SUBSCRIPTION ENTREPRENEUR

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The Smart Way To Sell Your Business with John Warrillow

“There's something in the mergers and acquisitions world called the “5 to 20 Rule.” That states that the natural acquirer for your membership site is going to be a business 5 to 20 times the size of your company. By definition, it's likely a company you've heard of, likely a company you respect and likely a company much larger than yours.”

INTRO:

You're listening to John Warrillow, my special guest on today's episode of The Subscription Entrepreneur Podcast.

If you're not familiar with John, he's the best-selling author of three books that are "must reads" for anyone in the membership or subscription world.

More than that, he's an expert in helping entrepreneurs design, build, and scale truly valuable businesses.

You know... the kind that can be sold for life-changing amounts of money.

And that's what today's episode is all about.

In our conversation, John reveals why recurring revenue businesses are so attractive to potential buyers. And we explore what the process of selling a business actually looks like.

John’s a wealth of information and shares many real-life stories of people who have built and sold their own membership and subscription businesses.

Plus, you'll discover some practical steps you can take to get your business ready to sell and the biggest mistakes you should avoid in the process.

Even if you never plan on selling your business, this episode is full of insights and advice that can help you make it as valuable as possible.

As always, I'm your host Eric Turnnessen and this is Episode 166 of The Subscription Entrepreneur Podcast.

Eric: Welcome to the show, John.

John: Thank you, sir. Good to be with you.

Eric: It's a pleasure to have you. I appreciate you so much for taking the time to join us. We actually recorded an interview with you back in June of 2015. In that conversation, we explored a lot of the topics you wrote about in your second book, The Automatic Customer. Since then, it seems like the rest of the world has caught up to your ideas because now membership and subscription businesses are everywhere.

At this point, you have three books you've written, Built to Sell, The Automatic Customer and the brand new one, The Art of Selling Your Business. Can you give us a high-level understanding on the relationship between these books and when one would reach for one versus the other?

John: Built to Sell is really about how do you create a valuable company that's not dependent on you personally. The Automatic Customer you referenced is really about how do you create a recurring revenue company and how do you optimize that? Then the final book, The Art of Selling your Business is really about the process of harvesting the value you've created. You hear all the time about SaaS businesses, membership businesses, ones with recurring revenue that are now trading at multiples of revenue rather than multiples of profit.

A lot of people, in particular those that are in that recurring revenue space are saying, "Well, maybe that was the time I could actually realize some value for all the sacrifice, and that's really The Art of Selling Your Business, is about how do you punch above your weight when it comes to selling your company?

Eric: Perfect. Thank you for that. Now, for those of you who haven't heard our earlier conversation, I highly recommend checking it out. There's a lot of valuable information in there and we'll include a link in the show notes. Now John, it's been some years since we recorded that and from your perspective, how has the landscape shifted for recurring revenue businesses in that time?

John: I think it's even gotten better as a result of the pandemic. The pandemic has been catastrophic for so many people, but for others, in particular membership companies, subscription offerings, I think it has been a boon. Look, people are at home, they've got time, they can start to consume some of these things.

I'll give you an example. Fender sells most of its guitars, of course, through retail outlets. When they sell through a retail outlet, somebody buys a guitar, they very rarely find out anything about the end customer unless they choose to register the guitar with fender. It's just a complete indirect business model.

Well, after the pandemic, they built out a whole subscription offering on teaching people how to use the guitar. Creates another recurring revenue stream for them, it creates a recurring revenue stream for them and gives them a direct relationship with their customers. I don't know if that's possible five years ago. It certainly is possible in the context of kids learning at home and just very comfortable with the online world. I think the pandemic, it certainly accelerated the adoption, a lot of digital offerings, including membership offerings.

Eric: We've definitely seen increased interest in our offering as a result to the pandemic. A lot of people with more time on their hands and wanting to build a virtual or digital offering. But we also see that the same ratio of people fail at getting things off the ground. Just because there is more interest doesn't mean that there's more people having success at starting a business.

Now, a lot of what you focus on in your books are teaching people how to create value in their business, even before they may be considering selling it. What are some of the things that we can do on a day-to-day basis to get our businesses to the point where the acquisition market would value it?

John: The market, when they look at acquiring a business, they're looking for your future potential, usually in their hands, but they're really looking to the future. They're going to look at your growth rate and try to graph that onto their business model. The growth rate of your membership model, your recurring revenue model is going to be important.

They're going to care much more about your recurring revenue than they would your one-off or transactional revenue, so really optimizing your recurring revenue. It can have massive, massive impact. I just got off the phone earlier today. I did an episode of my podcast with a guy named Adii, I hope I'm pronouncing his first name correctly, Pienaar, a South African guy, built a company called Conversio, up to $2 million of recurring revenue.

Well, when he went to market, he was getting offers of three and three and a half times top line revenue. Amazing output, but [inaudible 00:04:32] of the company and out the acquirer can look at that and graft it onto their business.

Eric: Is that something you were seeing before the pandemic or is that a reflection of recent increased appetite for recurring revenue businesses?

John: I think there has been, as a result of the pandemic, a whole army of private equity groups that have seen digital applications, digital products to being a very hot sector. We're seeing lots of different private equity groups start to really gin up the value of these companies because they're seeing the digital adoption happen. There's just a whole legion of private equity groups that are buying these digital companies.

Eric: Now in your most recent book, The Art of Selling Your Business, it's a playbook for small business owners that they can use to successfully navigate the complex and sometimes overwhelming process of actually selling their business. Now, given when you're just talking about, the thing that comes to mind, this voracious appetite of private equity firms, does that mean it's akin to a sellers’ market? Does that change how these companies are doing deals with businesses?

John: Yeah, look, it is very much a sellers' market right now. The pandemic has caused interest rates to drop to emergency levels. Buyers, when they buy businesses, they're often using debt in to maximize their return on investment. As a result, evaluations are going up in lockstep and we're seeing this across the board. It's not just small and medium sized businesses as you're seeing in stocks of Tesla, shares of Tesla, Bitcoin. Assets are accelerating very, very quickly as interest rates are dropping.

When an acquirer makes a purchase, they're going to use debt and therefore when debt is cheap, valuations go up. We're seeing lots of examples of these astronomical multiples so it's very much a great time to sell. I'm reminded of one of the people I wrote about in the book, a guy named Rand Fishkin. When it comes to the best time to sell, he learned this very important lesson, that the best time to sell is when somebody's buying.

Right now, there's going to be a lot of acquirers in the marketplace looking for companies. Rand had a great business. He did SEO, optimization software, and so it's called SEOmoz. Built it up to $5 billion in recurring revenue and he was under the impression that he should be trading at about four times revenue.

But the trick was that he was going from five, he expected it to be at 10 the next year. In Rand's mind, his company was worth like $40 million, five, but going to 10 and then times the 4X multiple. He got a call from a guy named Brian Halligan and Halligan is co-founder of HubSpot. Halligan approached Rand and said, "Look, we're thinking about buying your company. And Fishkin said, "Okay, what do you think it's worth?" Brian made them an offer of $25 million of cash and HubSpot stock.

Fishkin had this $40 million number rolling around in his mind and so he chose to turn down Halligan's offer. Instead he raised venture capital, built out a whole different suite of products. Unfortunately, many of them failed and it caused a cashflow crisis in Rand's company. Ultimately, he was removed as the CEO. He actually went through a period of depression where he was diagnosed and went through a very difficult personal period.

Since then he's come out of that and landed on his feet but I interviewed him for the book and I said, "What's your stake in Moz work today?" He said, "John, it's probably not worth anything." I said, "What you mean it's not worth anything?" He said, "Well, based on the way the venture capitalists invested, they use preferred shares and so they're going to get a preferred return. They're going to get all of their return before I get anything."

I said, "Gosh, that's several. What was that offer from HubSpot work today, if you take into consideration the appreciation of the HubSpot stock?" He said, "Well, based on what's happened to HubSpot stock over the years, that offer today would be worth close to $200 million." It's just a good reminder of this idea that the best time to sell your companies when somebody is buying. For a lot of membership companies, a lot of digital companies with recurring revenue, if you've built a successful business, you're going to be a very attractive candidate. If you've got a great offer, it is a great time to consider it.

Eric: If then these people listening, they potentially have a situation where they could sell their company. They have some value that they see in their business. What are some steps that they can take to be proactive about that and putting themselves out there?

John: You're going to want to go, I mean, lay out a whole process in The Art of Selling Your Business about how do you create this competitive landscape for your company, where you've got acquirers effectively bidding over you, bidding one against the other. But before you even start that process, you're going to want to do, I think something called pre-diligence.

Which is effectively assembling all the critical information about your company. What's your recurring revenue? What's your churn rate? What's your involuntary churn versus voluntary churn. All the stuff that you would expect and acquirer to care about in advance and now you're saying, "Well, why on earth would I spend all the time doing that before I even get an offer, before I even start the process?" Here's the reason.

I learned this from Michael Houlihan who started Barefoot Winery. I interviewed him about the sale of Barefoot and Barefoot was a great brand. They built out a ton of distribution at Trader Joe's in the U.S. Houlihan thought that the most natural strategic required for his company was E. & J. Gallo, the big U.S. wine maker. Houlihan thought he'd have one shot at impressing E. & J. Gallo, so he did all this pre-diligence stuff.

He put together his binders, all of the information that he expected E. & J. Gallo to want and to ask about. He went off to E. & J. Gallo with these binders and he said, "That benefited me in two ways." I said, "Okay, what are the two ways?" Well, number one obviously, it helped accelerate the process for them valuating the business and ultimately coming up an offer.

I said, "Okay, what's the second reason?" He said, "Well, it communicated to E. & J. Gallo that I was dressed for the dance. In other words, I was going to sell my company and E. & J. Gallo had an opportunity to buy it. But if they chose to not buy it or drag their feet, I was going to the next competitor.

Having a very polished pre-diligence package communicates to everybody that you are going to market. They will have a shot, but if they miss that shot, it will be gone forever. That's the second reason I think you want to do some of this, what I refer to as pre-diligence upfront before you even start the process of getting bids or getting offers for your company.

Eric: Got it. With that in mind, what are some of the other... because it sounds like that's a mistake that a beginner could make, is not to do the pre-diligence. What are some other mistakes that you see business owners making when it comes to selling their business or approaching it?

John: Giving way too much information early is a huge problem. When you get approached by an acquire, there can be really two or three reasons why they are approaching you. One is a legitimate interest in buying your company. The other is really not. The other is they're using the veil of an acquisition in order to either pick up secret information about your business or find your employees.

I'll give you an example. There is that a private equity company I wrote about in the book where they decided that they wanted to enter a new industry. They were doing a roll-up in that industry. They used a vague letter of intent as a way to get inside 80 different companies. They used this very vague letter of intent, didn't stipulate earn-out or offer price, gave a range, but it was very vague.

But when acquires got this letter of intent from this private equity group, they were all excited and thought, "Man, I'm going to sell my company." They started down the process of revealing way too much, way too early. Including letting the private equity company interview their managers. Well, long story short, they interviewed 80 different companies.

They made two acquisitions and then they turned around and stacked the management team of those two companies they acquired by poaching the C-level executives from all the other 78 companies. They went out and use this veil of an acquisition. That's one of the biggest mistakes that I think entrepreneurs make, is we reveal way too much too early in the process, and including letting an acquirer potentially even talk to your employees.

Eric: Well, I could see definitely one challenge there if I put myself in one of those people's position, is how do you know what's the information that's too much to share? Because you talk one hand about creating a pre-diligence packet, which has information in it. But then there's other information that shouldn't be in it. How do you know?

John: Well, I think you want to run... Again, we outlined this entire process in the book, but the first step of the process starts with what's called a teaser. A teaser is a one-page document, which effectively, it teases the acquirer into wanting to learn more about your company. I remember I learned about these in a funny way. I was in an EO meeting and an EO member that I was on a board... EO stands for entrepreneurial organizations. It's a mastermind organization.

I'm in my EO meeting and this guy named Sam, in all of our breaks, in all of our downtime had this little piece of paper he kept unfolding and working on. It was like this dog-eared ancient piece of paper with all sorts of cracks and crevices in the highlights. You could tell he'd been working on it for years.

Finally, I'd gotten to know Sam well enough to turn around and say, "Sam, what's with the piece of paper? What is that thing?" He said, "It's my teaser." I said, "What do you mean it's your teaser?" He, "Well, that's the document I use to market my business to potential acquirers." He was working on it for years leading up to the sale of his company, but the teaser's important because it's how you position your business in the eyes of an acquire.

It's what industry are you in? How fast are you growing? What are your churn rates? What is really unique about your business. But it does not include the name of your company. It's sufficiently vague to force acquires to remain curious about who you are. The teaser, if written well, will trigger an acquirer to sign a nondisclosure agreement in order to get what's called a CIM, and that's when the name of your company is revealed.

But it's only revealed after a nondisclosure agreement is put in place, and usually if you're working with a good lawyer, that also includes a non-solicitation. You're covering the process legally so you're minimizing the chances that someone would use the veil of an acquisition in order to learn your deepest darkest secrets.

Eric: In this situation, going back to the story about the private equity firm who interviewed the 80 different companies, in that situation were none of those people signing non-disclosures? And if they had, would that have protected them against the ultimate outcome of that situation?

John: Yeah. That example, it was where the private equity group used, again, this fairly vague non-committal letter of intent as a way to get inside under the covers. The sellers were not proactively running the process I'm describing. They were on their back foot reacting to an inbound inquiry. When you're reacting effectively, you're playing defense. They are basically approaching that company, and so no.

The private equity company would not have been in their best interest to sign an NDA so they in most cases would not have signed an NDA with the acquiring companies. They're simply using, again, the veil of an acquisition in order to get an entrepreneur excited enough to start to open their kimono way too early.

Eric: I've had that experience. I don't know if it was tied to the same thing, but I've definitely over the years had a number of emails from private equity groups, venture capital, and a lot of the times it ended up being some intern level type person who you end up talking to and they're interviewing you about something and asking you information. Is that the situation?

John: Yeah. I think you can tell a lot by who's doing the asking. Again, I'll go back to Adii Pienaar, the entrepreneur I referenced early in the conversation that built this company called Conversio. He went out and sent the teaser document that I'm describing to 150 different businesses, and received lots of different inbound inquiries based on the teaser.

Now, he bucketed or divided the inbound interest into two buckets. There are the vaguely interesting opportunities and then there were the very, very serious buyers. I asked him on the podcast, I said, "How did you distinguish between the two?" He said, "Well, it came down to who was making the inquiry." When the inquiry came, in his case it came from a company called Campaign Monitor, very established strategic acquirer, and they were owned by a private equity group.

The private equity group person making the ask of Adii or raising his hand saying he was interested in the teaser was a senior partner from the private equity group. Which was a very strong buying signal. Had it been an analyst level person at the private equity group or a vice-president at the private equity group, that would have fallen into the first bucket of vaguely interesting. But when a senior partner from a private equity group that is backing one of the strategic acquirers reached out, he knew that was a really strong opportunity.

I think asking yourself, what's the title on the business card in the footer of the email? Most private equity groups give away vice-president titles to newly minted MBAs and young kids right out of school. It's not a big title. Whereas senior partner or partner is a much more indicative of a decision maker within a private equity group.

Eric: There's a lot of reasons so far that we've talked about given the nature of the environment and the pandemic and everything, that it seems like an ideal time, sorry, it doesn't seem like, it is an ideal time to sell a business. That might get a lot of people excited. We've talked a little bit about, okay, well, if you are, what can you do to start that process? A lot of it's outlined in your book and we touched on a few things.

But I'm interested in a higher-level picture here because entering into this for someone like me who's never sold a business. What is that experience actually like? Is there a way that we can get a high level, just piece of what the race looks like from start to finish of what the experience is going to be like to sell a business?

John: Yeah. Look, there's a couple of key gates along the way. The first as I referenced, is in a formal process itself, is a teaser. Again, you're probably talking hundreds of different companies that you're going out to with a teaser. Strategic acquirers, private equity groups and individual investors. Then the next gate, if you will, is that some of those people will raise their hand and say, "Yeah, I'm interested enough to sign a nondisclosure agreement." At which time the second gate or second step in the process is a confidential information memorandum or CIM. This is a document that you put together that describes more detail about your business.

That's when you get into details about your products, your growth rate, your future projections and so forth. Then based on the CIM, the next gate is that some people will raise their hand and say, "Man, I really liked this company. I'd like to meet with a management team." That's the step in the process where you're meeting, what are called management meetings. These days they're held over Zoom but before they used to be held in-person. That's when you will be grilled with a litany of questions from potential acquirers.

Then that then breaks down into another round of what are called letters of intent, where the people that you've met within the management team meetings will put their letter of intent together, which is a written, usually non-binding offer for your company. You then will have to sign as part of all those letters of intent, they will likely be a no-shop clause. Which means that if you sign a letter of intent, you will end up giving up the rights to negotiate with the other potential acquirers. It's at the letter of intent stage that you're trying to effectively maximize the value of your company.

In the case of Adii from Conversio, he went out more than a hundred different acquirers. He did management presentations with a number of different companies. He got two formal letters of intent, but instead of just signing one of them, he basically used the fact that there were two competing bidders for his company and played one off the other to a point where he was able to raise the value he got for his company by 35%.

Just strictly negotiating playing one off the other, off the other in a sequence of back and forth negotiations. Then there's the process of due diligence. Then there's a closing meeting where the check gets wired to your bank account. That's effectively the process. Does that answer your question?

Eric: Yeah, for sure.

John: ... about the 30,000-foot level?

Eric: Yes. It still leaves one question in my mind, as someone who started the company from scratch, which is after the check is in the bank and all of that is done, what happens to the company? What happens to the people who work for the company? Of course, this is going to be different depending on the circumstances, but what are some of the usual ways that this goes through?

John: As the owner, you're likely to have to agree to some form of transition period where you stay on in the business. That can in a very small company, if let's say you have $300,000 of revenue and you have a membership website, well, the most likely acquirer for that business is going to be an individual investor. Someone who has an interest in that space and they are likely going to need to borrow money.

When they borrow money, they often do it from the SBA in the United States and the SBA will guarantee a loan, but they'll often ask you to finance some of their money in what's called vendor financing or vendor take-back. Whereas in effect, you're putting some of your proceeds at risk and agreeing to take it over time. That's one potential transition function.

Another is where usually in a private equity deal, you'll be asked to roll some equity into a new entity. Now, what does that means? It means that instead of buying a 100% of your company, they will likely buy 60, 70, 80% of your business and then say, "But we want you to hold on to 20, 30, 40% and we're going to roll that into a new legal entity. Over the next five or seven years, we're going to grow that up to a point where it will hopefully be a sellable asset."

In that case, you're still a shareholder of the business and a minority investor in the company. You're oftentimes asked to continue to run your business, even though you don't own the majority of the shares anymore in a private equity deal. Then the third scenario, a strategic acquisition, oftentimes the acquirer will use what's called an earn-out, which is a way to effectively set a set of goals for you as a division of their company and if you achieve those goals in the future, you'll receive an extra chunk of value.

Those are the three most likely scenarios, but in any event, you're likely to be asked to stay on for a period. Could be as little as a year, could be as long as seven years depending on the structure of the deal.

Eric: Got it. Do you have any examples of content-based businesses being sold, like membership sites, community sites, et cetera?

John: Obviously, there are lots of examples out there. One of my favorite is a guy named Trevor McKendrick who built a Spanish language Bible application. It was basically, as the name suggests, it was an application where he took the Bible and translated in Spanish. He had a million users and he sold the business and a great little exit. It was not a big company, five or $600,000, as memory serves in a way of revenue. But a successful exit for him for sure.

Again, in a recurring revenue businesses, there are different types, obviously. There are membership websites, membership offerings, and then there are SaaS companies or software as a service companies. What I would encourage anyone in the membership space to look carefully at is going to be your churn rate. Because an acquirer will really scrutinize your churn rate.

From what I've experienced, membership websites, often business to consumer membership websites have a higher churn rate than a business-to-business membership website. I don't know. Would that hold true for you, Eric? Is that what you've seen among your customers?

Eric: For sure.

John: In lockstep business to consumer membership websites generally trade at a lower multiple than business-to-business membership websites because the business-to-business membership is perceived as being stickier. It's got a lower churn rate and churn is going to be one of the biggest drivers of the value of your company.

When you've got, let's say 5% share in a month on $100,000 in revenue, or $100,000 of ARR as an example, well, that's not that much to replace, but if you have a million dollars of ARR $10 million of ARR, 5% churn a month would be virtually impossible to replace. The bigger your company gets, the more likely it is to slow down if you haven't been able to manage churn. Churn is going to be a really important driver.

If you have a model where it's virtually impossible, you've just got some natural churn... If I just go back to Adii's business, Adii had Conversio, it was a $2 million business. They had 5% monthly churn. I asked Adii to break that down, that sounds pretty high, that's 60% annually.

How does that break down? He said, "Well, we were selling to the SMB market and they were selling people who use Shopify as their E-commerce engine.

Shopify attracts a lot of new business owners, a lot of brand-new entrepreneurs who don't necessarily know what they're doing. When you unpack the 5% monthly churn, it turned out 4% of it was involuntary churn. Meaning it wasn't their decision. The business had gone bankrupt and therefore didn't need Conversio software anymore.

Again, you're going to want to look, get a handle on churn overall, but try to isolate your involuntary churn and your voluntary insurance. It's one of the reasons by the way, that membership sites and SaaS companies that sell to larger enterprise organizations are generally valued at a higher multiple than those selling to the SMB or small medium business market. Just because the involuntary churn in the SMB market tends to be quite high because people go in and out of business at a higher rate.

Eric: We definitely experienced that. That's pretty much we're in a similar situation at Shopify because we're a provider of a service that people need as the foundational building block of a business, so we have anywhere from people who just woke up one morning and want to start a business this weekend, to people that are on their third or fourth recurring revenue business and know exactly what they need to do, have a development team who's a very experienced all this other stuff. Our involuntary churn is, I've always looked at it as it's the same percentage as when people give a quote of how many people go to start a business and fail.

John: Absolutely. Unfortunately, an acquirer is not going to look at that and say, "That's fine. That was involuntary churn." They're still going to discount because you had an involuntary churn, because they're going to say, "Regardless of why they churned, it's still churn." What you can try to do as best you can, is manage down your net churn rate.

Your net churn rate, as you probably know, is the difference between your gross churn and your upgrade revenue. If you've got any upgrade path that you've got with existing customers, let's say you have a silver membership program and you have a gold membership program, if you can offset some or even all of your gross churn with people who upgrade from silver to gold, as an example, well, now you've got a very valuable company because you can make the case that on a net basis... If you can get to negative net churn, that's really the panacea.

It doesn't always happen. It's very, very high bar to reach, but when it does, it can absolutely jack up the value per capita. I'm reminded of Rob Walling who built a company called Drip. Drip does email marketing, where he was at the point of having $2 million of annual recurring revenue. Not a really big company, but he had successfully managed churn down to negative net churn, which means that his upgrade revenue actually exceeded his gross churn. Because he charged on number of contacts in his system.

The more contacts you uploaded into Drip, the more he charged you and as a result, he was able to achieve negative net churn. Well, when he sold Drip to lead pages, he was looking at offers in the nine to 12 times revenue. Not nine to 12 times earnings but nine to 12 times revenue. Again, that's the top, top, top, top, top end of valuation. But it's possible if you are able to manage down your churn to a negative net churn number.

Eric: That's really amazing. When you're in the negotiation process, obviously in any industry where there's huge opportunity, you have different levels of people with different levels of ethics approaching how they're going to succeed in accomplishing their goals. As people with different experience levels are going through this process of selling their business, what are some of the things that they can and should look out for in terms of knowing if they're building the relationship with the right partner?

John: Look, I think you want to understand how the acquirer is going to get a return on their investment. In particular, that's going to be really important when a private equity company is looking at you by your business. Because a private equity company is not buying your business for lifestyle reasons. They're not buying your business because they love your brand or they love your product.

They're not buying it for a strategic reason where your company is worth more in their hands as it is worth in your hands. They are buying your business to flip it. That's what a private equity company do. They buy low and they sell high. I would be asking myself, what do you see as the opportunity to create value? What you're really want to listen for is are you comfortable with the changes they're planning to make?

Let me give you an example. There's a woman named Sherry Deutschmann that I interviewed for the podcast. She built a wonderful business where they did billing software for hospitals. It wasn't a software, actually. It was a billing process for hospitals. You get your kidney replaced and they'd send you a bill. She was the one who actually printed the bill, sent it, later mail out to the patient. Great little business. They started off from scratch and from the early days, she wanted to share the wealth with her employees.

Many of whom were ranking file, people working on the printing press, relatively low paid people and she wanted to share in the profits, so she created a profit-sharing program. First month or two, it was negligible. It was a few dollars on someone's paycheck. But every single month, Sherry brought all the company employees together and described how they performed and how much they were getting in their profit-sharing program.

Well, long story short, over years and years and years, she built this business up to 40 employees, 7 million in revenue when she decided to sell. She got a beautiful acquisition offer from a private equity group and she fell in love with this company and shows to sell to them.

Well, a couple of weeks after she sold, she was still on the board of the company and still very much actively involved when the private equity company came to her and said, "Look, I know you've been doing this profit-sharing thing for a while, but man, it's getting to be a pretty big number and it's really screwing up our return statistics or amount here. We're going to have to eliminate the profit-sharing program." Sherry said, "But guys, this is the part of our culture. This is why people work here. This is the way we give back."

They said, "Yeah, but look over here on line 14 of my spreadsheet here. You can see that if we removed the profit-sharing plan, we increase our return on investment by 16.4%." Long story short, they eliminated the profit-sharing program. When I spoke to Sherry, three of her 40 employees were still at the company. 37 of the 40 had left the business.

Look, everybody loses in that scenario. Sherry loses, her employees lose, the private equity company loses because they've effectively bought something that's cratering and value because the employees are leaving, and nothing good came out of that. Long story short, I think what you want to really scrutinize is say, "Okay, you're a financial buyer. You're interested in buying my company. What are the things you're going to change that will enable you to create a return?" And listen very carefully to the way they're planning to make the business worth more valuable in their hands.

Because by definition, they are going to change the way you do business. They're going to change your processes and procedures, and likely you're the author of those processes and procedures and so it can feel like open-heart surgery when your business is being effectively re-engineered when you're the one who created those policies and procedures. It can be very traumatic for folks.

Eric: Which is personally precisely why anytime I've received any emails like that, I ignore them. Because I think about that scenario. A lot of the building the business for me has been creating a place where I want to work. Essentially, it hasn't been a strategic endeavor in a sense. You know what I mean? It didn't set out from day one, "I'm going to be an entrepreneur and I want to do this and get here and make this and do that." For me, thinking about selling my business, it's a personal choice rather than hard numbers.

John: I get that. At the same time, I think the flip side of that coin and the reason I think a lot of entrepreneurs choose to go down the route of selling even though the potential for a private equity group doing what I just described exists, is they reach something called the freedom point, where they wake up one morning and realize that the sale of their business will create enough liquid wealth they can live for the rest of their lives.

The second thing they realize is that every day I retain 100% ownership of my company. I'm effectively risking financial freedom in return for something I may not want. I've reached the point where the ultimate goal was to achieve freedom, which is, I think that the underlying motivation of most entrepreneurs deciding what they do, what creative projects they work on.

When the sale of your business would create a nest egg for you to be financially independent, you are effectively risking that freedom every day you hold your business. Because we don't know what's around the corner. We don't know if membership websites will fall out of favor or if private equity groups stop buying businesses if interest rates go to 10%.

We don't know what the future will hold and if 50, 60, 70, 80% of your net worth is the shares in your privately held business, it gets to a point where a lot of people just go, I can't stomach the risk. I go back to the entrepreneur I've referenced a couple of times, Adii, he just happens to be top of mind for me because I literally just interviewed him.

I asked Adii, "What triggered you to want to sell?" He said, "Well, really it came down to diversification. I built this business up. They were two million in recurring revenue. He figured that maybe he could get three times revenue. In his mind, it was a $6 million investment. It represented the vast majority of his net worth. The concept of diversification had been drilled into his head from childhood and here he was diversified in his stock portfolio but totally undiversified overall because $6 million represented a huge proportion of his net worth. He just said, I can't stomach the risk anymore. And that's what triggered him to want to sell.

Eric: Well, that makes a lot of sense. If I knew what questions to ask as someone who had some familiarity with this process and et cetera, what questions would I be asking you that I haven't already asked you?

John: Well, I think you've asked a ton of great questions. I think one of the ones that you've asked but maybe I'll provide a slightly different answer to, which is what are some of the most common mistakes that entrepreneurs make in the process of selling their company.

One of the big mistakes we hear is that entrepreneurs will answer the question, what do you want for your company? That's almost always a mistake because you can do one of two things. You can throw it an outlandish number. A number so high that there's no way that an acquirer was even thinking possibly about that number. Here's the problem with doing that. You'll oftentimes be perceived as so out-to-lunch and so unaware of the multiples in your space that the acquirer will go, "Okay, thanks very much." And they'll dismiss you as a quack.

You could throw out some really high number, and it's not like they're going to enter into negotiation with you. Because many of them will just walk and say, guy is a quack. Likewise, if you throw out a more reasonable number, you're almost always putting a ceiling onto which you will never sell your company for.

I'll give an example. There's a guy named Kris Jones I wrote about in the book. He built a great company called PepperJam. They did affiliate marketing programs. Kris got a call out of the blue from a guy named Michael Rubin. Michael built a company, GSI, sold it to PayPal. Huge massive success in the tech industry. Kris Jones was flattered to get a call from Mike Rubin and Michael Rubin said, "Why don't you come down to my office? We'll have a little chat about your company."

Jones walked in thinking he was going to have a one-on-one with a fellow tech luminary. But Rubin, when he opened his door was not alone. He was flanked by his chief financial officer and his head legal counsel. Jones looked a bit of gas to take it back. Without really exchanging pleasantries, Rubin just asked Jones, "Okay, what do you want for PepperJam?" Jones is really, he's like, "What do you think, what do I want for PepperJam?" I was expecting to come here for a casual coffee.

Rubin just went back in and said, "No, what do you want for your company?" Jones' feeling on the spot blurted out a number and Rubin without really acknowledging the answer, turned to his CFO and said, "Okay, I think we can get a deal done." What he was doing was communicating to a CFO that he was not to pay a penny more than the number of Kris Jones just uttered.

Jones, when I interviewed him for the book and I said, "Would you do anything different about that if you had to do over again?" He said, "Yeah, I wouldn't have answered the question. I would have differed." I think, if I go back to Adii Pienaar, the guy sold Conversio, he had an M and A professional and the M and A professional had one rule.

That was that Adii, when you go into those management meetings with all the potential acquires I'm going to line up for you, you can answer any question, any question that they ask you with the exception of one question. Adii said, "Okay, what's the one question?" He said, "Anything around the value of your business, what you want for your business, you differ and you give that to me."

He knew, the M and A professional knew that by answering anything around valuation, Adii was effectually negotiating with himself. It's a common trap that acquirers will try to make an unsuspecting, a new entrepreneur that's first to the process to try to answer.

Eric: I can just almost put myself in that situation and imagine the emotionality that Jones was feeling. In situations like that, forget whether it's about mergers and acquisitions situation, it's hard to feel the discomfort of what that feels like and not do something. Which is the strategy of the people doing it.

John: Exactly right. Again, remember there's something in the mergers and acquisitions world called the five to 20 rule. That states that the natural acquirer for your membership site is going to be a business five to 20 times the size of your company. By definition, it's likely a company you've heard of, likely a company you respect and likely a company much larger than yours.

Almost by definition, you are likely to be flattered to be asked, somewhat enamored, somewhat feeling all impressed with yourself that this big company that you think of as a leader in the industry has expressed interest in your company and it can feel very validating. All of that halcyon glow, that warm feeling you get for being flattered can really be a trap because the acquirer will use that as a way to make themselves appear like your friend.

They shower you with praise about what you build and then maybe after a glass of wine, certainly after a fancy lunch, they'll turn to you and say, "What's your bottom line? What do you think your company is worth?" It seems like such an innocuous question to answer but it almost always backfires.

Eric: Well, I certainly appreciate you sharing that, John. It seems like one of those critical things, so thank you for putting out there for everyone. I think we're pretty much at the end here. I really appreciate your time and your candor and everything you shared here. I just want to mention everybody, again, John just came out with this book, The Art of Selling Your Business.

Everything that he shared here, which is on its own very valuable also came with, well, I go into much more detail in my book, so it's definitely something that's piqued my interest to go check out, so I encourage everybody to do that as well. John, where's the best place people can go to get your books?

John: The best place to go is probably just builttosell.com, which is the website for all of the books. Then on the top right-hand corner, you'll see the word free gifts. If you click on that and enter your email, we'll send you a free chapter of the book along with, you'll get an episode of Built to Sell Radio once a week. People like Adii, some of the other entrepreneurs, Rob Walling, people that I've referenced on the call are all people I've interviewed for Built to Sell Radio. That's free and it's an opportunity to just hear some other stories of other entrepreneurs who sold.

Eric: Perfect. Again, thank you John so much for your time. It's been really great chatting with you.

John: Thanks sir.

OUTRO:

Thank you so much for listening to this entire episode of our podcast.

I sincerely hope you enjoyed our conversation and learned a lot from what we discussed.

Many thanks to John for coming on our show and sharing so freely from his years of experience.

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Thanks for being here and we'll see you next time!