many forms—from products that work well and strong customer relationships to a predictable cash flow and a well-trained staff. Some of the key characteristics of an IT business that entice buyers are:

- A strong management team and skilled employee base who will remain in place after the sale
- Reasonably predictable financial performance, including cash flow and profits
- A diversified customer base
- Superior in-house systems, technology, and processes
- Sought after offerings—services and products
- Strong relationships with customers, lenders, and suppliers

- Respected market presence
- Perpetual focus on research and development
- Ethics

A Strong Management Team and Skilled Employee Base, Who Will Remain in the Business after the Sale

It may seem counterintuitive, but in many (perhaps most) cases, the most important asset of any IT company is its people. If a company loses its key people, the value of the business will decline. Employees are important to a business in various ways, supplying skills and commitment and working from an established relationship with the organization. Ultimately, most IT businesses are purchased for their ability to execute, and that is largely a function of their human capital. Depth of management talent is vital to the value of any business, particularly IT businesses, and because some turnover is likely after the purchase, most buyers view current management as an important component of a sound business.

It is vital for every company to have stable and well-documented relationships with its employees. For instance, reasonable noncompete, nondiversion, and confidentiality agreements with key employees and consultants will increase the value of a business. More generally, a history of low turnover, especially in the short term, is another indication that the company has good relationships with its staff.

Although there are exceptions, most people today do not spend, and do not expect to spend, their entire career at one company. Some of the drivers behind this trend include the increasing propensity of businesses to size their workforce as conditions dictate and a growing belief by many that changing jobs typically produces individual improvement and monetary rewards. Therefore, it is important to develop individuals in every organization who can assume the roles of others. Knowledge, know-how, experience, and expertise cannot be obtained or transferred quickly; staffs need time to develop, and a management team needs time to coalesce. To the extent that the members of the management team have confidence in one another (and are well-managed from above), each person can focus attention both on what he or she does best and on what is best for the company, and no one will be wasting time on redundant tasks.

It is essential that the buyer of an IT business attempt to induce your key employees to remain with the business after the sale. The more you as seller can assist in this goal, the better the chances of the sale being a success. As soon as is feasible, you might want to attempt to discuss staff inducements with the buyer: equity sharing, increased compensation, bonuses for the employees who remain, expanded responsibility, more autonomy, increased funding for projects, or a commitment to support the existing business culture. Much of your efforts in this regard will be in the form of increased dialogue with the existing employees to allay their fears of the unknown. The employees know and have a relationship with you, and initially they will have more confidence in you than in the buyer.

However, this cultivation of staff has to be balanced with the seller's need to keep the proposed sale confidential until consummated. For this reason, discussions with certain employees frequently do not occur until just before or just after the sale.

Also as soon as is feasible, the potential buyer should speak directly with your key employees to determine their future plans. Therein lies the dilemma. To the extent the potential buyer conducts due diligence, he or she may become more comfortable with the decision to acquire your company; in many cases your employees will be very impressive and enthusiastic about "their" company, and their feelings probably will be contagious and serve to increase the buyer's desire. However, with each additional person informed about the intended acquisition, the possibility rises that confidences will be broken and rumor-fed uncertainty about the business's future will spread. One of your goals during this period should be to continually monitor and allay your employees' fears.

There is no single guideline for how long it takes to develop a good management team and employee base. However, an astute buyer will attempt to gauge the quality of yours quickly.

Reasonably Predictable Financial Performance

Steady growth in revenues and earnings is a persuasive indicator of the vibrant health of a business. Although some of the hottest initial public offerings during the recent bubble involved companies with no revenues or earnings, today most must show a history of continued growth in bottom-line earnings and top-line revenues to be attractive. By doing this, companies demonstrate that recent successes are not aberrations and that future growth is likely.

It is important to realize, however, that although traditional financial analysis looks for steady growth in revenues, unit sales, gross profits and earnings, these criteria do not always strictly pertain to closely held information technology businesses. These businesses often experience development cycles followed by sales cycles that can each last for several months, often totaling more than one fiscal year. At the beginning of the development phase, and even more so as that portion of the cycle continues, sales typically lag, since clients are hesitant to purchase technology that will soon need updating. And when a new product is finally announced, there is a lag before sales are concluded and revenues are received, causing further drain on company finances. For these reasons, a 12-month profit and loss statement often cannot fully portray an IT business's health and viability. Although not generally accepted, an 18- or 24-month statement may well portray the business's position and operating cycles with more accuracy.

Regular cash flow and profits offer tremendous reassurance to a potential buyer. Profitable long-term contracts for software, hardware, and services, as well as maintenance contracts, are the best way to demonstrate value, because these revenue streams are predictable and will reduce the buyer's concerns about risk.

Prudent businesspeople want to reduce their risk whenever practical. To the extent that your business maintains a predictable cash flow and profits as a result of long-term contracts and recurring business, a potential buyer's concern is allayed, increasing your business's potential purchase price.

Well-Diversified Customer Base

A company with a broad customer base will be more attractive to a potential purchaser. If a significant percentage of your revenues and/or profits is derived from a small number of customers, no matter how impressive or steady their purchases have been, many potential buyers will be wary, because if those few customers were to disappear for some reason, or to reduce their purchases, the impact on the company would be serious. Having a well-diversified customer base is good insurance.

If your business has been able to diversify its customer base across sectors, industries, and geographic regions, its vulnerability to adverse consequences affecting a particular customer or group of customers is greatly reduced. (Interestingly, the attempt to diversify may create an inherent conflict for some IT businesses, as they frequently grow and prosper by capitalizing on expertise in a particular niche, albeit a narrow one.)

Superior In-House Systems, Technology, and Processes

One of the greatest competitive advantages your company can have is superior in-house systems, technology, and processes. They indicate that your business understands its operating environment and is focused on improving overall service levels, revenue growth, and profitability. In addition, superior in-house systems, technology and processes allow a business to operate with less need for human interaction, making it less subject to error, labor shortages, absenteeism, and other personnel problems. Superior in-house systems, technology, and processes enable a business to continually and effectively plan for the future, mine its data more effectively, offer superior customer and supplier services, and respond quickly to new opportunities. All of these attributes encourage repeat business from existing customers, making your firm more attractive and salable.

Sought After Offerings—Services and Products

Sought after offerings—services and products can offer assurance to buyers of your company's continued success. Although this fact is not always explicitly stated, when customers purchase a given IT solution, they are entering into a long-term relationship. Implicit in this relationship is the understanding that it is to their benefit for you to prosper, as growth positions your business to provide them with innovations to improve their own businesses. Moreover, customers expect your business to be available in the future to provide ongoing service, whether it is support, software fixes, repairs, updates, maintenance, and consulting or "professional services." Interestingly, it is often an IT company's latest products or services, fine-tuned and improved through ongoing iterations, that initially attract a potential buyer. Future relations aside, if your company can supply something that your competitors cannot, a potential buyer will have greater confidence in his or her future ability to meet customer expectations. Market presence and leadership—real and perceived—are of paramount importance.

Strong Relationships with Customers, Lenders, and Suppliers

Just as good relationships with managers and other employees are important, so are strong ties to customers, lenders, and suppliers. High customer-satisfaction ratings, as well as low customer turnover, are signals to a prospective buyer that your business is healthy and should continue to thrive. These traits allow a buyer to predict future demand more easily. A good relationship with a lender also has many positive ramifications. It indicates that a third party who is knowledgeable about the business is satisfied with its creditworthiness and that the business will be able to borrow funds to achieve its objectives. Finally, a business that has developed strong partnerships with suppliers typically can achieve good credit terms, minimal inventory-carrying costs, and lower overall cost of goods and operating expenses. All of these relationships improve a business's efficiency and profitability.

Respected Market Presence

An IT business with a well-respected presence and visibility in its market will be more attractive to a buyer than one with little recognition. If a buyer wants to enter a market, his or her first choice typically will be to acquire a business with strong market visibility, good brands, and a loyal customer base. All of these traits increase the chances that existing customers will continue to buy. In addition, businesses with the highest name recognition—market leaders—typically will be the first ones any buyer will consider purchasing in a particular sector or market space.

Predictable Cash Flow and Profits

Perpetual Focus on Research and Development

Because the IT world is in a constant state of evolution, it is of paramount importance that your business strives continually to improve its offerings and satisfy market and technological demands. Every solid business leverages its market knowledge to maintain competitive advantage. A business with a history and continued future likelihood of introducing new solutions, products, and services that meet the needs of the market will naturally be far more valuable than one that does not.

Of course, your business has its own strengths and unique characteristics, so it is not necessary for every factor listed to exist for your business to be desirable and seen as such. In fact, sometimes only one of these factors will make it attractive to buyers. However, the stronger your business appears—meaning the more of these factors exist—the greater the price it will command.

Ethics: A Key to Success

All businesses should be operated ethically. This high, but required, standard is of continual and paramount importance throughout a business's existence and assumes greater importance when a business is being sold. The purchaser will attempt to verify the accuracy of the representations and statements made by the seller. A buyer must have confidence in the business that is being purchased. Moreover, ethically run businesses generally have fewer issues that will cause concern to the purchaser and delay the transaction. As the purchaser's level of comfort rises, the level of perceived risk declines, which results in a higher sale price for the business. There is a very high correlation between the businesses that succeed and the ones that are operated ethically.