Family Business

THE MANAGEMENT GUIDE FOR FAMILY OWNED COMPANIES SPRING 1994

WHAT MAKES A LEADER?

"One father came to me and said, 'I want you to change my son, make him more aggressive.' And I said, 'I can't do that.'"

THE LESSONS OF STEW-GATE
A forum on pressures in the family business culture.

GROWING PAINS
How Dorian International cured employee turnover.

TAX SHIELD
The Family Limited Partnership is IRS-proof—for now.

FLASHBACK
Northwestern Golf keeps its eye on the green.

SPECIAL: MIDWEST SERVICE DIRECTORY

BUYOUTS

Prettying up Plain Jane companies for sale

What strategic and financial buyers look for in acquisitions, and how you can get top dollar.

By Lloyd Greif

If all family businesses were beauty queens, their owners would have little trouble finding buyers when they're ready to sell. But in the real world there are far more Plain Janes than there are Miss Americas, and getting a good price for these less attractive companies can be difficult.

Difficult, but not impossible. Because many of these seemingly ordinary companies have very good features that, if identified and enhanced, can make them alluring to buyers that are willing to pay top dollar.

Consider some of the characteristics that make a family business unattractive to potential buyers. One is an apparent lack of a second tier of management. If the owner and his family sell the business, who's going to run it afterward?

Another is the lack of any proprietary or defensible position in the company's industry. Buyers like companies that have carved out a niche for themselves—a position in the market that few, if any, other companies occupy; these companies will almost certainly command a higher price than businesses with hordes of competitors.

A third turnoff to prospective buyers is a lack of growth—a situation in which sales and earnings have reached a plateau. A company that's growing at a rate of 20 percent or even 10 percent annually will fetch a far higher price than a company that has reached maturity.

A company afflicted with this misperception was Aerosol Services Company Inc., located in the City of Industry, a suburb of Los Angeles. In 1993, when ASC retained our investment banking firm to find a buyer, I saw a company that had been in business since 1967, had grown to the point where sales exceeded $50 million a year, and was quite profitable. Stability, size, and profitability—all pluses in the eyes of a potential buyer.

But at first glance, ASC also seemed to have all three of the previously noted negative features. The founders and key executives of ASC were 67 and 57 years old; one was past normal retirement age and the other was fast approaching it. The company was in a relatively mundane business, the contract packaging of consumer products ranging from lubricants to hair sprays, gels and lotions. And there appeared to be little prospect for significant further growth in sales and profits because ASC was already the largest contract packager on the West Coast and its sales had flat-

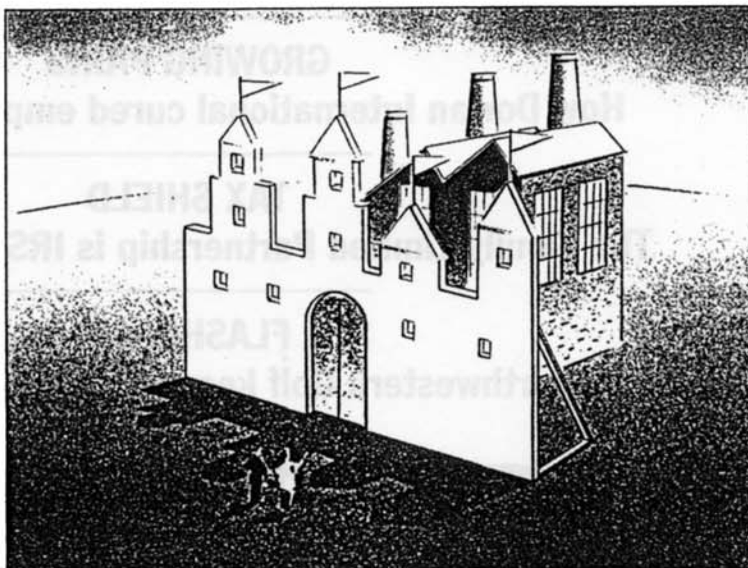

Illustration by Min Jae Hong

tened out in recent years.

My colleagues and I knew the key would be in properly positioning and presenting the company. ASC's founders and owners, President Walter Lim and his brother, Executive Vice-President Howard Lim, had built a strong second level of management consisting of eight executives; these managers had been with the company for an average of nine years. We believed that the value of ASC could be enhanced by giving these executives an opportunity to buy stock in ASC when it was sold; as part owners, their ongoing commitment to the company would be even stronger. The Lims accepted this suggestion and it became a major selling point in our subsequent negotiations with potential buyers.

We also determined that ASC had created a strong proprietary position in its industry. The company was widely known for its technical expertise; not only did it provide packaging services for many well-known consumer products, it also created many products for its customers.

For example, a customer might say, "We want a 11-spray with this kind of texture, this kind of aroma, this kind of sheen, this kind of hold." ASC, in its fully-equipped laboratory, would develop different formulations until the customer was satisfied. Then the customer would contract with ASC to do all of the packaging of the new product.

This capability clearly distinguished ASC from other contract packagers who simply made products according to their customers' formulations, and it tremendously increased ASC's marketability.

We also found a way to deal with the apparent lack of growth potential at ASC. We knew that potential buyers would be impressed when we pointed out that ASC continued to be very profitable despite the worst economic downturn since the Great Depression. But we realized that we had an even more powerful sales pitch to present when we learned that ASC could expand into some related areas of business, such as providing new packaging services to the company's existing customers. This held out the promise of sharply increased revenues and profits.

The best of both worlds would be to find a financial buyer who would pay as much as a strategic buyer but leave the Lims as part owners of the company.

Having marshaled our arguments against the apparent negatives and for the positives we had identified, we turned to the next question: What kind of buyer should we seek for ASC? Prospective purchasers generally fall into one of two categories: strategic buyers and financial buyers.

There are three types of strategic buyers: companies in the same field as the business that's for sale, companies in a related business, and operating companies that want to enter the targeted company's industry. These buyers are interested in acquiring businesses that can complement or expand their existing product lines or open up new markets for them.

Financial buyers, in contrast, are companies, funds, or individual investors who are looking primarily for significant appreciation in the companies they buy. These buyers typically don't purchase companies that aren't growing, but instead look for businesses that are achieving double-digit profit increases each year.

Often it's possible to get a higher price from a strategic buyer than from a financial buyer, and in fact we did hold discussions with some companies in ASC's field. Obviously, one of our objectives was to maximize the price that could be obtained for ASC. As a rule, strategic buyers are willing to pay more than financial buyers, for two reasons: In most instances they don't have to borrow to make an acquisition and thus aren't dependent on cash flow to pay off debt; and they may be able to increase cash flow of an acquired company by using their own people and facilities to eliminate duplication.

But this type of purchaser usually wants to buy a company outright; it may let the former owner stay on as manager, but it wants to own 100 percent of the stock. The Lim brothers expressed a strong desire to remain in their present positions with the company, and said they preferred either to retain own-

ership of some of the stock or to purchase stock in a new, restructured corporation. Even if the Lims had been able to get a good price from a strategic buyer, it's unlikely they would have been permitted to retain any ownership.

The best of both worlds would, of course, be to find a financial buyer that would pay as much as a strategic buyer but leave the Lims as part owners of the company. With this as our primary objective, we approached several financial buyers, emphasizing all of the sales points outlined earlier.

The result of these negotiations was a "win-win" deal that satisfied both the Lims and the buyer, a private investment group based in California. I can't disclose the terms, but I can say that the Lims were able to buy back nearly 40 percent of the company's stock for less than 10 percent of the amount they were paid for all of the stock.

How could that happen? It was made possible through the magic of leverage. In a typical leveraged buyout, 80 percent of the purchase price is provided by borrowings, with the buyers themselves putting up only 20 percent. That 20 percent represents the equity—all of the stock—of the company. But after a leveraged buyout, a company's stock isn't worth as much as it was before the buyout because of the debt that's incurred; some or all of the cash flow that previously was available to the owners must be used to pay off the debt.

The buyer was willing to have ASC take on the debt because its partners saw that the company had strong growth potential and would be able to pay off the loans. If ASC had lacked prospects for increasing profits, the buyer wouldn't have found the company attractive enough to acquire on a leveraged basis.

This story has a happy ending because ASC had underlying qualities that, when emphasized and properly presented, made the company attractive to buyers willing to pay a good price. Not every ordinary-looking family business has such features, but many do and the owners don't know it.

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