Endgame

A Business Owner's Guide for Deciding When to Sell

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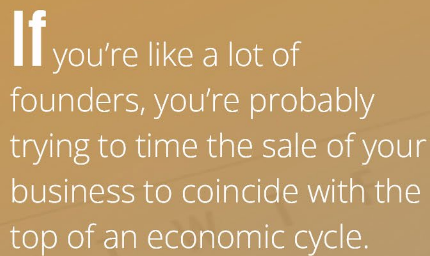
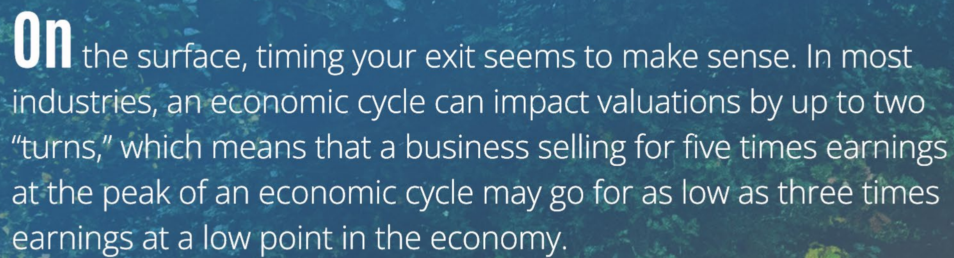


If you're like a lot of founders, you're probably trying to time the sale of your business to coincide with the top of an economic cycle.

Given today's headlines, you may be wondering if you have waited too long.

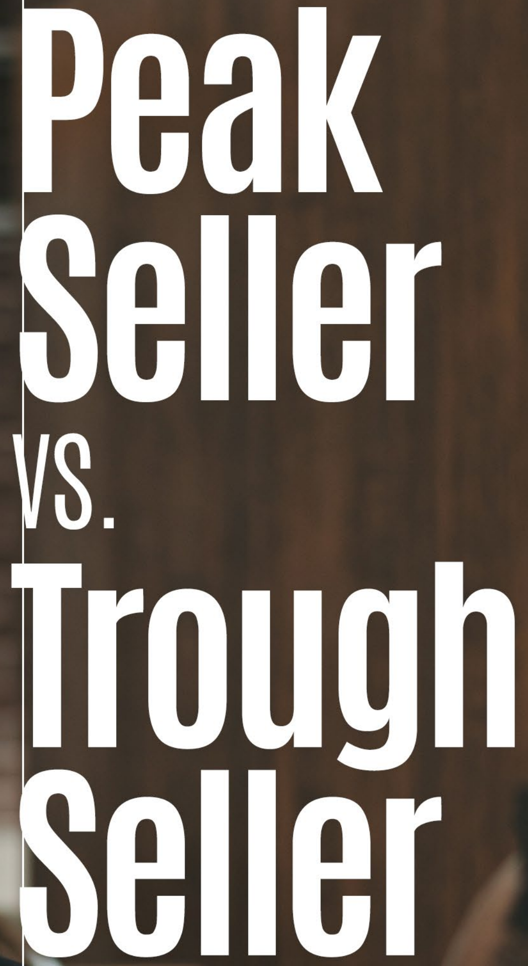
However, as this paper will attempt to demonstrate, timing the market is a fool's errand, and contemplating your endgame requires a completely different approach.



On the surface, timing your exit seems to make sense. In most industries, an economic cycle can impact valuations by up to two "turns," which means that a business selling for five times earnings at the peak of an economic cycle may go for as low as three times earnings at a low point in the economy.

The problem is, when you sell your business, you must do something with the money you receive, which usually means buying into another asset class that is being affected by the same economy. Sure, you may diversify a bit, but most asset classes you'll consider—from residential real estate to stocks and vacation property—generally move in the same direction as the economy.

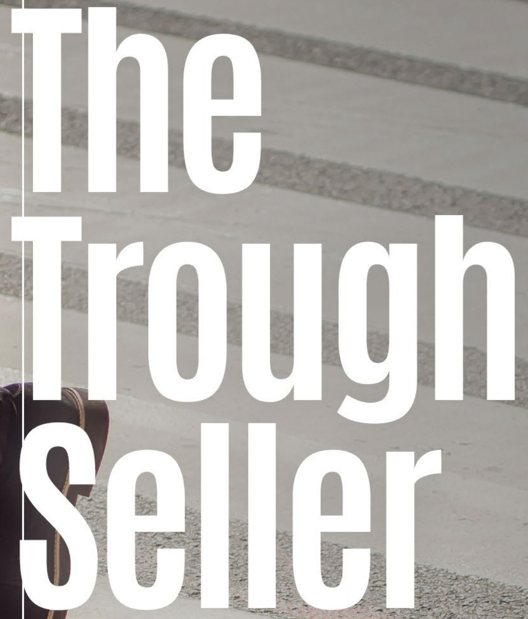
Peak Seller vs. Trough Seller



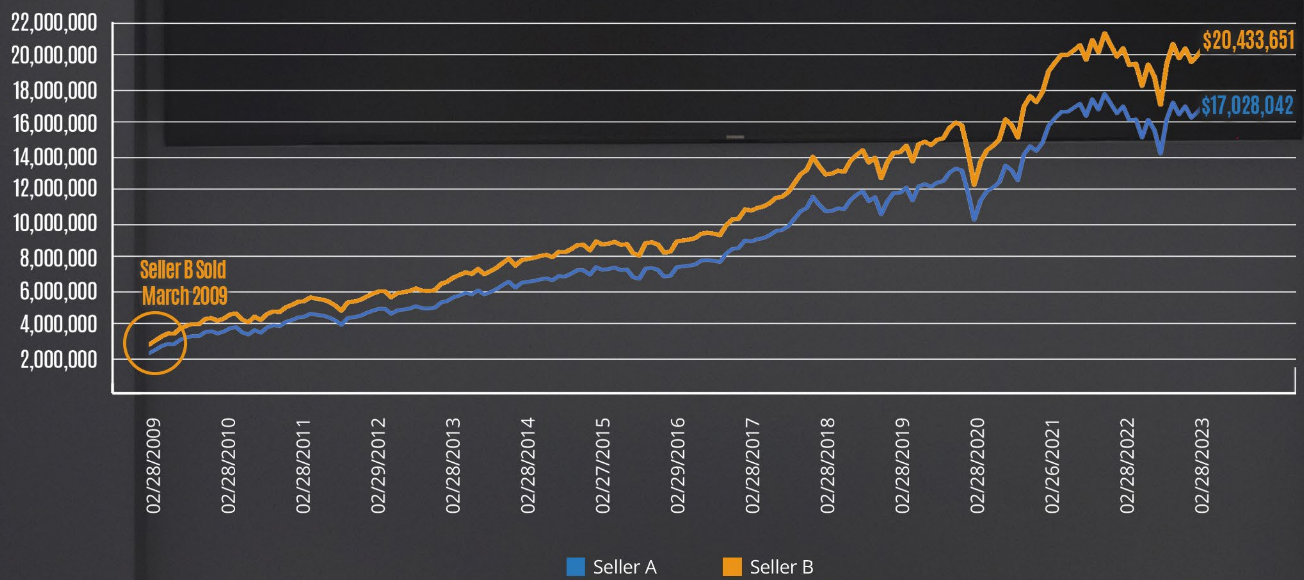
For example, let's compare two hypothetical sellers. Seller A and Seller B have identical businesses in the same industry, both generating $1,000,000 in pre-tax profit leading up to the Great Recession of 2008. To keep things simple, let's imagine they were both living in a country that required no tax to be paid on the sale of a business.

Seller A sat stealthily on the sideline until the economy reached the absolute peak and sold his business for $5,000,000 (five times pre-tax profit) in October 2007. Seller A then took his $5,000,000 and bought into a Dow Jones index fund when it was trading above 14,000. Eighteen months later—after the Dow Jones had dropped below 7,000—Seller A would be left with less than half of his money.

Even though Seller A cleverly waited until the peak of the economic cycle, by March 9, 2009, having invested in the index, he would be left with less than $2,500,000 from the proceeds of his sale.



The Trough Seller



At first glance, Seller B waited too long and sold her business in early 2009—the trough, or lowest possible point, in the economic cycle—and got only three times earnings: $3,000,000. Yet notice that even in the trough, Seller B got 20% more than if she had sold at the peak like Seller A and bought an index fund at the top of the market.

The difference between Seller A and Seller B's outcomes gets amplified over time. By May 2023, Seller A has around $17 million,[1] whereas Seller B is sitting on more than $20 million.

The Seller A scenario is just like selling your house in a good real estate market; unless you're downsizing, you usually buy into equally frothy conditions. When you sell, you can't put your money under your mattress, which is why timing the sale of your business on external economic cycles is usually a waste of energy.

1. Assumes the money was left invested in a Dow Jones Index fund with dividends re-invested. Does not account for inflation.

The Alternative to Timing the Market

As the example of Sellers A and B demonstrates, trying to time your exit with the peak of an economic cycle may be a fool's errand. Nobody knows with absolute confidence what the market will do in the future, so trying to bet on an outcome is unlikely to succeed. Even if you are clairvoyant and manage to predict the peak, you need to do something with your sale proceeds, and that means buying into the same economy you're selling out of.

There are several better ways to decide when to sell, and the following section outlines four alternatives.

1. When You're Risking Your Financial Freedom

If your business has grown in value to the point where it's a significant portion of your wealth, it may be time to take some chips off the table. This is especially true if your assets outside your business would not create enough free cash flow to fund your lifestyle if you stopped working. In other words, you're relying on the sale of your business to be financially free.

If you have the bulk of your net worth tied up in your business, you're breaking the first law of long-term investing, which is to diversify. You have most of your wealth in one asset, and no matter how bullish you are on the future of your company, the lack of diversity will sting in the event of an unexpected drop in your company's performance.

CASE STUDY

Selling Early

Fudging the books has always been frowned upon by lawmakers, but the failure of both Enron and WorldCom was a new low in American business, ushering in an era of more rigorous audit and financial requirements for public companies. In 2002 the United States passed new legislation known as the Sarbanes-Oxley Act, which, among other changes, forced big companies to do a better job archiving old emails.

An ocean away, in the small town of Wellington, New Zealand, an entrepreneur named Rod Drury smelled an opportunity.

Drury reasoned large companies would now be ill equipped to deal with the emails they needed to archive, so he created Aftermail, a software program that provided a better way for companies to store old emails. He targeted large, global businesses for his application and successfully signed up a handful of Fortune 500 companies, building his annual revenue to approximately $2 million in U.S. dollars.

At this point, most founders would have taken their initial success and doubled down, growing as fast as possible with the goal of capturing the maximum amount of market share and selling the company at the peak of an economic cycle. But Drury, knowing there was a lot of risk associated with trying to dominate a new market as an independent software company, chose a different tactic.

He approached Quest Software, which already had most of the Fortune 500 as clients, and together they reasoned that Quest was in the best position to benefit from what Drury had created. A few weeks later, Quest acquired Aftermail for a reported $35 million.

2. Before You're Sick & Tired

The worst time to sell your business is when you're suffering from a health crisis. Your attention will be on your doctor's orders, and your business will likely suffer. Worse, any attempt to negotiate the sale of your business from a hospital bed will undermine your negotiating leverage.

Equally, a business run by a tired owner is likely to suffer a slow melt that accelerates over time. Your company may not drop in value immediately, but a business decline tends to accelerate like a runaway train when an owner is tired and disinterested.

At the first sign your interest is waning or your health is faltering, it's worth considering your strategic alternatives no matter what's happening in the economy.

CASE STUDY

Waiting Too Long

The opposite of selling early in your life cycle, as Rod Drury did with Aftermail, is waiting too long—which is something Rand Fishkin found out in the most painful way.

Fishkin started his entrepreneurial journey when he joined his mother's marketing agency as a partner. Fishkin realized how much his mom's customers were struggling to get Google to display their company in a search, so he immersed himself in the emerging field of search engine optimization (SEO).

In addition to helping clients with their SEO, Fishkin began writing a blog called SEO Moz, which led to the founding of an SEO consulting and software company called Moz. By 2007, when Moz was generating revenue of $850,000 a year, Fishkin decided to drop consulting to become solely a software business.

The company began to grow 100% per year. By 2010 Moz was generating around $650,000 in revenue each month, attracting the attention of a variety of investors and acquirers, including Brian Halligan, co-founder of marketing software giant HubSpot.

HubSpot wanted to buy Moz and offered $25 million in cash and HubSpot stock—an offer almost five times Moz's $5.7 million of revenue in its last complete financial year.

But Fishkin wasn't satisfied. He believed a fast-growth Software-as-a-Service (SaaS) company was worth around four times future revenue and was confident Moz would hit $10 million by the

end of that year. So Fishkin counteroffered, saying he would be willing to accept $40 million.

Halligan declined. Instead of selling Moz, Fishkin raised a round of venture capital and started to diversify away from SEO tools into a broader set of marketing offerings. The adoption of Moz's new applications was weaker than he expected. The further Fishkin veered away from his core in SEO, the more money his business began to lose.

By 2014 Moz was in full crisis mode, and Fishkin had begun suffering from a bout of depression. He decided to step down as CEO, later describing his resignation in his book, Lost and Founder: A Painfully Honest Field Guide to the Startup World, as "a lot of sadness, a heap of regrets, and a smattering of resentment."

Fishkin became a minority shareholder in a company he no longer controlled, where the venture capitalists had preferred rights in a liquidity event.

When John Warrillow interviewed Fishkin on Built to Sell Radio, Fishkin estimated his liquid net worth to be around $800,000—much of which he was about to spend on elder care for his grandparents. The Moz stock he holds may or may not have value after the venture capitalists get their preferred return[2].

Not selling when he could have done so cost Fishkin dearly. Based on the increased value of HubSpot's stock, Fishkin estimates HubSpot's offer of $25 million in cash and stock could now be worth more than $100 million.

2. Preferred shares have priority over common stock in the payment of dividends and upon a liquidation event (i.e., company sale). Depending on the structure, a preferred share can come with a built-in return for a holder, which has to be funded before common stockholders are paid and can wipe out the value of common stock if there is nothing left after paying out the preferred shareholders. This is how some venture-backed founders end up with little or nothing even after they sell their company.

3. When There's Something Else You Want to Do

A lot of founders enjoy the challenge and creative process of starting a business but lose energy for the next stage of a company. Yes, there are celebrated examples of founders who both start and grow a giant business, but people like Jeff Bezos and Bill Gates are the exception rather than the rule.

As the old song says, "If you love someone, set them free." The same is true of your business. There's a point where your lack of interest and/or conservative financial approach may start holding your company back. Your business and its employees are often better off when a new owner with enthusiasm and a willingness to invest in growth takes over.

It's natural to lose enthusiasm for your business as it matures, and if you find yourself dreaming of doing something else, that might be the right time for you to step away.

4.
When You're on a Winning Streak

Most owners think of selling when their business starts to struggle. A key employee quits or a big customer leaves, and the owner contemplates their exit.

That's exactly the wrong time to sell.

Instead, you want to do the opposite. You want to sell when the business is growing and its future prospects are strong. Like the blackjack player who has the discipline to walk away from the table when they are up, you want to market your business when it's on a winning streak. Consider selling when all or most of the following are true:

- Your company is growing revenue and profits, and your prospects for the future are good.
- Your gross margin is improving (or steady over time).
- Your management team is stable and relatively happy.
- Your marketing is working and bringing in new customers with a degree of predictability.
- Your customers are happy and buying more.
- The relationship you have with your key suppliers is healthy.
- Your cash flow is stable.

CASE STUDY

Why We Sell

Sandy and Randy Hansen had only been married for a few months when Randy was diagnosed with leukemia. The doctors gave Randy a 75% chance of survival.

The couple struggled to deal with Randy's diagnosis. They also wondered what would happen to Randy's feed business, AgVenture Feed & Seed. It was generating around $1 million in revenue, and Randy didn't know how it would hold up if he were to pass.

Sadly, Randy died a few months later.

Sandy was left with little more than a handwritten list of Randy's business assets, most of which were heavily leveraged. Worse still, Randy had recently pledged the couple's home as collateral on a bank loan to pay off his former business partner.

Randy had left the love of his life with a colossal mess to clean up. To her credit, Sandy picked up the pieces and started to figure out how AgVenture worked. Determined not to make the same mistakes Randy had made, Sandy documented their standard operating procedures. She leaned on her employees and approached business problems with a beginner's mind while embracing her vulnerability.

In the end, Sandy was able to get AgVenture to thrive again under her leadership, but it took years; a little part of her began to resent Randy for putting her in the position she was in.

It turns out the story of Randy and Sandy Hansen is common. Statistically speaking, the two most common reasons owners decide to sell are 1) they receive an unsolicited offer from an acquirer or 2) they experience a health scare.

In either case, you are reacting to a situation rather than proactively planning your exit.

Your Endgame

It can be tempting to try to time the sale of your business to coincide with a peak in the economy. However, unless you have a crystal ball, it's impossible to know when that moment will hit.

Worse, you'll need to do something with the money you accumulate, which means buying into an asset class that is being propped up by the same economic conditions you're selling out of.

Instead of trying to time the market, look inward and consider selling when the time is right for you and your business. Know that no matter what the economy is doing at the time of your sale, you'll have the opportunity to invest in the same market. Your health, energy, dreams, and financial position are the most important things to consider when designing your endgame.