



# Rebalancing inventories

## Improving turns a critical step to increasing M&A value

**S**ustaining inventory at historically low levels is critically important to a company's value—even as the economy recovers and demand accelerates. But it's particularly significant when business owners are contemplating a sale of their company. Careful inventory management could result in substantially greater net proceeds for selling shareholders.

In the declining price environment we experienced in 2008 and 2009, manufacturers and distributors were caught with high-priced inventory. Softening demand, compounded by wild swings in commodity prices, forced companies to rebalance inventories. Although inventory levels at many metal processors, fabricators and distributors have since returned to historical levels, the recent volatility intensified the focus on supply chain management—in particular, inventory control and management.

As we anticipate a sharp increase in the number of merger and acquisition transactions in 2010, improved inventory management could translate into hundreds of millions of dollars in greater value to sellers.

### Defer sale until inventory turns improve

InterOcean Advisors' recent experience

EBITDA	Valuation Multiple	Enterprise Value
\$5.5	5.8X	\$32
Less: Outstanding Debt		(22)
Equity Value		\$10

with a client clearly illustrates the point. The owner of a value-added metal service center was contemplating the sale of his company. The company's average EBITDA was \$5.5 million, and its net asset value was approximately \$39 million. We advised the owner that the enterprise value of the company in a sale transaction would be approximately \$32 million—despite NAV of \$39 million. He indicated that he would like to net \$15 million pre-tax from the sale, but the company's debt was \$22 million. As such, we estimated that he would only net \$10 million.

When we examined the client's inventory detail, we found his inventory turns

were far below industry averages. He was averaging turns of 2.25x in an industry where the average is more than 4.0x. The slower turns could be explained, in part, by the unique nature of his products. But the differential was indicative of a bigger issue.

We advised the client to defer the sale of his company until he could improve inventory turns. We suggested that increasing turns to just 3.0x could increase his net proceeds from \$10 million to \$17 million, as demonstrated in the calculations below.

The net asset value of the business would then align more closely with the value of the business derived from the cash flow the company generated. With inventory turns of 3.0x, the NAV and enterprise value would each be approximately \$32 million.

The alignment in value would smooth the way toward completion of a successful sale transaction. The seller wouldn't feel he left money on the table because he would receive a fair value for the assets. In addition, the buyer might avoid creation of goodwill, creating a win-win situation for both parties. Improving inventory turns beyond 3.0x would give the business owner the opportunity to recognize a premium to NAV, ultimately improving value for the selling shareholder.

The owner is working to improve inventory turns and has already paid down a significant amount of debt. He expects to revisit the sale of the company when we believe he can achieve his pre-tax proceeds target.

### Maximize M&A value

Many factors—several of which are outside the control of company owners and their management team—impact the value of a business. Company owners contemplating a sale should endeavor to address those factors that are under their control—such as inventory levels and related working capital financing. These factors should be addressed well in advance of an anticipated transaction to recognize value-creating results. ■

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Securities are offered through 1st Worldwide Financial Partners, LLC.

INVENTORY TURNS (\$ in millions)	2.25X	2.75X	3.0X	3.25X
Inventory	\$29	\$24	\$22	\$20
Net Assets	39	34	32	30
Net Debt	22	17	15	13
Enterprise Value	32	32	32	32
Less: Net Debt	(22)	(17)	(15)	(13)
<b>Equity Value (Ent. Value less Net Debt)</b>	<b>10</b>	<b>15</b>	<b>17</b>	<b>19</b>