

Is It Time to Sell Your Research Business?

By Nicolas Cindric

The COVID-19 pandemic has caused the owners of many clinical research sites and other businesses to reassess their future prospects. In addition, implementation, or even discussion, of President Biden's tax plans will significantly affect the actual or perceived value of many companies. Some business owners are thus considering whether it is time to take their chips off the table.

Impact of the COVID-19 Pandemic on M&A activity

Unlike the financial crisis of 2008/09, the pandemic has had very little impact on the demand side of mergers and acquisitions (M&A). During the pandemic, the Federal Reserve has pursued everything in its power to maintain liquidity in financial marketplaces. With interest rates close to zero, discounted cash flow calculations yield high numbers, as demonstrated by the booming price of technology company shares.

As a result, many private equity groups and other buyers have continued pursuing transactions as usual. Generally, these firms have been able to secure debt financing to fund their deals at the standard level of roughly 2.5 times cash flow. Demand for quality businesses has thus remained strong and there is ample capital to fund the transactions.

The supply side is a different story. The pandemic has impaired the financial performance of many businesses. As a result, the supply of healthy businesses for sale has declined by about 75% over the past nine months. When the economy returns to normal, the supply of firms for sale will return after some delay. The reason for this is simple: Most buyers want to see continuity of revenues and profits, so they are reluctant to pay top dollar for acquisition candidates until the companies can reestablish stability in revenues and earnings. Traditionally, buyers have wanted to see three years of continuity, although those expectations may be pared back due to the unique nature of the pandemic. At a minimum, however, it seems reasonable to expect that most buyers will want to see at least 12 months of revenue and profit stability at or near pre-pandemic levels.

This imbalance between buyers and sellers has created a tremendous opportunity for businesses that have not been impacted by the pandemic. Valuations that were at historically high levels pre-pandemic have actually increased due to low debt financing costs and the same number of buyers chasing fewer acquisition candidates.

Is Now the Time to Sell?

The decision on when to sell is different for each business owner. For businesses that have not been negatively impacted by COVID, this could be an opportune time for the reasons noted above. For those that have been affected negatively, it probably makes sense to wait until financial performance returns to pre-pandemic levels and stabilizes prior to contemplating a sale.

Factors outside a business owner's control, such as the pandemic, often trigger consideration of a sale. In addition, possible changes in tax law under the new Democratic administration would have a significant effect on the value of businesses to both buyers and sellers. The proposed changes to federal tax law under President Biden's tax plan include:

- Increasing the top federal individual tax rate from 37% to 39.6%

- Increasing the federal capital gains tax rate from 20% to 39.6% for individuals with income greater than \$1 million
- Increasing the federal corporate income tax rate from 20% to 28%

The potential impact of President Biden's tax plan on M&A transactions could be dramatic. Assuming a 15% annual growth rate (with all other variables remaining constant), a business owner would need to work an additional two years to net the same proceeds under the Biden plan as compared to a sale under current tax law, assuming no effect on the buyer or its higher tax rates.

Fortunately, it appears that the window for consummating transactions under the current tax law will stay open through 2021. Until the pandemic is behind us, it seems unlikely that President Biden and Congress will prioritize contentious legislation that could impair a fragile economic recovery.

In addition, we cannot rely on interest rates to remain near zero forever. When they do eventually increase, the cost of debt financing for business acquisitions will increase, driving down their value.

10 Other Considerations for Business Owners

In addition to external factors, every business owner should ask themselves the following important questions to determine if it is time to consider a sale:

Yes	No	Consideration
___	___	1. It is time to do something different with my life.
___	___	2. My burning desire to compete is failing; I may be "burned out."
___	___	3. My children are not interested in or capable of running the business.
___	___	4. I have been approached by a competitor or the market is hot for companies like mine.
___	___	5. My health is uncertain, so it's time to "stop and smell the roses."
___	___	6. I do not know what my business is worth.
___	___	7. My company is losing market share, or revenues or profits are declining.
___	___	8. To diversify my assets, I want to take my chips off the table.
___	___	9. Relationship issues make the business emotionally draining.
___	___	10. I want to leave my business on my terms and from a position of strength.

Results – based on total **Yes** responses:

- 0-3 You should stay the course.
- 4-6 You should start thinking about a sale for planning purposes.
- 7-8 You should actively consider a sale.
- 9-10 Considering a sale is well overdue.

How to Add Value to Your Business

If you are thinking of selling your business, you will want to ensure you get top dollar for all the hard work and sacrifice you have invested over the years. To do that, take the following

steps to increase the value of your business by maximizing cash flow and reducing risk for the new owner:

Drive cash to the bottom line. Most businesses are sold as a multiple of cash flow. The greater the cash flow, the more debt the buyer can raise to pay your price. Ideally, prepare three years in advance. For example, remove any personal expenses or perks you are running through the business, and evaluate current and future customers for their impact on your cash flow. (Narrow profit margins and slow payments negatively affect cash flow.)

Assess and mitigate market risks and opportunities. For example, if your clinical site addresses only one narrow therapeutic area, e.g., Alzheimer's disease, what will happen to your business if scientific progress stalls? Sites that specialize in vaccines have done very well recently, but what is the prognosis going forward?

Develop your team. Work your way out of the business by developing a management team and cross-training staff. Start transitioning your responsibilities to team members. The more the business can run without you, the more valuable it will be to a new owner.

Diversify customers and suppliers. Most buyers are comfortable with your top customer representing up to 15-20% of sales. Anything more than that and buyers will walk away or reduce their risk by building contingencies into the transaction. Likewise, source multiple suppliers for key products and materials.

Create recurring revenue. A business with recurring revenue (e.g., from subscriptions or maintenance contracts) has lower risk and is, therefore, more valuable to buyers than businesses with repeat revenue (e.g., those that rely on a steady stream of new customer orders). Clinical research sites depend on repeat revenue, so the closest they can come to recurring revenue are long-term studies and stable relationships with customers (e.g., by joining preferred site programs and site networks).

Systematize your business. By developing, documenting and implementing operational, quality and management processes that help your business run itself, you increase the value of your business by reducing risk, minimizing the need for day-to-day management by the new owner, and setting the stage for growth.

Clean up. Much like selling a house, getting rid of the clutter, disposing of obsolete inventory, collecting or writing off aging receivables, organizing messy offices, etc. demonstrates that your business is well-managed, less risky, and prepared for growth. When buyers see disorder on the surface, they are right to suspect hidden disorganization at the most fundamental levels. "Fixer-uppers" sell at a discounted price.

Financially structure your business. For example, should you transfer some ownership of the business to your heirs now? Should you own your offices personally and lease them to your business?

Sustain your commitment to the business. Second to retirement, burnout is the leading reason business owners sell their companies. Businesses deteriorate when the owner is burned out, so make sure you sell before that happens. Drive energetically through to the conclusion of the sales process.

Recognize the costs of selling your business. You will incur professional fees, but the biggest cost is the time required to prepare your business for sale, create all the documentation the buyer will insist on seeing, and attend to the other myriad details involved in a sale—all while running your business as normal. Prepare as

much as possible in advance to minimize the disruption, impress the buyer, and complete the transaction before unforeseen events intervene.

Assemble the right sales team. When you are ready to sell, surround yourself with a team of individuals experienced at marketing and selling businesses. These individuals include:

- Your tax accountant to help create a tax-advantageous transaction structure.
- Your transaction attorney to help structure and negotiate the legal terms of the transaction.
- Your financial adviser to help you invest the sale proceeds for retirement or for financing your next business venture.
- Your sell-side M&A adviser to help market your business, establish a fair market value, negotiate the business terms of the transaction, and facilitate the sales process.

Consider your post-sale role in the business. It is common for buyers to want the seller to retain a full or part-time role in the business during a transition period, during which time you can keep the business running smoothly, share knowledge with new management, and help achieve any agreed-upon milestones. You will want to make sure that you receive any contingent payments from the buyer and that the buyer does not reduce the price because of concerns about being left “holding the bag.”

The clinical research industry has seen a great deal of consolidation of independent research sites. Initially, CROs acquired sites to increase their control of site-level operations, thereby ensuring studies were completed correctly and on time. More recently, private equity firms have been aggregating (“rolling up”) research sites to achieve efficiencies in business development and research operations. Another buyer motivation is that larger businesses are worth more to financial markets than the sum value of their parts.

If a potential buyer approaches you, consider the following factors:

Transaction Value. Most site owners, like most small business owners, have only a limited understanding of the worth of their business. Many site owners have received an unsolicited offer for their business and moved forward to a sale without knowing whether the price was fair. A competitive sales process that generates multiple offers for a business will usually secure a higher price. At a minimum, secure an independent “estimate of value” prior to agreeing to any sale.

Accounts Receivable. Many independent research sites have a poor understanding of how much they are owed by sponsors and CROs for work performed. Make sure your receivables are properly valued in the transaction. Specialists can help you with this determination. Depending on the transaction structure, the receivables may be conveyed to the buyer, factored into working capital, or retained by the seller, in which case the sale agreement must address the process for collecting receivables outstanding at the time of sale.

Earnouts and Milestone Payments. It is common and very reasonable for buyers to require a portion of the purchase price (typically 15-30%) to be based on achieving post-sale milestones, typically revenue goals. Unfortunately, clinical research site revenues can be very difficult to predict; even with a strong pipeline, studies can be canceled or suspended. You should, therefore, discount the value of contingent dollars and try to minimize earnouts or milestone payments. If the buyer insists on contingent payments, try to negotiate the same potential payout on the upside as on the downside.

Conclusion

The COVID-19 pandemic and change in government administrations have hammered home the point that the timing, price and terms of a business sale are subject to events beyond the business owner's control. Successful clinical research sites and certain other businesses are currently in vogue, with buyers in active pursuit. Even if the time is not right to sell your business, operating your business so it is appealing to buyers should be very similar to how you should be operating it for yourself. When the time does come to sell, be prepared to act decisively with minimum disruption to your business, so you can achieve the most favorable result.

Author

Nicolas Cindric, formerly CEO of PharmaSeek, is a Vice President at Cornerstone Business Services, a middle-market M&A advisory company. Contact him at ncindric@cornerstone-business.com.