by **Joy James** | The Joy James Group

Finding 'Black Gold' Part 3:

Exit Strategies for Smaller Remanufacturers

Editors Note: This is the final part of a three-part series.

Business owners seeking liquidity have several options available depending on their company's size, profitability and upside potential. As previously explored in the first two articles of this series, large aftermarket companies may consider 1) going public through an IPO or reverse merger (e.g., Teckn-O-Laser), 2) selling all or part of the company to a private equity firm or PEG (e.g., QIP), 3) creating an Employee Stock Option Plan or ESOP (e.g., GRC) and 4) selling to a strategic buyer (e.g., Golden Imaging).

Generally speaking, it is difficult for smaller companies to attract private equity funding because of the high transaction costs associated with the deal. For this reason, PEGs typically prefer to handle companies with more than $20 million in annual revenue or about $2 million in earnings before interest, taxes, depreciation and amortization (EBITDA). (For more information, refer to Part One of this series in the January 2005 issue of Recharger.)

Selling to a strategic or synergistic buyer for cash is probably the best way for a business owner to gain liquidity and maximize value. However, this option is typically reserved for businesses that fulfill a specific need that the acquiring company cannot develop themselves, such as serving a new market, increasing market share or gaining a new technology. For example, in 1993 ribbon manufacturer Nu-Kote Holding purchased Future Graphics and ICMI primarily to fulfill its distribution channel's requirement to supply remanufactured toner cartridges.

If a strategic acquirer is not knocking at your door, there are several other alternatives to consider. In this final installment of the series, we will explore the option to sell your business to an individual buyer or industry consolidator. In addition, we will cover the pros and cons listed in Figure 1. Although selling to friends and family does remain an option for some sellers, it usually provides for very limited liquidity and is therefore not included in this article.

Exit Options for Sellers by Businesses Size

	Individual Buyer
Typical Size	Annual sales less than $10 million
Pros	
	Flexible deal structure creates strong personal fit.
	Some cash up front, balance over time.
	Buyer may provide skills or contacts not previously available to the company.
Cons	
	Lower value multiple than larger company transactions.
	Seller financing required.
	Can be time consuming with many setbacks. Inexperienced buyers can waste seller's time.
	Fate of existing employees and corporate culture is uncertain.
Why choose this option?	Owners seek this strategy to add/change company management. These companies are generally too small for other options.
Aftermarket example	Paul Hawker/Laser Saver (1992) Jim Cerkleski/Clover Technologies (1999)

Figure 1: Exit options for sellers by business size.

Anything Goes

In general, individual buyers purchase smaller companies that require less cash down and offer more flexibility in payment terms. In almost all cases, some amount of seller financing is required as part of the deal.

Unlike PEG transactions or strategic acquisitions, the individual buyer can sometimes be less sophisticated — perhaps even irrational — and may lack professional guidance. As a result, these transactions can take a long time to complete and a high percentage of deals fall through. In fact, 25 percent of all businesses listed never actually sell. These odds can be improved with proper planning, good books and a competent adviser.

Individual Buyers

Most individual buyers seek to purchase a financially healthy business that they can own and operate post-sale. Typically, these buyers have some expertise and/or practical experience in a related industry, giving them the ability to manage and grow the business.

This type of transaction is usually coordinated through a business broker, who discreetly "shops" your business to qualified buyers both in and outside of the industry. In addition, the broker facilitates the transaction in exchange for a fee, which is typically between 10 percent and 13 percent of the selling price.

"Buyers buy value — what's in it for them," explained Deborah Alagna, a business broker in Newport Beach, Calif. "The more turnkey the business is, the better." Alagna added that there is a "right" buyer for every business based on qualifications and the business' needs. "If the company lacks marketing acumen, for example, someone with special skills in that area would be a good candidate as a buyer."

Valuation

Valuing a business, particularly a small business, is more of an art than a science. In the end, it is the market that determines what someone is willing to pay for your business. Generally speaking, individual buyers will not pay as much as PEGs or strategic acquirers.

The most common business valuation method is based on the company's earnings, or EBITDA. EBITDA is used to analyze the profitability between companies because it eliminates the effects of financing and other accounting decisions. It is not, however, always a good indicator of cash flow.

A business' value is usually determined by calculating a multiple of EBITDA. This multiple is based on a number of factors unique to the business such as location, years in business, customer composition, number of employees, level of competition and the business' overall dependency on the owner.

Currently, individual buyers are reportedly buying businesses from a 1.5x to 3x multiple of EBITDA. Two different examples of valuation scenarios are listed in Figure 2. In this example, a $1-million company is valued at $150,000 using a 1.5x multiple, and a $1.5-million dollar company is worth $900,000 using a 3x multiple.

Buying a Job?

According to Alagna of VR Brokers, there's been a recent surge of former corporate executives seeking to be their own bosses. "(More than) 90 percent of the deals I do are individual buyers looking to purchase a job and/or lifestyle," she said.

Aftermarket Profile: Paul Hawker

While working for Johnson & Johnson in 1991, Paul Hawker sought to purchase a company to become his own boss and avoid relocating from sunny Southern California to a colder climate. In addition, the travel associated with his marketing and sales position at J&J had taken a toll on Hawker, who eventually purchased San Diego-based Laser Saver in 1992. Laser Saver produces, sells and delivers remanufactured printer cartridges, and provides on-site service and equipment direct to the end user.

Calculating EBITDA — 1.5X

Total Sales	$	1,000,000
Cost of Goods Sold	$	500,000
Gross Profit	$	500,000
Less:		
Sales, General and Administrative Expenses	$	400,000
EBITDA	**$**	**100,000**
Less:		
Interest, taxes, depreciation, and amortization	$	60,000
Net Profit	$	40,000
1.5X EBITDA — Value	**$**	**150,000**

Calculating EBITDA — 6X

Total Sales	$	1,500,000
Cost of Goods Sold	$	700,000
Gross Profit	$	800,000
Less:		
Sales, General and Administrative Expenses	$	500,000
EBITDA	**$**	**300,000**
Less:		
Interest, taxes, depreciation, and amortization	$	110,000
Net Profit	$	190,000
3X EBITDA — Value	**$**	**900,000**

Figure 2: Two different valuation scenarios.

Hawker purchased the unprofitable business with a plan to turn the company around within the first year. At that time, Laser Saver's annual revenue totaled $627,000.

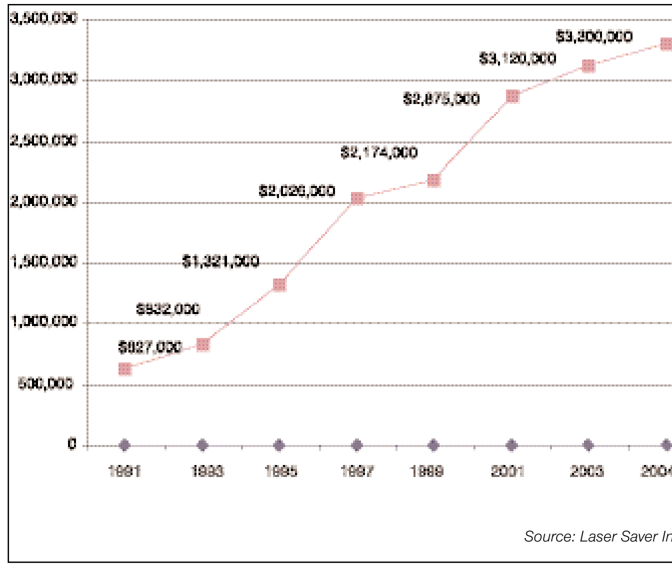
"At J&J we knew that we could buy an unprofitable business and then use our marketing and sales abilities to make the business profitable. I followed the same model," said Hawker, who added that "coming out of the medical industry I was shocked at the high failure rates of (toner) cartridges. I knew that I could add some value to the business by establishing some standardized procedures and quality-control initiatives."

Hawker gave the former owner some cash down (based on what he could afford) and set up seller financing to pay off the balance of the loan over a four- to five-year period. According to Hawker, "If certain results were met, I would accelerate the payment terms and pay more for the business."

Hawker executed his plan and made the company profitable within the first year. "Necessity is a mother," explained Hawker. "We didn't have a choice but to make it profitable." As Figure 3 shows, Laser Saver's annual revenue grew to more than $3.3 million in 2004.

Calling all Competitors — Industry Consolidator

Since paying off the original business loan, Hawker has acquired four other local competitors. Most of these transactions resulted from long-term relationships with other business owners, many of whom Hawker, who is currently president of the West Cost chapter of the ITC,



Source: Laser Saver Inc.

Figure 3: Laser Saver total revenue over time.

met at local association meetings.

"I remember shooting pool at an ITC chapter meeting where I met up with a local competitor," recalled Hawker. "He was a good competitor who made a high-quality product. We talked. I told him that I'd be interested in buying his business if he ever wanted to retire. Years later he called and we did the deal."

As with most industry consolidator transactions, Hawker created value by consolidating manufacturing facilities and operational overhead. Typically, these transactions were asset sales that did not pay for any goodwill or consulting agreements to the seller. In most cases, Hawker did not acquire the business' existing employees or any long-term debt. Very little (if any) of the inventory was purchased.

Hawker describes these deals as a win-win opportunity. "Most of the deals weren't profitable enough for someone else to buy the company on a stand-alone basis. It wouldn't support a livelihood," he explained. "It worked well for Laser Saver because all of the fixed expenses went away post-sale. I simply tied the customer base directly into my existing business."

Hawker expects to continue Laser Saver's impressive growth pattern through a combination of organic growth and future acquisitions. "We currently have capacity for a $5-million operation," Hawker said. "We will get there."

Profit and Loss — Existing Ownership			
	Amount		%
Sales	$	600,000	100%
CGS	$	408,000	68%
Gross Profit	$	192,000	32%
SGA	$	290,000	48%
EBITDA	**$**	**(98,000)**	**-16%**

Profit and Loss — Post-Consolidation Sale			
	Amount		%
Sales	$	600,000	100%
CGS	$	390,000	65%
Gross Profit	$	210,000	35%
SGA	$	27,000	5%
EBITDA	**$**	**183,000**	**31%**

Figure 4: Company XYZ's profit and loss with existing ownership and post-consolidation sale.

Example of a Small Company Consolidation Deal

In a consolidation play, the buyer attempts to gain market share and economies of scale by purchasing the assets of another business that may or may not be profitable. Most often, the seller can eliminate the majority of the fixed expenses associated with running the seller's business by folding the operation into the buyer's existing company.

The main benefit of this option is the ability to extract higher profits than what is possible under the current ownership structure — a real 1+1=3. Figure 4 on the previous page illustrates this point. The selling company — Company XYZ — is a local remanufacturer and service provider that is currently not profitable given its existing overhead structure. However, when the company is successfully folded into the buyer's existing company, a profit of $183,000 per year can be realized. Ideally, sellers could receive a 1x to 3x multiple of the post-consolidation EBITDA. (Note: Valuations vary widely. This may or may not be typical.)

The product mix of the business is one of the variables that will change the value of the transaction. As Figure 5 shows, 35 percent of the company's sales are comprised of low-margin products. Sellers will typically discount the value of the business and exclude the low-margin segments, as shown in Figure 6. In this case, the business' valuation is based on the lower EBITDA figure of $143,000.

Business Segment Analysis			
	Total Sales	Gross Profit Margin	Percent of Total Business
Remanufactured/Compatible Toner	210,000	50%	35%
New Cartridges	150,000	12%	25%
Printer Service and Repair	180,000	36%	30%
Equipment Sales	60,000	8%	10%

Figure 5: Company XYZ business segment analysis.

EBITDA With Discount for Low-Margin Segments		
	Amount	%
Sales	$ 390,000	100%
CGS	$ 220,000	56%
Gross Profit	$ 170,000	44%
SGA	$ 27,000	7%
EBITDA	**$ 143,000**	**37%**

Figure 6: Company XYZ discounted EBITDA.

Seller Example: Prime Laser

When Glenn Hetzel founded Prime Laser in 1983, he already had an exit strategy in mind. "From day one my plan was to build the company into a viable operating business that someone could step into and run. The whole point of starting the business was to eventually sell it."

Hetzel's first love has always been accounting. Prior to starting Prime Laser in his garage, Hetzel worked as the chief financial officer for a publicly traded international conglomerate. "I enjoyed the travel and working with foreign banking systems," explained Hetzel.

Although for the past 20 years Hetzel was able to maintain an independent accounting practice on the side, he was never able to develop the accounting business into an international practice as he'd first dreamed. "At times, it became very difficult to manage both Prime Laser and the accounting practice. Tax season was nuts because both the toner business and accounting practice were at a high. I remember not sleeping for days at a stretch in mid-April. It took its toll on me physically and mentally."

Prime Laser continued to grow by selling service and supplies direct to the end user. At its peak, the company employed nine people and did more than $600,000 in annual sales.

Hetzel noticed things starting to change in late 2002 and early 2003 when HP released the 4200/4300 line. Revenues and profits were down. Sales per customer were also declining.

Hetzel recalled, "The OEM technology became more difficult and required more R&D time to decode. As a result, my customers were forced to buy (lower-margin) OEM product until the technology obstacles were overcome. This effectively reduced the opportunity to sell (higher-margin) remanufactured products to my customer base." Hetzel also observed that the OEMs were adding more toner to increase their page yields. As a result, the annual number of cartridges sold per end user was declining.

During this time Hetzel noticed direct costs trending upward. "Replacing components was no longer an option — you had to do it. This naturally increased costs and declined margins."

Along the way, Hetzel was forced to tap into several lines of credit to expand the facility and to carry more OEM inventory. In addition, Prime Laser invested in some marketing campaigns that failed to deliver a return on investment.

Hetzel made the decision to sell Prime Laser in 2003 and completed the deal 13 months later. Prime Laser was purchased by Irvine, Calif.-based Triumph Business

Single-party transactions offer significant flexibility in terms of the deal structure. Effective communication and full disclosure create the best possible "fit" for both sides.

Systems. "I felt that the opportunity with Triumph gave me the greatest potential for the company to succeed," Hetzel said.

Hetzel and Triumph's owner, Pam Feld, had worked together for many years as executive board members of the ACCR. "The comfort level between Pam and I helped. The fact that we know each other and have worked together in the past made the deal a lot easier to do," Hetzel said.

Interestingly, Hetzel was not interested in selling the business to an individual buyer. "I question whether someone without industry experience could effectively protect the asset," he said. "This is an important aspect because you don't get all of your cash up front when you sell a business."

Since selling Prime Laser six months ago, Hetzel has focused on his accounting practice and is slowly building an international clientele.

"It's a great time for me right now. My accounting business is growing, and I'm also fitting in more travel time." In fact, since selling the business Hetzel has traveled to three countries and was headed for New Zealand right after being interviewed for this article.

As for regrets, Hetzel doesn't have any about selling. "Your business is just something that you do," he said. "If you're not where you want to be, then simply take the steps necessary to do something different."

Pros and Cons

Selling to an individual buyer can be a good source of liquidity for businesses with less than $10 million in annual sales. Unlike a PEG or ESOP transaction, there is no minimum size requirement to attract an individual buyer.

Another main advantage is that these single-party transactions offer significant flexibility in terms of the deal structure. Effective communication and full disclosure create the best possible "fit" for both sides. Also, individual buyers may offer relevant skills and opportunities that will help the company grow faster and more profitably.

Some of the cons associated with an individual buyer include owner financing requirements, complete seller exit and a lower probability of closing.

Typically, the buyer will pay some cash up front and require the seller to carry a note with interest for the balance of the loan. Although the note is almost always personally guaranteed, the seller is not always the first in line to be paid. For example, it's not uncommon for a buyer to borrow the down payment from a bank that demands priority within the capital structure. In some cases, the seller financing payments are not made and the only option is to go to court, which can be expensive and time consuming.

In addition, the note payment schedule is often dependent on the business' performance level. Since most sellers exit the business completely and have no control over the post-sale operation, this aspect of the agreement can prove challenging.

Also, sellers may find the process consuming with many setbacks. According to Chris Schenkenberg, senior manager in the federal tax practice of Grant Thornton LLP, "Caution should be exercised as sellers compare potential buyers, as sometimes individual buyers, when compared to institutional buyers including financial or strategic buyers, may have limited access to capital. This may impact the ability to close the deal. As a seller, you don't want to waste valuable time with the wrong buyer."

Finally, there can be culture-integration issues. Paul Hawker noted that he has never been successful in acquiring the employees of a business that he's purchased. "It just doesn't work," he said. As a result, the fate of your existing employees is an unknown.

Conclusions

Selling a small remanufacturing business to an individual buyer or industry consolidator requires foresight and patience. Because of the nature of the marketplace, there is no "typical" deal structure or valuation process. In the end, it is up to the two parties to carve out an agreement that both sides can live with. R

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