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# What Motivates the Buyer of a Private Small Business?

The fact is, buyers **want** to buy your business. They're already interested. That's why they're talking to you! Assuming you've done a good job explaining what your business does and have honestly presented the revenue and cash flow, they've already made their decision...

**Except...**

What's holding them back is fear of concealed problems, like inaccurate financial statements, undisclosed legal problems, labor issues, and the like. A prospective buyer of your business will only feel comfortable to proceed with the purchase when they feel like they've eliminated all of the potential for unseen threats.

For example, let's say your revenue was down two years ago but recovered last year. You might think that this will affect the saleability of your business or the price. However, if you can convincingly show the reason for the hiccup and show that it isn't likely to happen again, then the truth is that the buyer will not be concerned about it at all!

A recent example of this that we can all relate to is the general drop off in business revenues due to the pandemic.

Another example might be a new piece of equipment you bought so that you could expand your operations. Your profits might be lower in the year you bought it, but you can show how it increased your revenue down the line. If you don't point this out to the buyer, your business might be rejected out of hand for poor or erratic profitability when if fact, the opposite is true.

Even if the news is truly poor, like a new product on the market that's taking some of your market share, if you're up front about it, it won't affect things as much as you think, and the buyer will appreciate your honesty. They're creative people that like to solve problems; they just want to know what the problems are.

## So What Should You Do?

Paint the most complete portrait of your business that you can and don't try to hide your business's shortcomings! Buyers of lower middle-market businesses are sophisticated and will almost certainly find hidden problems during due diligence. When they do, the best case is that they will want to renegotiate the deal; the worst case is that trust will be lost and the deal will come apart late in the game after both parties have spent a considerable amount of time, effort, and cash. Buyers actually appreciate disclosures of defects in the business, especially early on in the process.

## How Do You Do This?

You start by assembling the documents a prospective buyer is eventually going to ask for anyway. Then, write out a narrative of your business and point out it's strengths **and** it's weaknesses. This

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generally takes the form of what's called a SWOT analysis. SWOT stands for "Strengths, Weaknesses, Opportunities, and Threats. It's a standard way of condensing this type of information into an easy to read table.

Also take note of any problems the business experienced in the past: financial, legal, etc., and explain why they happened and what steps were taken to prevent them from happening again.

At East Forty, we look at over one hundred businesses every year and we can tell pretty quickly when a seller is being evasive. When that happens, we immediately pass on the business, because if the seller is willing to hide one problem, they will be willing to hide others.

**Buyer Motivations May Surprise You**

Another very important thing to realize is that buyers have different motivations. Many buyers are actually looking for businesses that aren't perfect as that provides them with an opportunity to improve operations and increase the value of the business after they've purchased it. For example, if your gross margins aren't quite up to your industry standards, this may actually be attractive to a buyer, as they will see opportunity in increasing efficiency, improving product lines, reducing input costs by negotiating with suppliers, etc.

This notion of buying a business where everything isn't completely dialed in may be attractive to a prospective buyer in another surprising way. If an economic downturn were to affect the business in the future, having areas that can be improved provides a safety net of sorts; a way to weather the storm by fixing problems, exploiting untapped opportunities, gaining market share, etc. A business that is already operating at peak efficiency and has expanded completely into their market has fewer options when business turns down due to unforeseen circumstances.

**The Different Buyer Types**

We can further get an idea about buyer motivations by briefly talking about the different types of buyers out there. They are generally divided into two categories: "strategic buyers" and "financial buyers". Even within these categories motivations can diverge quite a bit.

**Strategic Buyers**

Strategic buyers acquire businesses that will enhance their operations. This can be horizontally or vertically.

Horizontal strategic buyers are looking to acquire their direct competitors in order to increase their market share, allow them to consolidate overhead, and potentially acquire proprietary technology or product lines. These buyers will generally absorb the business they've acquired into their own. They will cut overhead by consolidating back-office space, maintenance facilities, etc. and by laying off redundant personnel, almost always from the acquired company.

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Vertical strategic buyers want to acquire their suppliers, or in some cases, their clients. This lets them control key business inputs or sales channels. Their thought process is that they will be able to acquire these needed materials and services more reliably and at a cheaper cost than if they were paying the acquired company for them, or in the case of sales channels, directly capture the profits that third party sales channels are receiving.

Strategic buyers are sought after, as they sometimes offer more for a business, but the reality is that they are few and far between. If you have a business that a strategic buyer is interested in, the likelihood is that they would have contacted you already. Strategic buyers tend to court their targets for a long time, sometimes even supporting them financially and guiding their growth and development before acquiring them.

**Financial Buyers**

Simply put, financial buyers want to make a return on their investment. Within this category, however, their are a couple of different types of buyer and they are differentiated by **how** they go about realizing that return which boils down to the difference between short term and long term investments.

**Short Term Buyers**

Short term investors consist of private equity funds, institutional investors, and some individual investors. What sets them apart from long term financial buyers is that they have a predefined exit strategy. They are looking to exit (i.e. sell) their investment in the near term, 5 years or less, at a price that yields a minimum Return on Investment (ROI) to their investors, usually 25% or more.

They will generally look to do this in one of two ways: either by taking the company public (rare), or positioning it in the market to be attractive to a cohort of strategic buyers and then aggressively courting them. If that fails, they will usually "flip" the company to another short term investor, possiblye even at a loss.

Short term buyers are guaranteed to make significant changes to an acquired company from day one to suit their particular strategy which will include laying off personnel, changing management, discontinuing "unprofitable" operations, etc.

**Long Term Buyers**

The last type of financial buyer we'll talk about in detail is the long term financial buyer. These buyers seek to hold on to the acquired company indefinitely and focus on sustainability, profitability and growth of the business. Of all the types of buyers, financial long term buyers are the least likely to make radical changes to the acquired business.

Long term buyers want to buy good businesses and make them even better. The most well-known long term financial buyer is Warren Buffet.

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Long term buyers primarily consist of family offices and wealthy individuals. Family offices are companies set up by one or two allied families who pool family resources, including financial resources, but also knowledge, connections, etc. to buy and hold businesses for the benefit of their family members.

East Forty is a family office. We want to buy well-run, stable, profitable businesses and we want to hold on to them indefinitely.

**Other Types of Buyers**

There are other types of buyers like turn-around specialists, who buy distressed businesses, get them back on their feet, then sell them off for a profit; and liquidation specialists, who buy distressed companies for less than the value of their assets, dissolve them, and sell their assets for a profit. We're not going to go into these in any detail. Hopefully you're not considering selling because your business is in that much trouble!

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