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Non-Financial Factors
The Most Important Questions

Neal started and ran his company for 17 years, then sold it, and stayed on with a five-year management contract. He was now leaving and wanted to buy three or four "small" businesses.

Why buy three or four businesses? Because three of the vice presidents at his old firm had approached him and asked if they could work for him when he found a new company. His plan was to make each of them a company president (they would make an investment in "their" company). He would be Chairman and run one business himself.

Interesting story, isn't it?

What if you wanted to buy Neal's old company and were comparing it to another company in a similar industry, with similar sales, and similar profits? If you only looked at the financial statements you would conclude the two companies have a comparable value. But isn't it riskier to buy a company where three of five department heads are ready to leave? Isn't that company worth less?

Numbers guys (and gals), also known as CFOs or accountants, like to stress that you can run a business better "by the numbers." In other words, know your margins, ratios, and other financial benchmarks to generate more profit and faster growth.
They're right, you have to know the numbers but it's what creates those numbers that is at least as, if not even more, important. Collectively the things that create the numbers are known as the non-financial factors and include just about everything other than the numbers.

The top 10 non-financial factors

Employees
Pareto's principle is also known as the 80-20 rule and it states that 20% of your effort will generate 80% of the results, 20% of your salespeople will bring in 80% of your sales, etc. The same is true with the top 10 non-financial factors. The top two are far and away the most important and they are customers and employees.
Neal's story is captivating, not all that common, and points out that whether it's one employee or the management team your people are what makes your business what it is. As a buyer told a seller, who didn't want the buyer to meet the key employees prior to the closing, "You may think I'm buying your business but I'm really buying your people." Private equity groups buy management teams and individuals buy an operation having capable people with diverse responsibilities.
Want to grow, make more money and sell for a higher price? Invest in your people. I had a client where they refused to invest in the right people for their accounting department. Their "accountant" was a bookkeeper and their bookkeeper was a data entry clerk. Any wonder their financials were screwed up and the owner wondered why there was no cash when they were, supposedly, quite profitable. Another client gagged when we recommended he hire two new salespeople with a monthly base salary double the highest they had ever paid before. He smiled three months later when both of those salespeople were into commission (and in record time). They were worth it!
And while we're talking about employees, cover these two issues. Make sure you're not overextended on off balance sheet items like accrued vacation and sick pay. Roy learned the hard way that his generous vacation policy with unlimited rollover could get costly when people don't use their vacation. Upon selling he had to write checks totaling over $100,000 to his employees (about 10 of them). Do you have independent contractors that really should be employees? The IRS and all State

governments don't like this (the States want workers compensation premiums and unemployment insurance premiums and the IRS knows contractors have an easier time not reporting income) and your people won't either if you have to let them go. A friend was paid as a contractor, wasn't eligible for unemployment, and her filing triggered the State to investigate the company. The penalties were severe.

Customers

Everyone, meaning business buyers, bankers, appraisers, and others, usually look at the customer list early and hope that one customer doesn't dominate. Anything over 5-10% warrants investigation. How solid is the relationship, who is the relationship with, why do they buy (price, service, quality, problem solving done by your staff).
Keith bought his business from a 70-year-old owner whom was truly coasting; sales had trickled down over the previous five years. After six months the business was on track and Keith's comment was, "It's amazing what happens when you actually pick up the phone and call your customers." It's not just having customers that's important, it's how you take care of them.
Pricing is another important factor with customers. A great customer (a lot of ongoing business) paying less than others may not be as great as you think. Especially if their loyalty is based on the price.

The rest are also crucial (to success)

Lease

Jim was buying out his partner. His eyes were opened when we asked questions about his lease. Because he didn't have a lease, he was on a month-to-month with the landlord and the rumor was the landlord was going to go after one big tenant for the building, getting rid of all the small tenants like Jim. To make matters worse, we calculated it would cost one year's profit if he had to move suddenly. Jim bought out his partner and then made an orderly move over the next six months, getting rid of a risky non-financial factor, the lease.
In the early to mid-1990's this was an oft ignored item. In fact, workshop attendees laughed when I said a killer factor was a lease less than the term of the loan. Then the SBA made it a requirement that the loan term could be no longer than the term of the lease including fixed options (a caveat may be if it's a consulting or training type business that can office anywhere). It's expensive to move and the banks don't want customers kicked out halfway through their loan.

Suppliers

A banker shared with me that they almost didn't make a loan because the company was overly dependent on one supplier. Bye-bye supplier meant bye-bye profits. Ken didn't learn his lesson because 10 years after being devastated by losing his top line, over half his sales, he lost his new top line, 60% of sales. Suppliers are important. Not as important as customers or employees but important nonetheless. You want a variety of suppliers that respect your business. You don't want to be in the position of one owner who told me, "I told my top supplier I was *thinking* of selling my business and they put me COD." On the flip side, Rick's second acquisition gave him a dynamic product line he could sell in his other locations. He wouldn't have got the product line on his own.

Growth Plan

In my book, *If They Can Sell Pet Rocks Why Can't You Sell Your Business (For What You Want)?)* and in talks I give I have for years stated showing a business can grow, not just say they can grow, makes it more valuable. The following three are key components:

1. My company, it's culture and employees, are poised for growth.
2. We have both a sales and a marketing plan in place and follow them.
3. We work on innovation as opposed to problem solving.

Do you have growth plan and a culture of growth? You should because stagnant companies are dying companies. Good employees want career advancement and will go somewhere else if you don't offer it. Profitable companies have a competitive advantage and they leverage that competitive advantage to grow. Your company is worth more if it's continually growing. Buyers, of all types, do not buy a business to keep it where it is; they all want to grow it.

Access to Capital

Unlike the old days, very few industries are blacklisted by banks although some, bars, restaurants, and select retail, may have limited options. Banks are regulated tighter than ever

and that means you are watched closer than ever by your bank. Your numbers have to be in line with standard guidelines. If you're profitable, don't drain every last cent out of the business, and have a history of paying back loans on time this shouldn't be an issue. However, not a month goes by that I don't see an article mentioning that many owners say they have trouble getting a loan.
Manage your business to meet the five C's bankers look for, Cash Flow, Collateral, Capital, Character, and Conditions, and you'll pass your banker's analysis. Realize that cash flow, like cash, is king, and adequate cash flow to easily repay the loan is crucial.
While you can also get an equity investment I'm not covering it here because it's rare (because most owners don't want to give up any ownership to outside investors). What is important is for the buyer of the business to get standard working capital as part of their deal.

Competition

Do you know your market and your competition? You don't have to be fanatical about it but you should know what's going on, the industry's issues, your competitors strategies, etc. It's one reason bankers have Conditions as one of their 5 C's. Conditions refers to what's going on in the economy and market. Above I referred to innovation. Is your competition out innovating you or do you have the lead in creative solutions for your customers? Demonstrate that you lead in this area and your value stays lofty.

Technology

I'd say at least half of the buy-sell deals I've been involved with since the mid-2000's have a selling company with outdated technology issues. Often it's pennywise and dollar foolish. Mike replaced his accounting department's printer and efficiency skyrocketed because the old printer was so slow the staff wasted time waiting for reports. Bob walked into a company that had four operating systems in use, going back to Windows 95. Bill found out his seller had unlicensed software (the seller's issue but a major distraction and a cost not in the P&L, which had to be included in the valuation). Manufacturing machinery can last decades. Computers and peripherals are outdated quickly and it behooves you to make sure you're getting the most out of your technology. It's there to improve productivity so use it and update it as needed.

Restrictive agreements

Franchises are the ultimate restrictive agreement. The franchisor controls almost everything a business does. However, there are many other types of agreements that can hamper a business. A distribution territory is one. If your vendor won't let you sell where you want to sell or restricts your Internet sales ability you have problems. Do you license a product, technology, or way of doing business? What about customer contracts; are they favorable (to you)? A client recently found out his attorney, many years ago, had put a clause in his customer contracts that forced him to tell his customers if sold the company and gave them the right to opt out of the contract. Talk about a value deflator.

Environmental

Just because you don't have oil dripping all over your facility doesn't mean you don't have hazardous material issues. Any business using machinery or vehicles is subject to environmental inspections. If you own the land, and especially if you come to sell the land or the business on it, there are definite procedures in place for hazardous material testing.

Conclusion

The non-financial factors tell you how your business got to where it is and where it's going. They are not an historical snapshot; they are living parts of your business. Pay attention to them and your numbers will fall into the right buckets, especially the profit bucket.