

DIRECT FLOORING CENTER - CASE STUDY

Date Deal Closed: September 28, 2007

THE COMPANY

Direct Flooring Center was established in 1996 by Gary and Kim Tharp. The business is a wholesale and retail supplier of floor coverings – primarily carpet, vinyl, and laminate flooring, serving Central Oregon. The Tharps utilized knowledge gained from ten years of previous floor covering industry experience as well as significant other retail operation experience to create one of the most systematized, well-run, and successful businesses of its size and type that Codilgent has seen. This is reflected in the business' much higher than industry profit margins achieved while still compensating employees at a level that is significantly higher than comparable jobs in the geographic area.

The business has a clean, professional, warehouse atmosphere with a competitive nationwide box look. Many customers ask if the company is part of a national chain. Consistent branding messages throughout the past ten years include “Carpet and Flooring Superstore!”, “Mill Direct!”, “Huge Savings!”, “Save Up To 65%!”.

The business manages floor covering installation but doesn't sell it. Installers are independent licensed contractors who are paid by the customer on completion of the installation. Direct Flooring Center has the strongest installer base in its market, which is attributed to the installers' respect for the company's systems, efficiency, and attitude.

THE ASSIGNMENT

During the eleven years that the Tharps operated Direct Flooring Center, they were also investing in real estate. They had always intended to build the business into something that had strong systems, policies, and procedures that would allow it to be sold at some point in time. After eleven years they desired to sell their business to be free of daily operations and gain liquidity to utilize for continued investment in real estate projects.

SELLER'S GOALS

- Get as much cash out of the deal as possible to utilize for real estate investment, rather than carrying a large contract.
- To turn the business over to someone who will continue to operate the business in a way that will be beneficial to their customers, installers, and employees.
- To maintain strong confidentiality during the deal process.
- To sell the business in as short of a period of time as possible to minimize the distraction of having to deal with issues related to a sale.

THE CHALLENGES

- The business was of a size that limited the number of potential qualified acquirers since the owner was not willing to carry significant financing. The asking price was an amount of that few people have available in cash, it was about 50% more than the SBA loan limit, and yet it was too small of a business for most equity investment groups to be interested.
- There were strong confidentiality concerns due to the fact that the local floor covering industry is very competitive and there were concerns that if some of Direct Flooring Centers' high quality installers learned of the sale, then those installers' availability and service may be at risk. Consequently, rather than advertising the business as a floor covering business it was advertised vaguely as a "Niche Home Building & Remodel Product Sales" business until a buyer signed a confidentiality agreement and passed Codiligent's screening process.
- It was determined that it was unlikely that there was a logical industry acquirer, which would necessitate a more general advertising and marketing program.
- The Bend housing market was softening and while much of Direct Flooring Center's business is for replacement carpet rather than new construction, buyers may be concerned about how the softening market would impact the business and, as a result of the uncertainty be less willing to pay a reasonable price for the business.
- There are low barriers to entry in the floor covering industry. However, while anyone can start a floor covering retailer, history has shown that most don't ever achieve the size or level of performance of Direct Flooring Centers. This business' policies, procedures, systems, branding, trained personnel, buying history, and location all make it unique. Nevertheless, there was concern that some buyers may be uncomfortable with the ease with which competitors could enter the market.
- An acquirer would need to assume the existing lease or negotiate a new lease on the property. Yet, the seller felt that the landlord had been particularly difficult to deal with in the past, and was not sure whether the landlord would create problems for a buyer, but didn't want to prematurely notify the landlord of the intent to sell the business.

PRICING STRATEGY DEVELOPMENT

Developing a pricing strategy on Direct Flooring Center was very challenging. While many buyers and sellers focus on a market comparable approach to value, there are many flaws and problems with such an approach. There are very few single-store floor covering retailers that are recorded in sold business comparable databases that are even close to the same size as Direct Flooring Center, and of those that are, they largely aren't as profitable. Furthermore, there are a variety of things that make this business more unique – namely its excellent systems, policies, and procedures. One interesting issue is that the business owners were actively managing the business to keep sales at a no-growth level rather than striving to increase sales. For example, they shortened their operating hours to be normal business hours Monday-Friday, rather than staying open evenings and weekends when traditionally many retail customers shop.

Discounted Cash Flow and Capitalized Earnings approaches to value suggested more aggressive pricing than a Market Comparable Approach. A price was established that took into consideration the confidentiality requirements, the softening market, the desire for an all cash deal, and the hope for a

relatively limited marketing period. The price did not include inventory. The pricing anticipated that the seller would retain all current assets at close but be responsible for all liabilities at time of close. Sold business comparable databases suggest that floor coverings stores would likely sell for 1.75-2.85 times Seller Discretionary Earnings. Direct Flooring Center was offered at 3.25 times Seller Discretionary Earnings to reflect the strengths of the business and goals of the seller. The asking price established was intended to be a very firm price for a largely all-cash deal structure.

POSITIONING & PACKAGING

There were a few primary ways that Direct Flooring Center was positioned in a seven-page initial information package and a more comprehensive 91-page confidential package:

- The business is located in Bend, Oregon, a very desirable, high quality-of-life resort town, but where many people have trouble figuring out how to move there and still achieve high employment or business earnings when the economy is largely tourism based. A strong emphasis was put on the fact that this business allowed someone to live in the Bend, Oregon area while also having high earnings. For potential buyers who may not be as familiar with the benefits of living in Bend, an abundance of information was provided on the area.
- The turn-key nature of the business was a key benefit that was promoted. The systems not only make the business easy to operate, but it also gives the buyer the potential to use the systems, policies, and procedures to open additional locations or to franchise the business.
- The stable revenue and earnings history of the business were considered a strong selling point, coupled with a high diversification of revenue by customer. This diversification meant that there was no risk that the loss of one client would have a material impact on the business, lowering risk to an acquirer.
- The positive population growth and demographic trends for the area were cited as evidence that there should be strong long-term future demand for the business, even if there were short-term market corrections.
- The highly visible, prime location in close proximity to complementary retail businesses is an unquestionable advantage for the business.
- A variety of opportunities for growth were shared including: increasing operating hours and staff, increasing advertising, adding product lines, increasing advertising and marketing activities, and turning the business into a franchise model.

MARKETING METHODS

The seller did not feel that it would be productive, and, for competitive reasons, asked Codiligent not to directly market the business to potential industry buyers. Consequently, Direct Flooring Center was advertised and marketed in a more general way. Following are the methods used to advertise and market the business:

- A search of Codiligent's database of several thousand people was searched to identify buyers who had acquisition criteria that made Direct Flooring Center a good match. Those potential buyers were sent initial information packages.
- Web-based ads were placed on major national and international business sale websites.

- Classified advertising was done in The Wall Street Journal, The San Francisco Chronicle, and The Los Angeles Times. The California papers were utilized because of the large number of people migrating from California to Central Oregon.

PROCESS & RESULTS

In late 2005 discussions about the sales process were begun with the owners of Direct Flooring Center. During the first quarter of 2006 Codiligent analyzed the business and began creating drafts of marketing packages. The sellers then decided to postpone the beginning of the marketing process until early 2007. At the end of 2006 Codiligent resumed development of packages and marketing materials.

In January 2007 active marketing of the business was initiated with on-line and newspaper ads placed. During that month there were 14 inquiries on the business. Ultimately during the marketing process there were a total of 66 inquiries, and 28 confidentiality agreements were received. Out of the 28 confidentiality agreements received, Codiligent screened out nine who didn't appear to be qualified. Out of the 19 remaining, there were substantive discussions with four individuals, and two submitted Letters of Intent (LOI). The first buyer to submit a LOI submitted it on March 23, 2007 and both parties signed a modified version on April 18, 2007. Unfortunately, the buyer was relying on debt financing for part of the purchase price, and due to a loan on another business the buyer owned which diminished his borrowing ability he was unable to secure funding in the amount needed and terminated the deal on May 5, 2007. Shortly thereafter, on June 14, 2007 another acquirer submitted a LOI that both parties agreed to and signed after modifications on July 3, 2007. At about the same time that both parties signed the LOI, the buyer learned that his bank, who he had a long successful business banking relationship with, declined the loan. Codiligent immediately made an introduction to a motivated lender who rapidly provided a loan commitment. The acquirer completed his due diligence on August 10, 2007. Purchase agreement negotiations were very cumbersome which prolonged closing until September 28, 2007. The transaction was closed at the full asking price. The seller received cash for the value of the business at closing, but agreed to carry a note for the value of the inventory and its freight cost (9.8% of the total transaction) with terms of an 8.75% annual interest rate, a 40-month amortization, and a 30-month term.

The seller's goals were largely realized in this transaction. While the deal wasn't an all-cash deal, the seller only had to carry financing for the inventory and for a very short term, and there was no reduction in price. So the goal of getting as much cash as possible at closing was largely met.

One of the seller's other goals was for a competent individual to continue operating the business in a way that would take care of employees, clients, and contractors. Prior to purchasing this business the buyers dramatically grew another previously owned business. The buyers have the ethics, integrity, ideas, and energy to continue operating the business in a professional way.

Another goal was maintaining the business' confidentiality during the process. Codiligent was very conscious about whether or not to share information on the business with prospective acquirers, and as a result screened out and did not provide information on the business to nine buyers who submitted confidentiality agreements, but who, for one reason or another, were not an appropriate fit. However, despite being very cautious, there was some evidence that some people in the community may have learned or figured out that the business was being marketed. Fortunately, there was no apparent harm

to the business as a result. The lesson here is that even when confidentiality is taken very seriously, there is still the risk that somehow the public will learn of the sale.

The final goal for the business sale was a fast marketing time frame. From the time active marketing of the business began until the deal closed was approximately nine months. So, this goal was not met. On the other hand, the time frame was not excessively long, either. Industry studies indicate that the average marketing time for closely held businesses is about eight months, and a significant portion of businesses that are marketed never successfully sell. Nevertheless, this is such a strong business that Codiligent had anticipated it would sell more quickly. Still, overall it was a very successful sale.