Wire Harness Business & Strategy

The Sale Process: An Introduction

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Despite some consolidation, the wire harness industry remains very fragmented, with over 1000 harness companies in North America. Because hundreds of them are owned by founding entrepreneurs who will at some point be pursuing a sale of their company, let's take an in-depth look at that process. We'll begin with the recommendation to engage an outside resource in the sale and conclude with the tricky matter of valuation. Future columns will address definitions of good and bad buyers, life after the sale, how not to sell and deal killers.

Fly Solo or With a Copilot?

I represent sellers, so you may want to disqualify me as an objective observer, but, yes, I believe it is prudent to involve an M&A (merger and acquisition) firm in the sale. The owner lacks experience, cannot bring objectivity to the process and cannot afford to be distracted from priority #1: the day-to-day responsibility of running the business and continually adding value.

A well-chosen M&A firm, on the other hand, with a solid grasp of the business, the industry and the firm's major selling points, will be adept at stimulating a confidential, competitive process resulting in an optimal selling price and terms. Meanwhile, the owner's ability to run the business will not be disrupted.

The Seven-Step Sales Process

Here are the seven key services an M&A firm should fulfill for the prospective seller:

1. **Establish price buy-in.** It is critical to get on the same page with an owner regarding a realistic price range (min-max) and likely terms. Without agreement on that central objective, going forward together is futile.
2. **Build a compelling narrative.** Because businesses do not sell themselves, paint a picture of where a company has been, where it is in the current environment and what the company's future might look like under effective management. This picture should be drawn with the understanding that brevity and precision are far more important than elaborate detail. And the most valuable part of the picture is a persuasive description of how a prospective buyer can grow the business.
3. **Helping prospective buyers appreciate the attributes of a company** includes providing context for historic performance, identifying expenses the new owner will not incur post-closing and a customer forecast—typically covering three years—of future performance.
4. **Make initial contact with prospective buyers.** During this phase, without revealing the name and location of the selling company, convey basic information to a broad range of potential buyers including private equity firms, wire harness companies, electronic assembly houses and connector manufacturers. This wide net reflects the difficulty in predicting likely buyers.
5. **Narrow the buyer list.** After gauging interest based on prospect responses and analyzing the strengths of prospective buyers, narrow the list to no more than a dozen. At this stage, do not reveal the name of the selling company without seller approval.
6. **Invite offers.** Once a viable list has emerged, invite potential buyers to submit bids—finally revealing the name of the company. Managing the competitive process that will ensue requires experience and judgment.
7. **Rank the offers.** The key criteria in evaluating offers include price, terms, motivation and credibility. Although assessing buyer motivation and credibility is somewhat subjective, that determination can be as critical as price.

Process a letter of intent (LOI) from the top-ranked buyer and manage the closing. The LOI spells out the price and terms a buyer is committing to. Once this document is signed by the seller, the buyer engages in due diligence. Unless something is discovered in due diligence that materially affects value (such as an undisclosed lawsuit, an environmental issue or misstated financial numbers), move to a closing. Typically, this process takes 45 to 90 days.

The cliché in the M&A world, "There's no such thing as an easy deal," is absolutely true because a buyer and seller need to reach agreement on so many issues. But all the "deal point" hurdles can be surmounted if the buyer and seller both strive for fairness and if both are truly motivated to get a deal done. And receiving outside support from a seasoned M&A firm certainly helps.

Bringing Objectivity to Valuation

Although data points can determine price ranges, these are just indicators. For example, if the sale process attracts a few highly competitive buyers, the projection can be exceeded. Here are the key factors determining the sale price:

- **The starting point: EBIDTA.** The fundamental value of a business is a multiple of earnings before interest, taxes, depreciation and amortization (EBITDA), plus add backs. For wire harness businesses, the sale price generally ranges from four to six times EBITDA, which tells a prospective buyer what the company's cash flow is before paying interest and taxes and reducing income by calculations of annual depreciation and amortization. Add backs are expenses the company is incurring under current ownership that would not continue under new ownership.
- **Risk.** What is the probability that historic cash flow (particularly over the last few years) will continue in the near future? Is there reason to suspect that the next few years will see a precipitous drop in revenue and cash flow—or is there reason to anticipate a spike because of market conditions or opportunities that have not been realized?
- **High on the list of factors to consider** are the quality and duration of the company's customer relationships. And if the company's large-customer base is highly concentrated, it can expect its multiple to be discounted because of the projected impact of losing one key customer.
- **Management team.** Will the management team responsible for recent performance stay in place for the foreseeable future, and is the current management team capable of growing the business?
- **Growth potential.** Two favorable factors for a harness company are customers that appear likely to expand and customers that currently award only a small percentage to the harness company and seem eager to increase that share based on recent performance. But the worth of a company needs to be downgraded if it is close to its ceiling in revenues from current customers.
- **Market.** Some harness companies can demand higher multiples than the standard four to six times EBIDTA because they primarily sell to customers operating with higher margins. Cases in point are military and medical equipment harness companies because their customers are in less competitive markets.
- **Size.** A $20 or $30 million revenue harness company will demand a higher multiple than a $5 million company.
- **Complexity of product.** A company producing wire harnesses with hundreds of circuits often enjoys a more secure position with its customers. Specializing in complex products leaves less room for competition.
- **Status of computer system.** Today, the capabilities of a company's hardware and software are crucial. Potential buyers will evaluate whether a company has outgrown its computer system or stayed ahead of the curve.
- **Bottom line.** Many owners are so focused on running their business they have little idea what their business is worth. But once they do contemplate selling, a solid beginning is multiplying the EBIDTA by four to six and then adjusting for the kinds of factors I've suggested. If they score reasonably high on these measurements and engage in a competitive sale process, they will optimize the price. But no matter how the calculations turn out, the decision to sell is almost always an emotionally difficult matter.

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Author & Company Profile...

Loren M Smith is CEO and sole shareholder of **Blue Valley Capital LLC**, a position he has held since 2001. From 1976 to 2001, he was CEO and majority shareholder of **MWC**, a manufacturer of electrical wire harness assemblies. During that period, by acquiring and integrating a number of mid-market wire harness manufacturers, MWC became the world's leading supplier of electrical wire harness assemblies serving the construction equipment industry. Loren eventually sold MWC to a private equity group.

As CEO of MWC and Blue Valley Capital, Loren has spearheaded the sale and purchase of dozens of mid-market (US$2M-US$75M) manufacturing companies.

Early in his career, he was with **Texas Instruments (TI)**, rising to general manager of TI's connector division. Smith earned a BS degree from **Miami University** in Oxford, OH, USA, and an MBA from **Northeastern University** in Boston, MA, USA.

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