Suits you sir!

When on the acquisition trail, play to your strengths and identifying a business that suits you. **David Parker** explains

Whether the item for sale is a car, a set of golf-clubs or a pharmacy, in order for any transaction to take place it is a fundamental requirement that a buyer perceives greater value in the item than does the seller. Although this "value-gap" may seem an obvious principle, it is one often lost on prospective sellers, the classic example being the advertisement in the local classified rag reading "Pentium II computer for sale, cost £700 will sell for £450." Simply mouthwatering!

I come across similar, albeit less extreme, examples in the business sales world, where a business owner will call and immediately break into a 15 minute soliloquy on the exceptional merits of his of her business, followed by the question, "How much will it sell for?"

My answer is always the same: "Although I can, and will, give you a good feel for the potential value at sale, the actual value will depend entirely on what a buyer thinks they can achieve with the business, given its, theirs and the markets circumstances at that time."

Unfortunately, on some occasions, all the caller wants to hear is "three and half times turnover" and any degree of objectivity simply brings the conversation to an abrupt conclusion which, in reality, is kinder on both of us.

For serious buyers and sellers, however, the principle of understanding what drives business values and the potential value gap can only help both parties achieve a better result. With that in mind, both buyer and seller (or their agent) should be seeking out a match that maximises this gap in their perceived values.

Unfortunately, things are often not so simple; as you are rarely bidding for a pharmacy in isolation and, as such, the value gap is a relative one. It is, therefore, important that a buyer recognises not only what they can do with the business, but also what competing buyers can do.

In general terms, the value of any business is driven by future profit. Therefore, if you can extract more profit from a business in the future than anybody else, then that is the business that is most suited to you. By breaking profitability into its constituent parts, a relatively obvious market divide opens up between businesses suited to large groups and those suited to independent buyers.

For reasons that will become obvious, I shall not address the lines of a profit and loss assessment in their traditional order.

Gross margin

Future gross profit is a major driver of value, given that 1 per cent uplift in gross profit can equate to 10 per cent increase in business value. The simple formula on gross profit is: the bigger you are, the better you buy. However well you think you negotiate — and, believe me, a clever supplier will make you feel as if you have taken the shirt from his back — a small or medium independent will get nowhere close to the terms and margins achieved by the large multiples.

Interest costs/cost of capital

A second major driver of business values is the cost of capital. If, in order to buy a business, Buyer 1 is paying interest at 7.5 per cent and Buyer 2 is paying only 5 per cent, then, on interest coverage alone, the second buyer can afford to pay 50 per cent more for the business. Once again, it is the big boys that win by a considerable margin. Furthermore, because of their performance history and substantial equity, the larger groups need only cover interest charges from their cash flow whilst the independent will often be forced to repay the capital sum from his or her profits, restricting further still the amount they can offer to pay for a business.

Staff costs/operating costs

The value pendulum starts to swing the other way when it comes to staff and operating costs. Although large groups generate some efficiencies at a cost level, inefficiencies can more than outweigh the gain. Human nature being what it is, costs can clearly be controlled more diligently by an owner manager, with his finger on the pulse and his house on the line, than by a young employee, whose greatest management concern is to have the doors locked and lights out by 5.30pm sharp.

Where an owner manager will be happy to keep the shop open for an extra few minutes if things get busy, eat their lunch astride a kick-step (I often wonder why they don't do an upholstered version) whilst doing some paper work, most employees would not only ask to be compensated handsomely for this, but would typically tackle the job with somewhat less verve.

Turnover

This is where the independent can really turn values on their head. For turnover read "customer numbers". For all its slick marketing and innovative customer services, an average multiple operated by an average manager cannot hold a candle to the affable and much loved independent when it comes to looking after customers. The extent of this advantage cannot be overstated. I have, over the years, seen some independent owners achieve absurd differentials in customer numbers over their similarly well located but multiple competitor.

All of the above lead to a general polarisation of the market and my strong recommendation to any buyer is not to covet the flagship business of your dreams but to focus on the area where you can improve value. For the first-time buyer or owner-operator, this means smaller businesses where attention to detail and enthusiasm will allow you to exercise your greatest levers on the P&L, ie, maximising customer numbers and minimising cost.

Once an independent buyer is properly focussed on the appropriate sector of the market, the next step is to identify the smaller detail in both the business and circumstances that suit them more than competing bidders and maximise the value-gap. Examples of such factors are extensive and sometimes quite idiosyncratic but some examples may be:

- A business with a three bedroom flat that is currently unused but perfect for your family
- A business open short hours to suit the existing owner's lifestyle
- An owner wanting a very quick deal with you being a cash buyer
- A business that you have worked in and of which you not only know the risks but also the opportunities
- Businesses with owners that are close to retirement and losing momentum
- Businesses with many competitors, and thus plenty of other people's goodwill available to capture
- Businesses with potential to relocate — a local and pro-active independent should always be able to identify and exploit these opportunities better than a multiple
- Businesses where a big competitor has recently been sold to a multiple
- Businesses with untapped nursing home potential and poorly exploited staff
- A business where the lead GP at the local surgery is a member of your golf club

The list could go on, but the theme remains the same, namely, that both buyer and seller should seek to identify a match where opportunities exist to maximise the value-gap. When the match is well made, both the buyer and the seller should walk away justifiably feeling as though they have struck a great deal.

David Parker is a specialist in pharmacy business sales and development. His e-mail address is david@davidparkerconsulting.co.uk and his telephone number is 0789 4234873.