SELLING YOUR BUSINESS FOR THE MAXIMUM PRICE AND ON THE OPTIMUM TERMS

A very successful businessman who owned multiple companies and who we once had the fortune to represent told us he began thinking about selling a company before he bought it. Most sellers don't have this foresight and arrive at the sell event without a plan, tired, burned-out, and their business flat or declining.

Think of the amount of preparation you go through to win a new customer that could account for 10 to 20% of your annual sales. The sale of your company has 30 to 50 times the economic impact to you and deserves proportionately more attention, planning, and effort. For many, selling their business is an once-in-a-lifetime event with no "do-overs".

Ideally, you the business owner should begin planning three years in advance in order to maximize your financial return and optimize the terms.

To be successful at this game, you need to take the following steps before offering to sell your company:

- Indentify your sale objectives.
- Determine the likely price and terms.
- Accurate financial reports
- Shrink your role
- Minimize dominant customers

ESTABLISH SALE OBJECTIVES - For most owners, the primary goal is financial - how much do I want (or need) out of the sale? This is the net proceeds after transaction costs, debt retirement, and taxes paid - what we call the "Walking Away Money" or "WAM". If funding retirement is your goal, a financial planner can calculate your required WAM to complete a retirement plan.

Other objectives you may have include retention of certain employees, retention of the business at its present location, or your continued involvement in perhaps a limited capacity. These conditions may have a cost attached to them, reducing the price or desirability of the business and you may need to weigh the relative importance of possibly conflicting objectives.

DETERMINE LIKELY PRICE AND TERMS - The first step is to obtain a realistic price the market will pay for your business and the probable sale terms. Sources of this information are accounting firms, valuation firms, and intermediaries - business brokers and investment bankers.

Value versus Price - Accounting and valuation firms take a more theoretical approach, guided by professional valuation standards and IRS guidelines. Their reports are usually well-documented and researched and address the value of the business but their single figure conclusion doesn't take into account the realities of the marketplace.

Intermediaries, by contrast, are more attuned to marketplace subtleties and approach the subject with a pragmatic "how will (can) this deal happen" attitude since most of our compensation comes from closing sales (real world activity) versus writing reports (theoretical world activity).

Our work product is focused on probable selling price and terms and takes into consideration, in addition to financial analysis and studying comparable sales, critical, non-financial issues such as customer concentration, importance of the departing owner to the entity, product life-cycle, key suppliers, and composition of the prospective buyer universe.

The responsible intermediary should be able to not only accurately estimate the price, but equally important, determine whether you will likely have to participate in the financing either on a guaranteed note or an earn-out basis, and whether you should prepare to be involved after closing as an employee or a consultant, in what capacity, for how long, and at what compensation.

If equipment and/or real estate constitute a substantial portion of the assets being sold, a separate appraisal of these assets by equipment or real estate appraisers may be appropriate particularly if these assets will be essential to a buyer's financing.

The pricing exercise compares the business owner's wants/needs/desires with the reality of the marketplace. If the price and terms don't meet your objectives, the intermediary should provide you with the financial benchmarks and other changes required that will enable you to attain your objective.

With intermediaries, however, you need to guard against some firms inflating values as a means of winning an engagement to sell the company. Chose an intermediary who is experienced in selling firms of your type and size, does not require an out-sized retainer, and provides references.

ACCURATE FINANCIAL RECORDS - Accounting is the language of business and your financial statements are the road map or score card buyers use to determine the price they will pay and for lenders, the amount they will loan. Sellers believing they can sell their business with no apparent earnings for a fair dollar by showing the buyer his $1million home with a Mercedes in the garage will be disappointed because even if the buyer is swayed, the loan officer can't and won't take these apparent benefits into account.

Understating earnings is prevalent in closely-held businesses. Yes, the practice reduces income taxes but the trade-off is a lower price when it's time to sell. To quantify the financial consequences of understated earnings, consider this: Assume (1) a business would show an average or above average profit if the financial statements were accurate and not managed to reduce income taxes and (2) firms in this industry typically sell for four times earnings. One dollar of identifiable earnings equals four dollars in selling price.

Here's the compelling argument for not understating earnings if the business is to be sold in the next few years. The seller's alternatives are:

Understate $1 of Earnings	Taxes saved @ 30%	$.30
OR		
Report $1 of Earnings	Sale price @ 4X	$4.00
	Taxes on sale @ 30%	(1.20)
	Net from Sale	$2.60

Is there any better after-tax return that comes from reporting income accurately for two years prior to sale at a cost of $.60 in exchange for $2.60?

This best-practices approach applies to unreported income and/or non-business expenses that are buried or clearly identifiable. It's not necessary for you to reduce or eliminate expenses such as owner's compensation, bonuses, life insurance premiums, etc. which can be normalized and the excess added back to earnings when presenting the company for sale. Other expensed perks such as non-business travel, autos, and entertainment have a chance to be added back to earnings provided that they are clearly identifiable and not buried in with legitimate business expenses.

Inventory Issues - For many businesses, inventory is their largest single asset, one often subject to accounting manipulation. This is particularly true of wholesalers where cost of goods accounts for 60 to 80% of revenue and retailers, 40 to 50% of revenue.

Inventory inaccuracies are usually flushed out before closing In nearly all transactions when, as a final step preceding closing, buyers physically inspect inventory and inventory-keeping records and adjust the claimed value to current market conditions. Variances usually result in adjustments to the purchase price.

Is Inventory Understated? - Have you reduced inventory book value at year end by either not counting items or taking unwarranted write-downs? This practice artificially reduces ending inventory, increases cost of goods and reduces reported gross profit, net income, and income taxes. If this practice has been engaged in for an extended period, it is nearly impossible to reconstruct the true, historic cost of goods and to convince the buyer and his lender of the enterprise's true profitability.

This understating practice results in inventory book value being less than actual value. The buyer, in allocating the purchase price to the various asset classes, prefers to purchase the inventory for its actual, higher value because they (1) don't want to incur the taxable gain arising by subsequently selling low-basis goods, and (2) want the higher value for financing and balance sheet purposes.

If the understated goods sell for their market value, the difference between the higher market value and the lower book value is taxable to the seller as ordinary income in the year of sale. Since you eventually have to pay the taxes in either case, why not, beginning at least two years prior to sale, report beginning and ending inventory accurately and gain the benefit of higher earnings and resulting higher sale price?

Is Inventory Overstated? - In due diligence, the buyer will inspect the inventory and identify slow-moving, obsolete, or damaged goods and claim a price reduction based on the lower asset value and/or the over-stated prior earnings. If the shortfall is material, it can derail the sale or at a minimum, create friction among the parties.

The variance between book and actual value can be the result of (1) lax inventory policies and procedures or (2) management's unwillingness to take write-downs to either remain compliant with lender covenants or satisfy other stakeholders.

A common response of buyers in this circumstance is to pay for the good and salable inventory at closing and pay for the remainder, if and when it sells. For the sub-standard goods, you lose control and the opportunity to squeeze all the available dollars out of the inventory. The buyer doesn't have much incentive to maximize the proceeds from these goods because they have a limited economic stake in the outcome.

You would be better off, in the years preceding the sale, to bite the bullet and sell the marginal inventory on your terms and take the write-off, treating it as a one-time, extraordinary, expense. Inadequate or inaccurate inventory manage-ment causes buyers to ask themselves "What else is wrong here?" and casts a cloud over every aspect of your operation.

Other Accounting Considerations - The fewer explanations needed to explain income statement and balance sheet entries, the greater buyer and lender confidence. Consistency in recording revenue and expense line items to the same charts of accounts year-to-year also instills confidence. Changes in outside accountants raise concerns.

Buyers of businesses with less than $10-$20 million in revenue don't expect the seller to have financial statements audited by certified public accountants. Reviewed statements generally add to credibility and understanding the seller's financial condition but by themselves are not imperative to getting deals done. Many of our transactions are done with only compiled financial statements and tax returns. Regardless of the degree of certification, prior to closing, the buyer's accountant will perform some level of audit of your financial statements.

Once the business is listed for sale, the seller needs to be able to produce timely monthly statements through out the sales process. Buyers will decide to buy businesses based on a 3 to 5 year history but still want to know, even a week before closing, what last month's numbers look like.

SHRINK YOUR ROLE - Often in firms with 20 employees or less the owner has a disproportionately large role. This dominant influence of the principal may range from controlling relationships with key accounts or vendors to being the chief creative person or the engineering wizard who solves difficult design and production problems.

Which ever the case, prospective buyers see this organizational weakness and are rightly concerned about what happens to the customer base and sales after you depart. Their caution translates into offers where (a) less of the purchase price is in hard dollars (cash and notes) delivered at closing and more is in an earn-out or variable dollars tied to subsequent performance, and (b) you have to stay around longer after closing to effect a transition.

Buyers want to know that customers do business with the organization and not the owner. If you are in this situation, here are steps to diminish your role:

- Empower the organization. Reduce your direct reports to four or fewer and expand their duties, responsibilities, and authority. Involve them in decision-making both in and outside their department. If someone can't grow, replace them with an individual who can.

- Draft and implement policies and procedures enabling employees to make decisions without having to refer to peers and bosses.

- Take extended vacations forcing you and the organization to function without your day-to-day involvement.

- If you are the point man for key customers, gradually phase in your replacement, introducing them to your customer as your "back-up".

Once the sales process begins, when meeting prospective buyers, don't regale them with your accomplishments. Instead, describe how your key managers perform. Make yourself redundant both in reality and in perception. Your goal is having the buyer comfortable in committing the lion's share of the purchase price in hard dollars and you essentially out of the organization in six months or less after closing.

Share Plans with Key Managers - Taking your key employees into your confidence helps the selling process. Your employees already know you don't intend to work until you drop and describing how the firm will continue provides them with peace of mind.

Owners are concerned that if they tell their employees they intend to sell the company, they will bolt and leave the owner empty-handed. In our more than two decades of selling businesses, in those instances where the owner did take his employees into his confidence, not once, to our knowledge, did an employee leave prematurely because they were concerned about their role under new ownership.

The chemistry in a small organization is such that when successive groups of strangers start showing up for meetings, something is in the wind. Better to control the scuttle-butt and deal with the anxiety on your terms.

The message to share with your employees is this: Buyers want to acquire an operating organization, not just bricks and mortar, machinery, inventory and receivables. They don't show up the day after closing with a new staff. Savvy managers leave the acquired company's personnel in place at least until they are fully grounded in its operations and culture. The employees need to understand their place is secure for the near term and then it is up to them, the employee, to earn their position with the new owner.

Further, since you are likely to have a financial stake in the new owner's success either in the form of a note, leased real estate or an earn-out, you are equally concerned about the buyer's ability to successfully lead and manage the firm.

If the buyer is possibly a larger and/or better capitalized company, you can point out the advantages to the employees of greater career opportunities and perhaps better benefits.

Another reason to share your plans is one or a few of the employees may want to buy the company, or if they can't swing it on their own, have some equity in the future enterprise. The buyer may find it desirable to have managers with skin the game. This is particularly true if the purchaser is a private investor group as they often like to have their managers "lashed to the mast".

And lastly, buyers frequently interview key employees before closing to insure they intend to remain with the company, at least for the near term and to obtain their impressions of the firm. Why wait to the last moment to bring your staff into the prospective sale and risk the loss of their goodwill and cooperation.

DOMINANT CUSTOMERS - A single customer accounting for 20% or more of sales is a red light to buyers. In today's world where customers go out of business, file for reorganization and short-change unsecured creditors, relocate operations domestically, shift production overseas, or get acquired by an entity with a different buying philosophy or preferred vendors, a significant book of business can evaporate through no fault of the supplier.

Buyers frequently react to a concentration issue by making part of the purchase price variable and tied to retention of that customer. The seller's dilemma with this contingency is after the sale, he no longer controls that critical relationship.

The seller's challenge is not "How do I shrink my dominant customer(s)?" but "How do I grow the others so we're no longer at the mercy of one or two?"

Other Dependencies - Personnel controlling sales or providing the company with a competitive edge in other areas should be under employment agree-ments with non-compete provisions. Even though these agreements are not typically assignable to a new owner (particularly in an asset sale), having the employee used to being subject to a non-compete makes it easier for the buyer to negoti-ate one as a condition to closing.

Key suppliers can reduce the seller's flexibility when it's time to sell. The common case is a wholesaler, retailer, or service provider who has a dominant supplier constituting the bulk of their revenue. The majority of these distribution agreements are subject to 30-day cancellation by either party. Because the buyer doesn't have the benefit of a long-time business (and perhaps personal) relationship with the vendor, they aren't as confident of its stability and often reflect that uncertainty by making their offer more contingent and less firm. If you are in this dominant supplier situation, one approach is to add other lines to mitigate the risk.

RECURRING REVENUE VS. PROJECT REVENUE. For B2B service businesses, buyers prefer regular and continuous revenues resulting from long-term contracts as opposed to one-up, project revenues. For example, an IT services company that has 40% of its revenues from service contracts is considered more valuable than another with only 10% contract revenues, all other considerations being equal.

SELL ON AN UP-TICK - You may not be able to control when you put your business on the market but if you have the latitude, market the firm when results are positive. Buyers target companies that will grow in sales and earnings after the acquisition and the best indicator of future growth is historic and current growth.

If sales and earnings are flat, the purchase price will reflect the value of the tangible assets with little consideration for goodwill.

When sales and earnings are declining, if the business is salable, the purchase price will only reflect the tangible asset value (usually measured in liquidation value) and anything in excess is strictly on an earn-out basis, paid if and when the firm regains profitability.

For help in identifying and improving your firm's position, contact

Becker & Beggs
2055 Reading Road
Cincinnati, OH 45202
513-621-0004
www.beckerbeggs.com