HOW TO BUY OR SELL A BUSINESS

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Preparing the Company for Sale

- Plans to sell a company should be made years in advance of the actual sale. This will allow time to adjust accounting practices and demonstrate 3-5 years of maximum profitability.
  - Nearly every privately held company operates to limit tax liability. However, the same operating techniques that limit tax liability also minimizes the value of the business.
  - Although it often possible to reconstruct financial statements to reflect more optimistic performance (recasting), this process may raise doubts among buyers.
  - The premises should be clean, have current inventory, and the equipment in good working order. In addition, financial and other records should be maintained in a neat and orderly manner.
- To determine pricing, a valuation report should be prepared. This eliminates guessing and is more accurate.
  - Often, sellers will arbitrarily decide on a price, making it difficult, costly, and timely to strike a deal. Likely not making one until the cost has continually been lowered.
  - Pricing a business will be discussed in more detail later.
- ·A business presentation package should be prepared by an experienced professional. This document is extremely important because, if poorly done, interested buyers may get a wrong impression of the company. All the following things should be addressed in this document:
  - History of the company
  - Description of how the company operates
  - Description of the facilities
  - Discussion of the suppliers
  - Review of marketing practices
  - Profile of customers/customer base
  - Description of the competition
  - Review of personnel, including organizational chart, description of job responsibilities, rates of pay and willingness of key employees to stay on after the sale
  - Identification of the owners
  - Explanation of insurance coverage
  - Discussion of any pending legal mattes or contingent liabilities
  - Compendium of three to five years' financial statements

Finding Buyers and Sellers

Intermediaries

- A good intermediary can save a client time and effort, whether buying or selling a business.
- Business opportunity intermediaries are usually the best source of information on both the companies for sale and on buyers seeking acquisition opportunities. There can be three different types: (1) business brokers (2) investment bankers (3) merger and acquisition specialists.
- The lines of distinction may be blurry, but in general, business brokers primarily handle small businesses. The broker doesn't need extensive knowledge about the business being sold or creative techniques for financing the transaction.
- Investment bankers handle the largest transactions, such as megabuck takeovers or mergers of large public corporations. They have their own sources of financing, but generally don't have expertise in specific industries.
- Merger and acquisition specialists handle in-between companies, those with sales of $150 million. These services are similar to those of investment bankers except they help obtain outside financing rather than provide the financing themselves. A good specialist will have a proprietary database of potential buyers for most companies.
- For small transactions, the fee is almost always paid by the seller. For larger deals, it's common for the fee to come from the buyer as it is from the seller. Buyers typically enter into two types of agreements with intermediaries.
    - The first type authorizes the intermediary to undertake a specific search for the buyer. The intermediary is compensated with a retainer fee which is credited against a success fee if an acquisition is made.
    - In the second type of agreement, the intermediary receives no retainer but only the success fee when an acquisition is completed and is not obligated to perform any search work.
- ·A good intermediary performs a number of functions including: (1)pricing a company (2) setting the financial terms and other conditions (3) compiling a comprehensive presentation package (4)professionally marketing the company (5)screening potential buyers (6)assisting the process of negotiating and evaluating offers (7) maintaining confidentiality by preventing customers, suppliers and others from knowing the company is for sale.

Advertise Your Business For Sale

Writing the advertisement:

- Word it to demonstrate the company's best qualities (financial and non-financial).
- Many include a qualifying statement describing the kind of cash investment or experience required.
- Keep it professional, you are targeting serious investors and business owners.
- Keep it brief, your goal is to entice the right kind of potential buyer to seek out more information.
- Think like a buyer, which details would you want to know?
- Eliminate sales talk, don't use "trigger words" or linguistic tricks to impulse purchases. Remember you target audience is a savvy businessperson.
- Include visuals, this will help generate more interest.
- Keep the ad current, keep the ad updated and make sure it always accurately represents the business.

Placing the advertisement:

- Know who you are targeting and where they are located. Should you be posting to a local, national, and/or international audience?
- Post online as well as paper ads. Biz Buy Sell and Facebook could be a good online option, as well as your local newspaper.
- Consider contacting specific buyers, you can do this even after you have posted ads.
- Sometimes, larger privately held companies are marketed by intermediaries to a carefully chosen group of potential buyers.

Evaluating the Company- Due Diligence

Study the company's history and operation. Learn how the nature of business may have changed since its inception. A buyer should understand the company's methods of acquiring and serving its customers and how the functions of sales, marketing, finance, and operations work and interrelate.

The company's financial statements, operating practices, and other documents should be reviewed.

Balance Sheet (obtain a schedule of each)

Accounts Receivable

1. Determine if there is concentration in a few accounts.
2. Determine the reasons for any overdue accounts.
3. Find out if any amounts are in dispute.
4. Do the delinquent accounts have the ability to pay?
5. Are any of the accounts pledged as collateral?
6. Is the allowance for doubtful accounts sufficient?
7. What is the policy for granting credit?
8. Is accounting/record keeping computerized and organized?

Inventory

1. Make sure the inventory is determined by physical count and divided by finished good, work in progress, and raw materials.
2. Establish the method of valuation: cost, material retail, LIFO (last in/first out), FIFO (first in/first out), etc.
3. Determine the age and condition of the inventory.
4. How is damaged or obsolete inventory valued?
5. Is the amount of inventory sufficient to operate efficiently?
6. Should an appraisal be obtained?

Marketable Securitas

1. How are the securities valued?
2. Determine the fair market value of the securities.
3. Are any securities restricted or pledged?
4. Should the portfolio be sold or exchanged?

Real Estate

1. Determine the condition and age of improvements to the real estate.
2. How was the property used before the current business was established?
3. Determine the fair market value.
4. Should appraisals be obtained?
5. Are repairs or improvements required?
6. Are maintenance costs reasonable?
7. Do any of the principals have financial interest in the company's that perform the maintenance?
8. Is the real estate required to operate the business efficiently?
9. How is the real estate financed?
10. Are the mortgages assumable?
11. Will additional real estate be required in the near future?
12. Is the real estate adequately insured?

Machinery and Equipment

1. Determine the condition and age of the machinery and equipment.
2. Identify what is state of the art and which is obsolete.
3. Identify what is in compliance with Environmental Protection Agency (EPA) or Occupational Safety and Health Administration (OSHA) standards and determine if additional equipment and machinery is needed to comply.
4. Should an appraisal be obtained?
5. Will immediate repairs be required?

Accounts Payable

1. Determine if there is concentration among a few accounts.
2. Determine the age of the amounts due.
3. Identify all amounts in dispute and determine the reason.
4. Review transactions to determine undisclosed and/or contingent liabilities.

Accrued Liabilities

1. Determine the accounting treatment of
   - (1) Unpaid wages at the end of the period (2) accrued vacation pay (3) accrued sick leave (4) payroll taxes due and payable (5) accrued federal, state, and local income taxes (6) other accruals
2. Search for unrecorded accrued liabilities.

Notes Payable and Mortgages Payable

1. Identify the reason for the indebtedness.
2. Determine the terms and payment schedule.
3. Will the acquisition accelerate the note or mortgage?
4. Is there a prepayment penalty?
5. Determine if there are any balloon payments to be made and the amounts and dates due.
6. Are the notes or mortgages assumable?

Income Statement

The potential earning power of the company should be analyzed by reviewing profit and loss statements for the past three to five years. It's important to substantiate financial information by reviewing the company's federal and/or state tax returns. The company's earning power is a function of more than bottom-line profits or losses. The owner's salary and fringe benefits, non-cash expenses, and nonrecurring expenses should also be calculated.

*The four-step formula for this calculation is noted in the Pricing the Company section under the subheading Income Statement methods of valuation.

Sales Journal

All sales records, such as sales journals and sales reports, should be used to verify sales information on the income statement. Sales journals can also help determine the level of sales concentration among key customers.

Financial Ratios

While analyzing the balance sheet and income statement, sales and operating ratios should be calculated. Some of the most important ratios are the current ratio, quick ratio, accounts receivable turnover, inventory turnover and sales/accounts receivable. The significance of these ratios, the methods for calculating them, and industry averages are available through Dun and Bradstreet and Robert Morris Associates. Look for trends in the ratios over the past three to five years.

Leases

1. What is the remaining term of the lease?
2. Are there any option periods, and if so, how is the option exercised?
3. Is there a percentage of sales clause?
4. What additional fees (such as a common area maintenance or merchants' association dues) are paid over and above the base rent?
5. Is the tenant or landlord responsible for maintaining the roof and the HVAC?
6. Is a periodic rent increase required to adjust for changes in the consumer price index or for an increase in real estate tax assessment?
7. Is there a demolition clause?
8. Under what terms and conditions will the landlord permit an assumption or extension of the existing lease?

Personnel

1. What are the job responsibilities, rates of pay and benefits of each employee?
2. What is each employee’s tenure?
3. What is the level of each employee’s skill in his/her position?
4. Do any employees have an employment contract?
5. Will key employees stay after the company is purchased?
6. Are any employees part of a union or is any union organizing effort likely?
7. What employee benefits does the company offer?
8. Review any employment handbooks or policy manuals.

Marketing

1. Are any of the product's proprietary?
2. Describe any upcoming products and projected sales.
3. What is the company’s geographic market area?
4. What is the company’s percentage of market share?
5. What are the company’s competitive advantages?
6. What are the company’s annual marketing expenditures?
7. How are marketing strategies determined?

Patents

A list of trades names, trademarks, logos, copyrights and patents should be obtained, noting the time remaining before each expires.

Taxes

1. Are FICA, unemployment, and sales tax payments current?
2. What was the date and the outcome of the last IRS audit?

Legal Issues

1. Are there any suits now or soon to commence?
2. What OSHA and EPA requirements must be met and are they currently being met? If not, what is the extent of the company’s liability? An environmental audit may be appropriate.
3. Are all state registration requirements and regulations being met?
4. Are all local zoning requirements being met?
5. Review the articles of incorporation, minute books, bylaws, and/or shareholder agreements.
6. What are the classes of stock issued by the corporation and the restrictions of each, if any.
7. Has any stock been canceled or repurchased?
8. Is the business a franchise? If so, review the franchise agreement.
9. Are licenses required to operate the business transferable?
10. What is the company’s returned goods policy and the extent of its liability for returned goods?
11. What is the company’s liability for product warranty claims?

Competitors

1. Who are the company's competitors?
2. What is the company's market share?
3. What are each competitor's competitive advantages and disadvantages?
4. What advantages or disadvantages does the company have?

All the factors identified in this section on evaluating a company must be carefully scrutinized and weighed. Some factors will have a positive influence on the decision to buy and others a negative influence. Seek professional assistance if necessary to interpret the significance of the information. The important thing is to obtain all the information needed to make a decision.

In most instances, all business records should be made available to the buyer. In some cases, however, certain information may be withheld until a bona fide offer, contingent upon obtaining that information has been made. If important information is unreasonably withheld, the likelihood of completing the transaction diminishes.

Financing the Purchase

A buyer's source of financing depends in part on the size of the company being purchased. Many smaller businesses are purchased with a significant portion of the purchase price financed by the owner. The buyer, however, must provide equity in the form of a down payment and adequate working capital. *Seller-financed installment sales are discussed in more detail in Structuring the Transaction under the subheading Seller-Financed Transactions.

If the transaction cannot be financed by the seller, the buyer must seek financing from an outside source. To grant such financing for smaller businesses, an institutional lender is almost certain to require personal collateral for the loan; it is rare for such a loan to be secured only by the assets of the business.

The most attractive types of personal collateral from the lender's point of view are real estate, marketable securities, and cash value of life insurance policies. In addition to personal collateral, it must also be demonstrated to the lender that the buyer is of good character, has a clear source of repayment and has a good business plan. The most common sources for loans are banks and consumer finance companies.

The chance of obtaining outside financing improve as the size of the business being acquired increases. Not only does the willingness of the lender to participate increase, but the number of potential lenders increases as well. Banks, insurance companies, commercial finance companies, and venture capital companies all may be interested in lending money for a sizable acquisition.

Before beginning the process of procuring financing, a buyer should identify hidden sources of cash within the company. A pending lawsuit against a third party that can be resolved quickly may be a source of funds, as may an overfunded pension plan. Alternatively, the pension plan may actually be able to acquire real estate owned by the company, thus reducing the need for conventional financing.

After looking for hidden sources of cash, the next step is to apply for the loans needed to complete the acquisition of the company and provide adequate working capital.

Types of Financing

The borrowing complexity of each project is different. Sometimes only one secured loan is needed. Other transactions require more than one, or perhaps an unsecured loan. Large transactions often need many lenders and have many types or layers of debt.

Term Financing is usually seen in small company acquisitions. This kind of debt is secured by a first lien on fixed assets and a first or second lien on current assets. Commercial banks are the most common underwriters of this type of debt.

Revolving Debt is another type of financing typical of such transactions. Again, commercial banks usually provide such financing. They require a first lien on inventory, accounts receivable, and other current assets.

Junk Bond Financing or Mezzanine Debt (unsecured debt or debt that is subordinate to term or revolving debt) is a third type of financing. It is used only in the largest leveraged buyouts. Investment bankers and investment group typically arrange this type of debt.

Many lenders set loan conditions and restrictions on certain activities of the business. Lenders such as insurance companies and venture capitalists may insist on an equity position in the company and a role in major management decisions. Insurance companies typically only participate in transactions above $10 million.

In instances where obtaining bank financing for the purchase of a small company on a stand-alone basis without additional collateral or co-borrowers is not possible, a SBA guarantee or underwriting by a state or municipal economic development agency may be available.

Financial institutions charge fees for making loans. These fees, which vary from bank to bank, reflect the time and effort required to evaluate and complete the financing. They are typically paid at settlement and range from 1 to 2 percent, depending on the bank and the complexity of the deal. Many financial institutions require that the borrower be liable for their out-of-pocket expenses.

Applying for Financing

It is important to be well prepared and have the information that a lender needs to make a decision. Data should be submitted in the form of a loan proposal and should contain the following items:

1. Purpose of the loan
2. Amount required
3. Term desired
4. Source of repayment
5. Collateral available
6. History and nature of the business
7. Age, experience and education of management
8. Key advisors
9. Product
10. Market area and method of distribution
11. Major customers
12. Suppliers
13. Competition
14. Facilities
15. Employees and unions
16. Three years of business financial statements
17. Three years of business tax returns
18. Current personal financial statement
19. Business income statement, balance sheet, and cash budget (for at least one year)

Pricing the Company

Determining the value of the company is the part of the buy/sell transaction with the most differences in opinion. Buyers and sellers usually do not share the same perspective. Each has their own rationale that may be based on logic or emotion.

The buyer may believe that the purchase will create synergy or economies of scale because of the way the company will be operated under new ownership. The buyer may also see the business as an especially good life-style fit that provides a measure of psychic income. These factors are likely to increase the amount of money a buyer is willing to pay for a company. The seller may have a greater than normal desire to sell due to financial difficulties or the death or illness of the owner or a member of the owner's family.

For the transaction to come to conclusion, both parties must be satisfied with the price and be able to understand how it was determined.

Factors that Determine Value

The topic of business valuation is very complex, there is no easy way to explain it. The process takes into account many variables and requires a number of assumptions. There are six important factors:

1.Recent profit history
2.General condition of the company (such as condition of facilities, completeness and accuracy of books and records, morale, etc.)
3.Market demand for the particular type of business
4.Economic conditions (especially cost and availability of capital and any economic factors that directly affect the business)
5.Ability to transfer goodwill or other intangible values to a new owner
6.Future profit potential

These six factors determine the fair market value. However, business rarely changes hands at fair market value. There are three factors that often come into play in arriving at an agreeable price:

1.Special circumstances of the particular buyer and seller
2.Trade-off between cash terms
3.Relative tax consequences for the buyer and seller, which depend on how the transaction is structured

Fair market value can be defined as the price at which property would change hands between a willing buyer and a willing seller, both adequately informed of all material facts and neither compelled to buy or to sell. In the marketplace, however, buyer and seller are nearly always acting under different levels of compulsion.

Rule-of-Thumb Formulas

The rule for using rule-of-thumb formulas for pricing a business is: Don't rely on them. The problem with rule-of-thumb formulas is that they address few of the factors that affect a company's value. They rely on a one-size-fits-all approach when, in fact, no two companies are identical.

Rule-of-thumb formulas do, however, provide a quick means of establishing whether a price for a certain business is in the ballpark. Formulas exist for quite a few industries. They are normally calculated as a percentage of either sales or asset values or a combination of both.

Comparables

Using comparable sales as a means of valuing a company has the same inherent flaw as rule-of-thumb formulas. Rarely, if ever, are two companies truly comparable. However, companies in the same industry do have some characteristics in common and a careful contrasting may allow a conclusion to be drawn about a range of values.

Balance Sheet Methods of Valuation

This approach calls for the assets of the company to be valued. It is most often used when the company generates earnings primarily from its assets rather than from the contributions of its employees or when the cost of starting a business and getting revenues past the break-even point doesn't greatly exceed the value of the business's assets.

There are several balance sheet methods, including book value, adjusted book value and liquidation value. Each has its proper application. The most useful is the adjusted book value method. This method calls for the adjustment of each asset's book value to equal the cost of replacing that asset in its current condition. The total of the adjusted asset values is then offset against the sum of the liabilities. The result is the adjusted book value.

Adjustments are frequently made to the book values of the following items:

- Accounts receivable- often adjusted down to reflect the lack of collectability of some receivables
- Inventory- usually adjusted down since it may be difficult to sell off all of the inventory at cost
- Real estate- frequently adjusted up since it has often appreciated in value since it was acquired
- Furniture, fixtures, and equipment- adjusted up if those items in service (probably more than a few years) have been depreciated below their market value or adjusted down if the items have become obsolete

Income Statement Methods of Valuation

Although a balance sheet formula is sometimes the most accurate means to value a company, it is more common to use an income statement method. Income statement methods are most concerned with the profits or cash flow produced by the company's assets. One of the more frequently used is the discounted future cash flow method. This calls for future cash flows (before taxes and before debt service) of the business to be calculated using the three-step formula below.

Step 1: Historical cash flows are a good basis from which to project future cash flows. Computation of cash flows include the following:

1.The net profit or loss of the company
2.The owner’s salary (in excess of an equivalent manager’s compensation)
3.Discretionary benefits paid the owner (such as automobile allowance, travel expense, personal insurance and entertainment)
4.Interest (unless the buyer is assuming the interest payment)
5.Nonrecurring expenses (such as nonrecurring legal fees)
6.Noncash expenses (such as depreciation and amortization)
7.Equipment replacements or additions (this figure should be deducted from the other numbers since it represents an expense the buyer will incur in generating future cash flows)

While the future cash flows may be projected for a few years, for many small companies it is meaningless to attempt projections very far into the future. Even with somewhat larger and more substantial companies, it is difficult to project cash flow for more than five years.

Step 2: Once future cash flows have been projected, they must be discounted to their present value. This is done by selecting a reasonable rate of return or capitalization rate for the buyer's investment. The selected rate of return varies substantially from one company to the next and is largely a function of risk. The lower the risk associated with an investment in a business, the lower the rate of return required. The rate of return required is usually in the 2050 percent range and, for most businesses, it is in the 3040 percent range. The present value of the future cash flows can be determined by using a financial calculator, Microsoft Excel, or a set of present value tables available from most bookstores or libraries.

Step 3: One more calculation must now be done -- the residual value of the company. The residual value is the current value of the company's estimated net worth at the end of the period of projected cash flows (in this example, at the end of five years). This is calculated by adding the current net worth of the company and future annual additions to the net worth. The annual additions are defined as the sum of each year's after-tax earnings, assuming no dividends are paid to stockholders. These additions are added to the current net worth and that total is discounted to its present value to yield the residual value. The residual value is then added to the present value sum of the projected future cash flows previously computed to arrive at a price for the business.

Although this three-step formula is widely used, it cannot be applied in this simple form to arrive at a definite value conclusion. It fails to address issues such as the buyer's working capital investment, the terms of the transaction or the valuing of assets such as real estate that may not be needed to produce the projected cash flows. It is best to retain a professional with business appraisal experience to get a more precise value.

Role of Advisors

A variety of resources are available for buyers and sellers seeking professional advice.

These resources include business owners in their industry, SBA counselors, industry consultants, professional intermediaries, business valuation experts, accounts and attorneys. Each can be of assistance and each has limitations.

Business owners, SBA counselors, consultants and intermediaries are the best source of industry information and operating suggestions. SBA, SCORE (Service Corps of Retired Executives), or ACE (Active Corps of Executives) counselors provide their services free of charge and can be reached through local SBA offices. Some SCORE counselors are qualified to advise clients regarding the purchase or sale of smaller businesses. Business owners may be able to give free advice and are often the best source of information. No one knows more about an industry than someone who is successfully running a company in that industry.

Business valuation experts can independently appraise a company's value. Bear in mind, however, that they rely on the representations of the seller. They render a conditional opinion based on the assumption that the seller's financial statements are accurate and complete. They will attempt to independently verify only certain information.

Accountants are best used to perform an audit (if one is needed), to help interpret financial statements or to provide advice in structuring the transaction to minimize tax consequences for the buyer and seller.

Probably the most frequently consulted advisor in the purchase or sale of a business is an attorney. Attorneys are asked to do everything from assessing the viability of a business and appraising its value to negotiating the purchase price and preparing the necessary documents. A good attorney advises and protect the client legally within the spirit of successfully concluding the transaction. Attorneys cannot assess the viability of a business undertaking. That is something only the buyer and seller can do. Few attorneys are qualified to value a company buy they can occasionally help negotiate a price between a buyer and seller. The involvement of an attorney (or any individual other than the principals) can, however, strain the lines of communication between buyer and seller, so an attorney should be used in the negotiation process only after careful consideration.

The primary function of an attorney is to prepare the purchase and sale documents as discussed by the parties. These documents should include reasonable and balanced protections for both parties. Reputation and experience in similar transactions are important criteria when selecting an attorney. It may make sense to choose one attorney to represent both buyer and seller. This avoids the adversarial relationship that opposing attorneys often adopt and improves the odds of successfully completing the transaction. It also eliminates some of the emotion in the negotiation process, improves the lines of communication between the parties, expedites completion of the deal and is less expensive.

Structuring the Transaction

The structure of a transaction has tax and other consequences to the buyer and seller as well as an important effect on the overall value of the transaction. The type of corporation (regular C-corporation or S-corporation) owned by the seller, the size and date of the transaction and the type of consideration paid may have a bearing on the tax consequences. Since tax laws are constantly changing, it is important to seek legal and tax advice in determining the best way to structure the purchase or sale.

Asset vs Stock Transactions

The purchase and sale of a company can be structured in one of two basic formats: (1) purchase of the assets of the selling corporation or (2) purchase of the stock of the selling corporation.

Asset Transactions

In an asset transaction, the assets to be acquired are specified in the contract. Practices vary from industry to industry but, in general, all assets of the company except cash convey to the buyer. None of the liabilities, except perhaps accounts payable, convey.

The selling corporation uses the proceeds from the sale to liquidate short-term and long-term liabilities. This means that the buyer purchases all of the company's equipment, furniture, fixtures, inventory, trademarks, tradenames, goodwill and other intangible assets.

An asset transaction is generally advantageous to the buyer. The buyer may acquire a new cost basis in the assets which allows a larger depreciation deduction. The seller must pay taxes on the difference between the basis in the assets and the price paid for the company.

The buyer may prefer an asset transaction for liability reasons. By purchasing assets, the buyer may avoid the possibility of becoming liable for any of the selling corporation's undisclosed or unknown liabilities. The most common liabilities of this type are federal and state income taxes, payroll withholding taxes and legal actions against the company that are contemplated but as yet uninitiated.

Stock Transactions

In a stock transaction, all of the shares of stock of the selling corporation transfer to the buyer. Therefore, all of the assets and liabilities also convey. In some cases, the buyer and seller may choose to exclude certain assets or liabilities from being conveyed. The seller must pay taxes on the difference between the seller's basis in the stock and the price paid by the buyer.

Sometimes stock deals are more expedient for both parties. Stock transactions provide for continuity in relationships with suppliers. They may also preclude the necessity of obtaining a lease assignment when there is no such provision in the lease in the event of a change in the controlling interest of the corporation. The risk of inheriting undisclosed debts of the seller in a stock transaction can be minimized by providing for the buyer's indemnification and the right of offset to future payments due the seller.

In choosing to structure a deal as a stock transaction, the seller should be aware that the sale of stock in a closely held corporation falls under the umbrella of federal securities laws. This places a greater burden on the seller in a stock transaction to fully disclose all material information about the company. Failure to do so exposes the seller to the risk of securities fraud litigation.

Seller-Financed Transactions

Sales of most smaller businesses and some larger ones, particularly corporate divestitures, are partly seller financed. Typically this arrangement calls for the seller to receive some cash at settlement, but for the bulk of the purchase price to be seller financed. Such transactions are a form of leveraged buyout. For smaller privately held companies, the down payment often ranges from 10 to 50 percent of the selling price and the buyer executes a promissory note (secured by the assets of the business only) for the balance. Such notes are typically for a period of three to ten years at an interest rate that varies with the prime rate but is most often 9 to 12 percent. The payments required to retire the debt service should not exceed 50 percent of the discretionary cash flow as calculated in the section on Pricing the Company.

Leveraged Buyouts

Just as in a seller-financed sale, in a leveraged buyout the assets of the company are used to collateralize a loan to buy the business. The difference is that in a leveraged buyout, the buyer typically invests little or no money and the loan is obtained from a lending institution.

This type of purchase is best suited to asset-rich companies. A company lacking the assets needed for a completely leveraged buyout may be able to put together a partially leveraged buyout. In this structure, the seller finances part of the transaction and is secured by a second lien security interest in the assets. Because leveraged buyouts place a greater debt burden on the company than do other types of financing, buyer and seller must take a close look at the company's ability to service the debt.

Earn-Outs

An earn-out, or contingent payment sale, as it is also called, is a method of paying for a company that helps bridge the gap between the positions of the buyer and seller with respect to price. Because the payment of money to the seller under the provisions of the earn-out is predicated on the performance of the company, it is important that the seller continue to operate the company through the period of the earn-out. An earn-out is usually calculated as a percentage of sales, gross profit or net profit. It is not uncommon to establish a floor and/or ceiling for the earn-out.

Earn-outs do not preclude the payment of a portion of the purchase price in cash or installment notes. Rather, such payments are normally made in addition to other forms of payment.

Stock Exchanges

In some instances the seller may want to accept the stock of the purchasing corporation in payment for the company. Typically, the stock received (if it is the stock of a publicly held company) may not be resold for two years. If the stock may not be freely traded, its value is diminished and should be discounted to allow for this lack of marketability.

There is an advantage to the seller in this kind of transaction, however. Taxes incurred by the seller on the gain from the sale of the company are deferred until the acquired stock is eventually sold. This kind of transaction is termed a tax-free exchange by the IRS. Several tests must be met to qualify for this tax treatment. Check with a competent accountant or tax attorney or request a ruling from the IRS Reorganization Branch in Washington, D.C.

Employee Stock Ownership Plans

An employee stock ownership plan (ESOP) can be a viable way of structuring the purchase or sale of a company. For the owners of privately held companies, an ESOP provides an excellent way to sell the company but still control it. In this arrangement, the ESOP is established with less than 50 percent of the company's stock. For a buyer, an ESOP has some powerful financial incentives to recommend it.

Here is how a leveraged ESOP works.

1. The ESOP purchases the stock of the company using funds borrowed from a financial institution.
2. The company makes tax deductible contributions to the ESOP.
3. The ESOP uses these contributions to repay the financial institution.

The best ESOP candidates have the following characteristics:

1. A consistent profit history with earnings of at least $300,000 (after restatement for owner compensation in excess of equivalent management). Companies in cyclical industries with fluctuating earnings are not good candidates.
2. An annual payroll of at least $500,000.
3. Enough management depth to run the company in the event the owner does not plan to stay on after the sale.
4. A relatively debt-free balance sheet.

ESOPs provide the unique advantage of a reduced interest rate on the loan to buy the company. Under some circumstances the law allows lenders to exclude 50 percent of their interest income on such loans.

An ESOP is a rare financial tool providing benefits not only for the owner but for employees as well. It gives employees access to the risks and rewards of a free enterprise economy. Experience demonstrates that sharing the risks and rewards of capital ownership with employees can improve a company's performance.

Negotiation

The fine art of negotiation plays an important role in buying or selling a business. Differences of opinion are inherent in the negotiation process and only realistic negotiators can find creative solutions to such differences. Because it is nearly impossible for the principals in a transaction to see the issues through the perspective of their counterpart, it is helpful to have a third party negotiate for them. Business brokers or merger and acquisition intermediaries are well suited for this task since they are usually familiar with the issues and options typical of such transactions.

Price is just one aspect of the transaction to be negotiated; terms are just as important, particularly the period of time over which the debt is to be repaid and the allocation of the purchase price for tax purposes.

Sellers usually have the upper hand in negotiations since they know the company best. A buyer can minimize the seller's advantage by learning as much as possible about the company. The section on Evaluating the Company identifies the key areas to be studied. It is important to do more than study the company to prepare for negotiations. The parties must understand each other's motivation for wanting to buy or sell the company and each other's plans after the transition. Each must also understand why the other has taken a certain position on a particular issue.

Developing a negotiating strategy means that each party must know the other's position and must develop his or her own position as well. The parties should prepare a list of reasons for their positions. They should also think through possible weaknesses in their reasoning. In this way, each can anticipate and respond to the objections of the other party.

The buyer should request that the seller not negotiate with other buyers while the specifics of the offer are being considered. It is to the seller's advantage, on the other hand, to negotiate with more than one buyer at a time. In negotiations it is most important to be able to see matters from the other party's perspective. This eliminates much of the difficulty of reaching agreement and saves time.

Making and Evaluating Offers

Making an Offer

Before making an offer, a buyer will typically investigate a number of companies. At some point in the investigation process, it may be necessary to sign a confidentiality agreement and show the seller a personal financial statement. A confidentiality agreement pledges that the buyer will not divulge any information about the business to anyone other than immediate advisors.

A buyer should determine a range of value for the company. An appraisal of the value of the hard assets of the company can be used to establish a pricing floor. A pricing ceiling can be established by using an appraisal that capitalizes projected future cash flows under new management.

A buyer should have access to all records needed to prepare an offer. If some information is lacking, the buyer must decide to either walk away from the transaction or make an offer contingent upon receiving and approving the withheld information. The nature and amount of withheld information determines which course of action to take.

An offer may take the form of a purchase and sale agreement or a letter of intent. Although they have different names, the two documents serve the same purpose. They are a means of documenting a buyer's expression of interest. They are usually binding on the parties although they often contain conditions that allow one or both parties to be released from the agreement. These may be the buyer's failure to obtain financing or the discovery of previously undisclosed adverse information.

Regardless of which form of the agreement is used, it should contain the following:

1. Total price to be offered.
2. Components of the price (amount of security deposits and down payment, amount of bank debt, amount of seller-financed debt, etc.).
3. A list of all liabilities and assets being purchased. The minimum amount of accounts receivable to be collected and the maximum amount of accounts payable to be assumed may be specified.
4. The operating condition of equipment at settlement.
5. The right to offset the purchase price in the amount of any undisclosed liabilities that come due after settlement and in the amount of any variance in inventory from that stated in the agreement.
6. A provision that the company will be able to pass all necessary inspections.
7. A provision calling for compliance with the bulk transfer provisions of the Uniform Commercial Code. (This does not apply to sales of the corporation’s stock).
8. Warranties and representations of clear and marketable title, validity and assumability of existing contracts, if any; tax liability limitations; legal liability limitations and other appropriate warranties.
9. A provision (where appropriate) to make the sale conditional on lease assignment, verification of financial statements, transfer of licenses, obtaining financing and other provisions.
10. A provision for any appropriate pro-rations such as rent, utilities, wages and prepaid expenses such as insurance, utility deposits, and license fee.
11. A noncompetition covenant. This document is sometimes part of and sometimes a separate exhibit to the purchase and sales agreement.
12. Allocation of the purchase price.
13. Restrictions on how the company is to be operated until settlement.
14. A date for settlement.

The purchase and sales agreement is a complex document and it is imperative to get professional help in drafting it.

Evaluating an Offer

The seller should look for all the same provisions in an offer that were just enumerated in the section on Making the Offer. The types of offers a seller is likely to receive depend in some measure on the size of the company. A seller should ask for a financial statement from an individual buyer. If the buyer is another company, the seller should request the company's financial statements.

Sometimes a commitment to the work ethic is the only nonfinancial attribute needed of a small business buyer. In other cases, successful related work experience may be important. If the buyer is another company, look for the logic behind the acquisition. Perhaps some kind of synergy or an economy of scale is created. A buyer should prepare and show the seller a post-acquisition business plan.

One final note -- carefully study offers to determine what assets and liabilities are being purchased. An offer for the assets of a business may be worth considerably less than an offer for its stock even though the price offered for the assets is higher.

Closing the Transaction

Business settlements, or closings, as they are also called, are the final legal procedure by which a company changes hands. It is important to have good problem-solving attorneys representing all parties. A good settlement attorney can help find creative ways to resolve differences of opinion.

One of the many details of settlement is that of meeting the requirements of the Bulk Sales Act in the event the assets (not the stock) of the company are being sold. This law calls for the company's suppliers to be notified of the impending sale. The suppliers must respond within the allowed time if money is owed by the seller. Another function performed as part of settlement is a search, to determine whether any liens against the company's assets have been filed in the records of the local courthouse.

Meeting Conditions of Sale

After buyer and seller have entered into a binding contract, there may be several conditions to be met before the sale can be closed. Such conditions often address issues such as assignment of the lease, verification of financial statements, transfer of licenses or obtaining financing. There is usually a date set for meeting the conditions of sale. If a condition is not met within the specified time, the agreement is invalidated.

Documents

A number of documents are required to close a transaction. The purchase and sale agreement is the basic document from which all the documents used to close the transaction are created. This agreement is discussed in detail in Making the Offer. The documents most often used in closing a transaction are described below. Other documents not described below may also be needed, depending on the particulars of the transaction.

The Settlement Sheet

Shows, as of the date of settlement, the various costs and adjustments to be paid by or credited to each party.

Escrow Agreement

Used only for escrow settlements. It is a set of instructions signed by the buyer and seller in advance of settlement stating the conditions of escrow, the responsibilities of the escrow agent and the requirements to be met for the release of escrowed funds and documents.

Bill of Sale

Describes the physical assets being transferred and identifies the amount of consideration paid for those assets.

Promissory Note

Used only in an installment sale, this note shows the principal amount and terms of repayment of the buyer's debt. It specifies remedies for the seller in the event of default by the buyer. It is signed by the buyer, and the buyer often must personally guarantee the debt.

Security Agreement

Creates the security interest in the assets pledged by the buyer to secure the promissory note and underlying debt. It also states the terms under which the buyer agrees to use those assets that constitute collateral. It is used only in an installment sale.

Financial Statement

Creates a public record of the security interest in the collateral and therefore notifies third parties that certain assets are encumbered by a lien to secure the existing debt. The cost to record the financing statement varies by jurisdiction. It is used only in installment sales.

Covenant Not to Compete

Protects the buyer and the buyer's investment from immediate competition by the seller in his or her market area for a limited time. The scope of this document must be reasonable in order for it to be legally enforceable. The covenant not to compete is sometimes included as a part of the purchase and sales agreement and is sometimes written as a separate document. It is not required in every transaction.

Employment Agreement

Specifies the nature of services to be performed by the seller after the sale, the amount of compensation to the seller, the number of times per week or per month the services are to be performed, the duration of the agreement and often a method for discontinuing the agreement before its completion. Employment agreements are not required in all transactions, but they are used with great frequency. It is not uncommon that the seller remain involved with the company for periods of as little as a week or as much as several years. The length of time depends on the complexity of the company, the depth of management and the experience of the buyer. For small businesses, the seller will usually provide some services for a period of several weeks. With larger companies, the seller is usually required to stay on for an extended period of time and is compensated for his or her services.

Contingent Liabilities

Contingent liabilities must be taken into account and provided for when a company is sold. They most often occur because of pending tax payments, unresolved lawsuits or anticipated but uncertain costs of meeting regulatory requirements. Contingent liabilities can be handled by escrowing a portion of the funds earmarked for disbursement to the seller. The sum escrowed can be used to pay the liability as it comes due and any remaining money can be disbursed to the seller.