ClearLight Partners LLC

DON'T STAY PAST MIDNIGHT:

HOW TO KNOW WHEN IT'S TIME TO SELL YOUR BUSINESS

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INTRO

As of today, we are currently amidst the longest period of economic expansion in our nation's history. To put this in perspective, between 1945 and the trough of the Great Recession in the late 2000's there have been 11 periods of expansion that lasted, on average, 59 months. Presently, we're around 120 months into a growth cycle. So, it's hard not to wonder about when the next recession is going to arrive given that it seems content to be fashionably late.

You've probably heard the saying, "Pigs get fat, hogs get slaughtered." This essentially means, do your best to maximize your outcome, but don't wait too long and miss out on the prudent window to sell. As investors, we can't and don't attempt to time economic cycles, but there are indicators that we've learned to recognize to determine the best time for an exit. In this guide, we're going to explore the following six business and market conditions that suggest that the timing could be right:

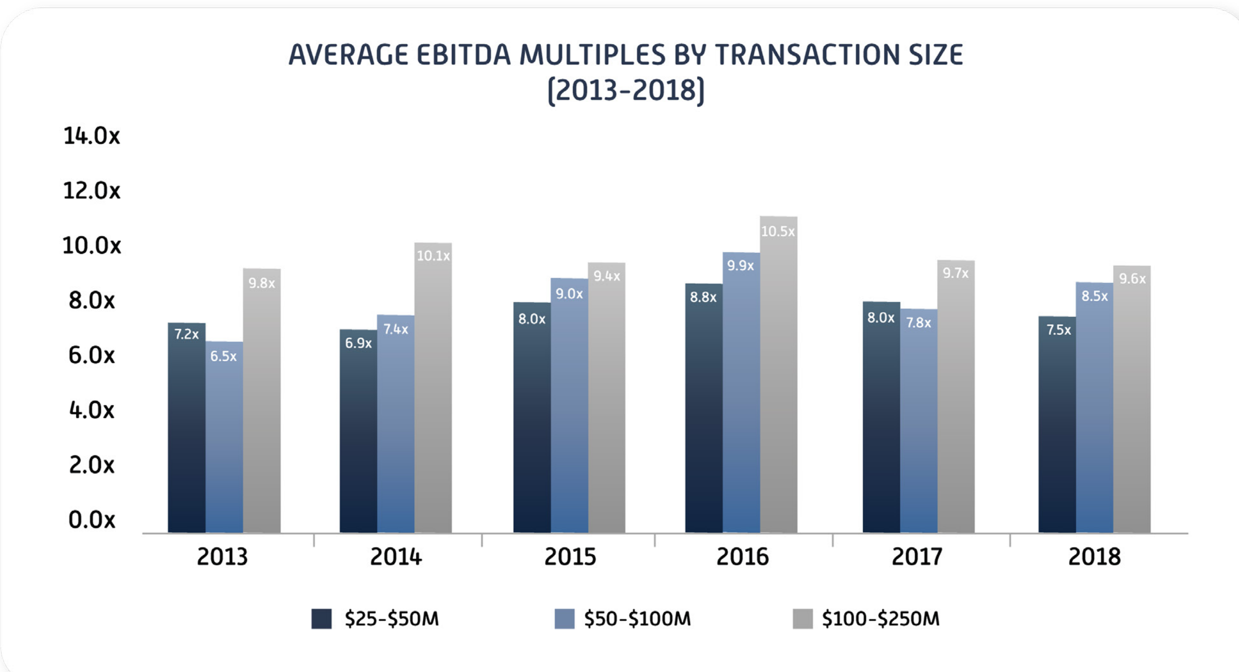
1. Valuations are Historically High
2. You've Experienced Multi-Year Growth in Revenue and Profits
3. Expected Proceeds from an Exit Exceed Your Previously Defined Goals (i.e. You'll Hit Your "Number")
4. Your Industry is Experiencing Tailwinds from Positive Trends
5. Value Remains for the Next Buyer
6. You See Your Competitors Deciding to Sell

1

VALUATIONS ARE HISTORICALLY HIGH

You can't plan for a favorable market to exit, but there's more than enough data readily available to help you assess where valuations sit relative to historical levels. If valuations are at a premium to where you bought in and/or are elevated compared to prior averages, this can be a positive indicator that the timing for a sale is good.

In case you're wondering, "Yes, Virginia, valuations are indeed historically high." This is due to a host of factors including a substantial amount of uninvested capital (or, "dry powder") controlled by an increasing number of private equity funds, sustained low interest rates, and the emergence of other types of investors (e.g. family offices, independent sponsors, search funds). To put some numbers around the discussion, please see the chart below that highlights the average EBITDA Multiples for companies valued between $25-$250MM. There have been some ups and downs over the past several years, but it's an undisputed seller's market right now.



Source: Pitchbook

And, don't just take our word for it. Andrew Carnegie said, "As I grow older, I pay less attention to what men say. I just watch what they do." Consider how people who do this for a living, the private equity community, have behaved in this period of elevated valuations – many are selling anything that isn't nailed down.

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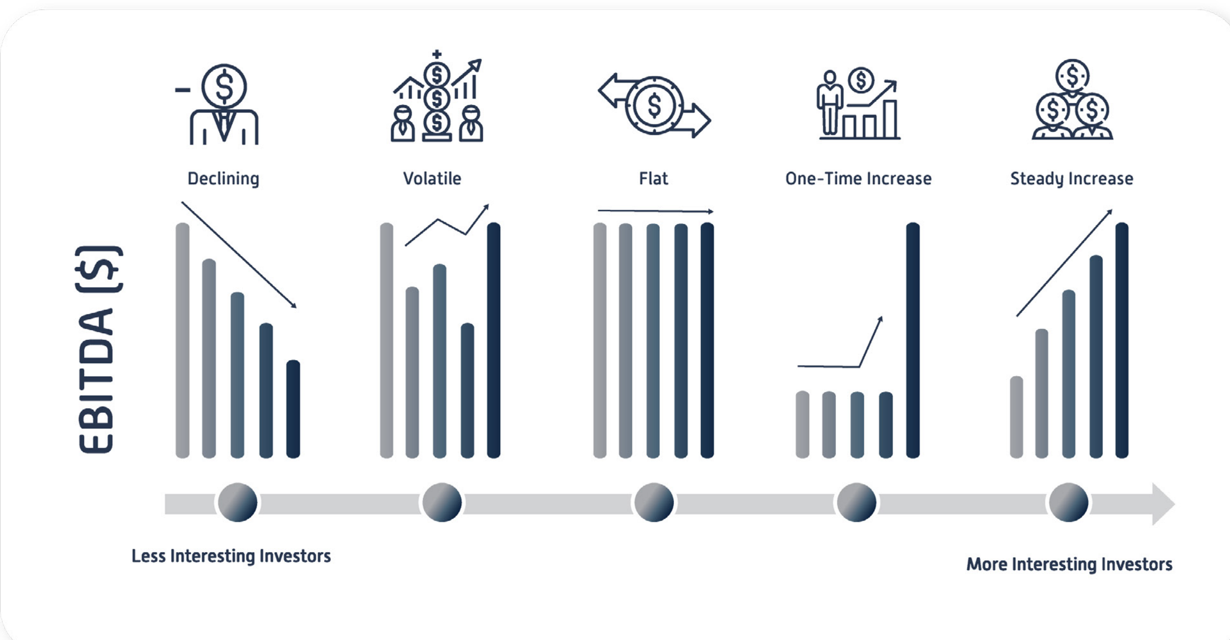
YOU'VE EXPERIENCED MULTI-YEAR GROWTH IN REVENUE AND PROFITS

Bruce Lee said, "Long-term consistency trumps short term intensity." This certainly applies to how investors will assess the quality, sustainability and growth potential of your company's cash flow. For instance, if you have a great year with outsized profitability, it can be tempting to conclude that you should exit to capitalize on a multiple being applied to your inflated earnings. However, if your pop in EBITDA seems to be attributed to one-time revenue wins or other unsustainable factors, a buyer is not likely to give you full credit for it. Further, if your financials have had significant volatility over the years such that there are a lot of ups and downs one year to the next, you're not going to garner the same multiple as a business that elicits more confidence in future growth.

Conversely, if you have generated a steady upward trajectory in revenue and profits across multiple consecutive years, it will increase a buyer's conviction that your historical results are replicable. Given that the economy has been relatively healthy since the recovery from the Great Recession, we like to see steady growth at the top and bottom line since 2011 (or so) through the present. The following exhibit will give you an idea for how an investor might value a company based on its historical performance:



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EXPECTED PROCEEDS FROM AN EXIT EXCEED YOUR PREVIOUSLY DEFINED GOALS

Most professional investors have a pre-defined notion of what "good" looks like from a returns perspective. Classically, in the private equity business a good outcome is doubling or tripling your money in around 5 years. Private equity funds might also describe success in terms of IRR %. Therefore, when considering an exit, if a private equity firm has reason to believe that a sale will generate returns that exceed its pre-defined thresholds, then this becomes a fairly black and white input that helps inform the exit decision. The benefit of defining these metrics ahead of time is that it wards off the judgement clouding effects of fear, irrational optimism, and/or whatever your gut is telling you that day.

However, returns metrics are likely not how you as a business owner are looking at the world. We've found that many entrepreneurs have a round number (after tax) in mind that they want to hit in order to have a post-transaction existence that fulfills their visions for the next phase of life. This number might contemplate future travel, real estate purchases, boats, starting a new business and/or allocation of the sale proceeds to family members. So, using the information available to you regarding valuation multiples, you should have a pretty good idea of whether a sale will allow you to hit your number. If it does, then considering an exit might be a good idea.

Here's a simple example to drive home the point:

Your Hypothetical "Number" = $20MM ($mm)

	X Too Soon To Sell	✓ Maybe Not Too Soon to Sell
Assumed Trailing-Twelve Month EBITDA	$3.0	$5.0
Exit Multiple	5.0x	7.0x
Gross Proceeds*	$15.0	$35.0
Less Capital Gains @ 33%**	($5.0)	($11.7)
Net Proceeds	$10.0	$23.3
Your "Number"	$20.0	$20.0
(Shortfall) / Excess Relative to Your "Number"	($10.0)	$3.3

Your net proceeds in this example exceed your "Number" by $3MM, so the timing might be right.

*Assumes the business is debt free at the time of sale
**For simplicity, 33% tax rate applied to Gross Proceeds

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YOUR INDUSTRY IS EXPERIENCING TAILWINDS FROM POSITIVE TRENDS

If there's one thing we've learned from investing in private companies for nearly 20 years, it's that getting the industry right is a powerful force in driving good investment outcomes. Not to over-simplify things, but Good Industry + Good CEO has proven to be more than half the battle in most cases. So, we pay close attention to the industry in which a company is operating if we are considering making an investment.

You might be surprised to learn that while we, as investors, like growth, we don't necessarily look for *rapid* growth in an industry to compel the pursuit of a deal. In fact, if we see graphs with industry growth rates that are too steep, we may often conclude that the sector is better suited for a VC investor who has the stomach for the valuations that accompany such growth.

In general, we want to invest in companies whose industry growth is comfortably beating GDP for tangible reasons, and we've historically pursued businesses operating in sectors with 5-15% expected annual growth for the foreseeable future. Ideally, this growth is being propelled by factors that are easy to understand, concrete and sustainable. Said another way, if you can explain why your industry is growing to a family member with no prior familiarity of it, then that is a good starting point. Further, all industries go through cycles, so if you are currently on an upswing and can explain in simple terms why favorable trends are likely to persist, then this should resonate with investors.

Here's a simple example to illustrates how an investor might evaluate the relative attractiveness of your business based on the growth of the industry in which you're operating:

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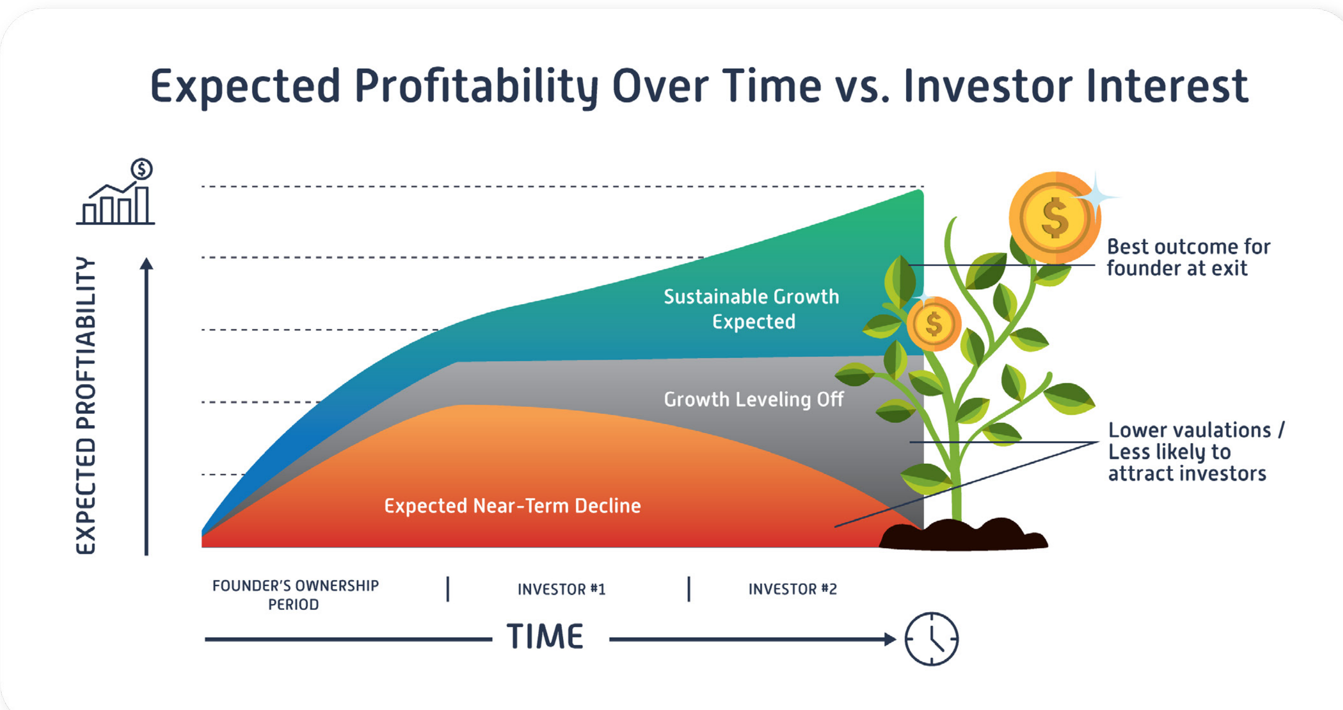
VALUE REMAINS FOR THE NEXT BUYER

Think of it this way, nobody would purchase a lemon with all of the juice squeezed out of it, right? Perhaps a lemon is not the best example here, but you get the point.

Sometimes, an owner's decision to exit is driven by the threat of looming headwinds to the business or industry. Conceptually, getting out before these challenges arrive makes sense, but it's likely that investors are already, or will be, attuned to those same issues, and it may then be too late to drive an optimal outcome from a sale. At a minimum, investors are going to need to know that the prospects for growth will remain strong for the next 5-10 years. Otherwise, they may encounter challenges when *they* ultimately seek an exit. Said another way, if you are considering an exit, <u>reflect on whether you would want to invest in your business today</u>.

To drive home the point visually, take a look at the following chart that illustrates how an investor may assess the relative attractiveness of your business based on the expected growth in profitability over time. The punchline is that your prospects for an exit are substantially improved if investors see a sustainably bright future for the company.



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YOU SEE YOUR COMPETITORS DECIDING TO SELL

Remember when your mom said, "If your friends jumped off of a cliff, then would you do it too?" Well, maybe you would if the cliff was a metaphor for selling your business and valuations in your industry were historically high, you'd experienced consistent growth in Revenue and Profits, a sale would allow you to live in a manner consistent with your goals, your industry was benefiting from an upswing, and the business would make for a good investment by an investor's standards.

If you assume that (i) an entrepreneur's business is their most valuable financial asset and (ii) that they are not likely to part ways with it unless one or more compelling factors drove them to the conclusion to sell, then news of a competitor deciding to exit should result in some real introspection on your own exit timing. And, an ancillary benefit of a competitor proceeding with a transaction is that you can often triangulate around the purchase multiple once the gossip mill starts humming about the deal. It goes without saying that just because your peers in the industry decide to sell, it doesn't mean that you have to. Perhaps you have a higher risk tolerance than they do and your patience will pay off. Just recognize that forces could be at work that are creating a good window for an exit.

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THINK IT MIGHT BE TIME TO SELL?

ClearLight Partners has invested in over 20 privately held businesses during its nearly 20-year history. We have a proven process to usher founder and family-owned business through a change of control transaction and to help shareholders achieve their personal & professional goals. Please contact us to have an informal conversation about how we'd approach a partnership with you and your company.

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ABOUT CLEARLIGHT PARTNERS

ClearLight Partners is a private investment firm in Southern California that invests in established, profitable middle-market companies with significant growth potential. Since inception, ClearLight has raised $900 million in capital across three funds from a single limited partner. The team at ClearLight has extensive operating and financial experience, and has a history of successfully partnering with owners and management teams to drive growth and create value. For more information, please visit www.clearlightpartners.com.