Buyers in the Marketplace

Understanding the basic concepts of value requires an understanding of the buyers in the marketplace. Just as beauty is in the eye of beholder, value, including future benefits, is in the eye of the buyer. As such, in scenarios where the future benefits—namely future cash flow—is high, as is the case when creating economies of scale, the value perceived by the buyer is high. When these cash flows are minimal as a result of greater expenses, the perceived value is reduced.

The differences in buyers classify them to two categories: financial buyers and strategic buyers. "Financial buyers" are considered to be those that are not able to create economies of scale, such as a successor buying into a business or acquiring a practice, without gaining any synergies from the acquisition. In this scenario, the primary interest is the cash flow from the business, and there are minimal—if any—operational synergies created. On the other hand, "strategic buyers" have a specific interest in acquiring practices that can create synergies by combining acquired operations with their own. Recognizing this difference between buyers will help provide clarity regarding differing opinions of value.

A financial buyer's focus is on the returns generated from the current operations of the business and his or her ability to modify the bottom line. A business that focuses on growth and increasing profits for its owners while paying reasonable and competitive compensation will be perceived by financial buyers as being more valuable than a business with greater operational costs and higher levels of owner compensation. In other words, if all the revenue flowing into a practice is consumed by compensation, a financial buyer's return is diminished and his or her perception of value is eroded.

Strategic buyers are less concerned with the operational expenses of the existing ownership. They are motivated by the efficiencies that can be created by acquiring clients in bulk and the ability to amalgamate various expenses such as compensation, rent, utilities, office expenses, and travel. These buyers are often willing to pay a premium as a result of creating economies of scale when compared to financial buyers.

Table 7.1 is an example of a strategic buyer's acquisition.

Table 7.1 Example of a Strategic Buyer's Acquisition

INCOME	COMPANY A	%	COMPANY B	%	COMPANY B*	%
Total Revenue	$1,000,000	100	$2,000,000	100	$3,000,000	100
Operational Expenses	$600,000	60	$800,000	40	$1,000,000	21
Expense Percentage	60%		40%		33%	
Operational Profit	$400,000	40	$1,200,000	60	$2,000,000	67

**After acquisition of Company A. Assumed 33% of total operational expenses transfer from Company A to Company B.*

The strategic buyer in Table 7.1 is able to acquire the clients and generate the same level of revenue as was generated pre-acquisition. The benefit to the buyer, which leads to an increased perception of value, is the ability to significantly reduce the amount of overhead necessary to operate the business. Instead of two separate operations generating a combined profit of $1.2 million, Company B, having its own operational structure, will acquire Company A and assume about 33% of its overhead. As a result of this synergy, Company B's revenue increases to $3 million and expenses increase to $1 million, which increases the profit margin after operations from 60% to 67% (or $2 million). In this scenario, which represents a majority of the acquisitions that occur in the investment advisory industry, a seller's operational inefficiencies are less important to a strategic buyer.

A sale involving a financial buyer, however, paints a somewhat different picture. A financial buyer may be a key employee being offered the opportunity to "buy in" to the practice, and as such rightfully has concerns regarding cost structure, operational efficiencies, return on investment, growth, and financially stability of the company. All of these factors need to be enticing enough to make buying equity financially feasible and worth a buyer's investment. This scenario also plays out with small-book acquisitions as well as mergers between similarly sized practices.

Financial buyers are looking for different benefits in a purchase than are strategic buyers. Oftentimes this difference is due to the way the buyer is gaining ownership—through an internal buy-in or an external acquisition. Understanding the differences in these circumstances as well as the buyer's focus can be helpful for an owner in identifying his or her buyer, as well as where to position the business to realize the greatest value.

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