

Selling a Business: Structuring and Negotiating The Best Deal

- **Nine Reasons to Sell a Business Today**
- **Steps to Getting the Most Money**
- ***Case Study: Sale of a Business***
- **Putting the Best Face on the Company**
- **Four Ways to Get Paid**
- **Valuing the Business**
- **How to Increase the Selling Price**

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The final price tag is just part of the story; how and when you get paid is the other part.

Selling Your Business

Selling your business means cashing in on your years of hard work and sacrifice. Buying a business offers an opportunity to expand, along with the assumption of risks. In both instances, the final price represents a significant cash commitment. But the price you think you are getting or paying can be dramatically affected by how the transaction is taxed by the IRS and the assumption of known or unknown liabilities. That's why the prudent buyer or seller analyzes all aspects of the deal, as well as the net after-tax cash received or paid.

In this **Resource Report**, we provide a comprehensive overview of how to structure and negotiate the sale of a business, including the four principal methods of payment, the tax considerations, use of a contingency earnout and installment note, continued benefits to negotiate, intangible assets to value, and much more.

You want to know the value of your business to any prospective buyer. Our evidence is the real-life example of a company acquired by a large company listed on the American Stock Exchange. The seller had revenues of \$4.3 million, a loss in its most recent year of \$128,000, and an accumulated deficit (negative) net worth of approximately \$1.2 million. Despite these facts, this owner *received \$1,800,000 cash at closing* because he knew and substantiated the value of his company to this particular buyer.

Selling your business can be one of the most difficult — and rewarding — experiences of your life. It takes a great deal of planning and attention to detail to make certain no areas are overlooked that will expose you to greater risk than necessary or leave you with less money than you deserve. Finally, if you're not familiar with the basic methods of valuing a business, please see page 16.

Buyers of businesses: The strategies, advice, and approaches in this Report are equally important reading. Knowledge of the seller's needs, questions, and concerns will help you close the transaction on a fair and feasible basis.

Thomas J. Martin, *Author*

Steps to Getting the Most Money for Your Business

#1 — Be knowledgeable of how deals are structured, what assets to keep, and what salary and benefits you want to continue.

#2 — Identify and list *all* the reasons the buyer is interested in acquiring your company.

#3 — Determine how much the buyer is willing to pay for your business, when you will get payment, and the type of deal structure: asset or stock purchase.

#4 — Analyze and quantify the buyer's savings and increased sales and profits *after* purchase of your company.

#5 — Adjust your own company's income statement to reflect the added sales and profits after the purchase. Do the same for the company's balance sheet to reflect today's fair market value of the assets, particularly real properties, leasehold improvements, and equipment.

#6 — Compute the total value of the company *to the buyer* and then set the asking price. Don't forget to include the value of your company's goodwill and intangible assets.

#7 — Structure the transaction to receive the most *after-tax cash* and know how to avoid or lessen the risks and problems associated with stock, installment, and contingency sales.

#8 — If you have substantial monies in a company retirement fund, life insurance policy, or deferred compensation plan, protect these assets. These are personal assets you accumulated as an employee of the company, not company assets. They should be separated out from negotiations on the company's sale.

#9 — If you or your family personally own the real property leased to your company, value and sell it separately. This alone can substantially increase the total selling price. Or, don't sell the property and enter into a rental agreement with the buyer.

#10 — Have alternative offers prepared in advance so an inability to come to agreement on one proposal doesn't kill the entire discussion.

#11 — Remember that the worst negotiating position is when a seller's back is against the wall and he or she needs to sell. Plan far enough ahead so you sell out before you get to that point.

Why Sell the Business

Too many business owners never think of selling out when their business is doing well. *Reasons:* They're collecting a good salary with excellent benefits, the business' future looks good, and there's little urgency to make big changes. But that's precisely when a company commands the highest price and can be sold for its full value. You've heard the saying about borrowing money from a bank: you can borrow on the most favorable terms when you don't need the money. Similarly, the best time to sell a business is when the company is doing fine and you don't have a reason to sell. That's when you, the seller, have the most negotiating strength.

You never want to be in the position of *having to sell* the business because of your illness or disability, sales and marketing problems, new competition, or any other management, financial, or legal problems. Selling your business is best done in a *stress-free* environment where you have plenty of time to prepare your company and consult with your professional advisers on how to present your company to buyers and negotiate the final price.

There are a number of excellent reasons for selling a business.

#1 — Reduced risk. Selling a business lessens an owner's financial risk by diversifying his or her personal investment holdings while providing increased liquidity. It's a matter of cash today versus owning a closely held, non-publicly-traded stock certificate.

#2 — Instant retirement money. Selling the business gives you and your family instant access to the financial resources that will allow you to retire on your timetable. You don't want to hold off on a planned retirement because you're stuck with the business in a tight-money market and you need to wait for the next market surge.

#3 — Higher return on investment. Look at your current ownership position from a return-on-investment point of view. Net proceeds of \$1,000,000 from the sale of a business should generate income of \$50,000 a year at an annual return of 5%. Now look at that 5% annual return from a continued *compensation* point of view. The \$50,000 is additional income (compensation) without tapping the \$1 million of principal.

#4 — Continued involvement. You don't have to walk away from the business after its sale. Many buyers want the owner to continue to be involved in the business, at least during the transition period, usually six months to one year, sometimes longer. That continued involvement earns you a separate salary or consulting contract as well as select benefits, such as health and life insurance. Any continuing involvement on your part should be negotiated and priced separately from the contract to sell the business.

#5 — Synergistic advantages and higher price. It is usually more efficient and economical for two companies, especially companies with similar products or markets, to operate under one roof. For example, a product or service developed by a smaller company might be marketed more effectively through a larger and more established sales force, better use can be made of technology, overhead expenses can be spread over more products, and duplicate operating expenses can be eliminated. The financial advantages for the buyer are: (a) the increased revenues from the added products, and (b) the increased savings from the combined operations. Keep this in mind when establishing the value of your company to the buyer; it can substantially increase the purchase price.

#6 — Business continuity. A purchase and sales contract that includes a comfortable transition period helps to assure continued success of the business you built. When there's no urgency to the sale, the new owners have time to get to know your customers and you have time to get your customers comfortable with the new owners.

#7 — Need for expansion capital. Merging with a larger company can provide the working capital needed to increase sales, expand production, or move into new product or marketing areas.

#8 — Your presence. An involved owner can carefully structure a sale to maximize the proceeds received, capitalize on the business' strengths, and provide for business continuity. When an owner has died, heirs often are forced to sell the business at a distressed price because of the urgent need for cash to pay living expenses or estate taxes.

* * *

To help in your work and analysis, we have included several discussions and

exhibits on the Tax Treatment for Sellers and Buyers, How to Adjust the Financial Statements for the Highest Value and Selling Price, and Proven Ways to Increase the Value and Selling Price of a Business.

Now to our Case Study.

By carefully analyzing all facets of your company, you should find many assets which were previously written off yet have real value for a prospective buyer.

Case Study: Sale of Business

Real-life example: Company A was out of cash and had exhausted its line of credit. Its loss last year was \$128,000 and its liabilities exceeded assets by \$1.2 million. Despite those facts, Company A sold for \$1.8 million cash at closing. Here's why.

Even if your company shows very little profit or ends the year with a loss, or your balance sheet shows a very high debt-to-equity ratio, or both facts exist, you can still justify a good value and selling price to a potential buyer.

The fact is that many potential buyers are interested in a company for reasons that have nothing to do with its current balance sheet and profits. Any of the following reasons — all prevalent in Company A — could justify a good selling price and significantly increase the final price tag.

Reasons: The combination of these two companies resulted in very significant economies of scale, cost savings and, most important, excellent growth opportunities for the buyer. The buyer could immediately increase the seller's revenues by at least \$1.5 million simply by selling its products to the buyer's own customer base. In addition, the buyer saved \$400,000 in research and development expenses for work already completed by the seller. There also were synergistic and other cost savings of about \$200,000 a year which made the seller's business profitable for the buyer despite its balance sheet deficit and operational losses.

The owner of Company A did his homework! He projected his company's profits after its sale and *then* calculated the value of his company to the buyer. Although the seller didn't receive 100% of the increased profits he had projected for the buyer, he did use that amount to negotiate for more money. *Remember:* The \$1.8 million price tag was negotiated even though the company showed a loss of \$128,000 in the most recent year and had a deficit net worth of \$1.2 million.

The \$1.8 million purchase price represented:

- 5.5 times the after-purchase operating profits of \$325,000,
- 9.5 times adjusted net income of \$190,000, and
- 4.1 times its adjusted EBIT (earnings before interest and taxes) of \$435,000.

This real-life example illustrates why it is *imperative* for sellers to identify all potential advantages to the buyer resulting from the acquisition — everything he or she stands to gain from owning your company. It is *not* just the company's reported book value, sales, profits, and cash flow that determine the value and selling price. *Consider the following questions.*

8 Questions in Establishing a Value

1. Does our product line fill a gap in the buyer's product line?
2. Do we have a trained sales force in place which can sell the buyer's products and services?
3. Does our company provide additional market coverage geographically that would cost the buyer a great deal of time and money to establish from the ground up?
4. Is the buyer getting a process, patent, or other assets which values are not reflected in our financial statements?
5. If the buyer can increase the company's revenues substantially, e.g., by selling our products or services to its own customer base, what will be its projected sales and incremental profits from adding our company's product lines?
6. How much would it cost *and* how long would it take for the buyer to get to where our company is today, considering our customer base, market niche, and the market and replacement value of our assets?
7. Are there significant tax advantages to the buyer from this deal? *Example:* How much can the value of the company's assets, principally equipment and real estate, *be written up by the buyer* to generate higher depreciation deductions and greater cash flow?
8. After I've identified the tax savings, *what is the buyer's after-tax cost* for acquiring my company? *Note:* It can be as low as 60% of the total purchase price.

Why buyers buy: Know that companies acquire other companies principally for three reasons. First, for *horizontal integration*, that is, to expand geographically or to sell a broader range of products to the same marketplace. Second, for *vertical integration*, that is, to acquire new processes or facilities in the same market, such as a publishing company which buys a printing company to print its books and manuals. Third, for *unrelated expansion*, where a company, frequently a large public company, enters totally new markets, either to increase its overall growth rate or to diversify and thus diminish its overall market and industry risk.

You must ask as many questions as the buyer. You then will determine why he or she is interested in buying your company. With that knowledge, you will be able to better assess the value of the company to the buyer and strike the best deal for you and other company owners.

Structuring and Negotiating the Deal

The best price in selling a business is not always the highest stated dollar price. You also must consider the effect of immediate and deferred taxes, the form and timing of the payments, any future benefits or restrictions on your activity, and any risks assumed in getting your money. *Ask yourself these questions:*

- How much will I net after taxes from the sale of the business?
- Will I receive cash, installment note, stock, or a combination thereof?
- Is the buyer purchasing the company's assets and assuming all or most liabilities, or is he buying my stock outright?
- If we are selling assets, what are the tax effects and how will I get the money out of the company? Will there be a double tax to pay: once at the corporate level and then again when the money is distributed to the owners? (Double taxation is explained further on page 13.)
- On an installment payout, what is the interest rate on the note and what are the risks of not receiving the money over future years?
- Is the installment note secured by the assets of the company or the shares of stock I'm selling? Is the profit on the installment note *immediately* taxable as income, which is usually the case with accrual taxpayers?
- What are my continuing obligations to the buyer, e.g., salaried employee, consulting, noncompete agreement? How much money will I receive for these conditions of sale?

- Do I have a bonus or contingency payout as part of the selling price? If so, what are the criteria for payment? (Contingent payouts are explained on page 15.)

Compute after-tax cash proceeds. The proceeds from the sale of a business can be taxable, partially taxable, tax-free, or tax-deferred. Keep in mind that if you can reduce or defer taxes by structuring the transaction to your advantage, you have the flexibility to accept a lower selling price. Remember also to make all calculations on both a pre-tax and an after-tax basis. You want to walk away from the deal with as much cash as you can on an *after-tax basis*. Your advisers will help you with this accounting and tax analysis. Be sure to use them.

Structure the payments. A seller can receive full or partial payment in the form of cash, notes, other debt instruments (sometimes convertible into the stock of the buyer), stock of the acquiring entity, or some combination of these payments.

Of course, all-cash-at-closing is usually best for the seller. Although tax liabilities accrue immediately, the seller has significant cash to spend or invest as he or she sees fit. He has tremendous liquidity; is free to diversify his investment portfolio; and has no contingent liability or installment payments to worry about.

Payment with the buyer's debt obligation, i.e., a deferred or installment payout, may spread the tax liability over the period the cash is received. However, if a larger corporation is involved, be sure that the installment note is the *direct* obligation of the parent company or at least guaranteed by the parent. You don't want a division of a larger company (of which your company is a part) declaring bankruptcy, recapitalizing, selling, or ceasing operations.

Separate selling price from compensation. You are entitled to *extra* monies if you are going to be a consultant or employee of the company. These payments *should not be* part of the purchase price for the company itself. It's best to negotiate these contracts as a *separate* agreement and to integrate its terms with the noncompete agreement so you are not restricted from competing if the buyer defaults on any payments due you. *Caution:* Don't accept a *lower* selling price for a higher consulting or compensation level which are taxed at personal income tax rates up to 39.6%; in contrast, the long-term capital gain rate is 15% and 20% for taxpayers with taxable income of \$450,000 (Joint) and \$400,000 (Single).

Protect your benefits. If you have substantial monies in a company retirement fund, life insurance policy, or deferred compensation plan, protect these assets. These are personal assets you accumulated as an employee of the company, not company

assets. They should be separated out from negotiations on the company's sale.

Value and sell real property separately. Be sure any real estate and leasehold improvements are valued separately from the company's operational assets. These hard assets are worth a lot of money to the buyer, particularly since they can generate future depreciation deductions. *Axiom:* Real estate affiliates should *always be valued and priced separately* from the business, particularly if the properties were purchased many years ago and carry little or no mortgage debt.

Value intangible assets and goodwill. Don't overlook *intangible* assets, including goodwill, which can greatly increase the value of your business and improve your negotiating position. You will find that many of these assets *have already been written off* and have a zero value on your company's balance sheet. They can include:

- Favorable customer and supplier contracts which extend longer than one year.
- Trained employees and a solid long-term management team with noncompete and employment contracts in place.
- Growth in the company's backlog versus a year ago.
- Interim financial statements that reflect a healthy increase in sales and profits.
- Sales literature, software programs, special manufacturing processes, drawings and dies, and marketing expertise.
- Licenses, trademarks, patents, registrations, copyrights, and trade name.
- Exclusive territory or product rights, e.g., franchisees, distributors, and sales reps.
- Location, e.g., a retail store with a long-term lease in a mall which has 30,000 visitors each week *or* a business which has approved zoning variances to easily expand at its current location.

By carefully analyzing your financial statements and all facets of your company, you should find more assets which were previously written off or for which the cash was already expended. Again, these assets can add greatly to the value and selling price of your business.

Know consequences of double taxation. The sale of C corporate assets can result in two taxations: the first at the corporate level and the second when the cash is

distributed to the company's stockholders. This double taxation also can apply to state and local income taxes.

In contrast, the owners of S corporations, sole proprietorships, partnerships, and limited liability companies **are taxed only once** when the profits and capital gains are passed through directly to them in proportion to their percentage ownership. *Example:* If you own 75% of an S corporation, you pay personal taxes on 75% of the company's profits and capital gains.

What to do: If you're planning to sell your business, discuss your existing corporate form with your accountant. There are IRS rules you have to follow in switching to another form of business but plan far enough ahead and you may get significant tax advantages for doing so. (*Note:* The double taxation above can apply to S corporations which converted from a C corporation within 5 years prior to the sale; check with your accountant.)

Four Ways to Get Paid

Method #1: All-Cash Sale

Advantages: You make a clean break with the company and are free to invest the proceeds and diversify your investment. *Disadvantage:* The tax payable on the proceeds could be substantial and it is due in the year of the sale.

Method #2: Installment Sale

Advantages: Your tax will be spread out and the buyer will have to pay you interest on the installment note. *Disadvantage:* There's the risk that the buyer will not be able to make the payments to you in future years.

Method #3: Stock-for-Stock or Combination Sale

Advantages: In most situations, you pay no tax on the stock received until you sell it and you share in the growth of both the buyer's company and your own former company. *Disadvantages:* You also share in any losses of the combined company. And, you usually are restricted from selling the stock of the acquiring company for a certain period unless you receive "registered stock", i.e., stock that is publicly traded and can be sold in the open market.

Method #4: Sale of Assets

Advantages: You may be able to get a higher price for the business because of the tax advantages to the buyer of *writing up* select assets to fair market value, particularly

equipment, which can then be depreciated by the new owner. And you make a clean break with the company. *Disadvantages:* It may be complicated both legally and tax-wise to take this route. Distribution of gains to the company's owners could result in *double taxation*, once at the business level and then again when the owners receive the distribution. In addition, you still will be liable for actual and unknown liabilities not assumed by the buyer.

Protecting Yourself on Stock, Installment, and Contingency Sales

Stock vs. asset sales. The current law makes stock sales, rather than asset sales, more attractive. As a seller, the payment you receive for a stock sale is taxed as a long-term capital gain, a big plus. And the buyer may be receptive to a stock purchase because the tax writeoffs on the purchase of intangible assets are stretched out over 15 years.

Cautions on stock sales: If you are accepting stock in exchange for your business, be sure you fully understand and believe in the acquiror's stock. Also, if the buyer is a publicly held company, try to get *registered stock* so you can sell the shares in the public market. If the buyer is a non-public company, accepting stock involves more risks and should be carefully evaluated with your advisers. Basically, you are moving from one illiquid position (your company's stock) into another illiquid position (the buyer's company). Furthermore, the new illiquid position is with a company you aren't managing, so its growth and profitability are under someone else's control, not yours. That's why many business owners are uncomfortable with selling out via a stock-for-stock exchange.

Still, there are benefits to a stock sale. It can be less hassle to effect and, in contrast to asset sales, it usually results in the assumption of all liabilities by the buyer, a big plus for the seller.

Installment sale. It's always preferable to *get paid today*, not over future years. However, if you must do an installment payout, limit it to five years, charge interest, obtain collateral (e.g., guarantee of the buyer and combined company and a first lien on the assets or stock sold), and try to limit the installment note to no more than 25% of the total selling price.

Caution: If you have any doubt about the financial soundness, character, and creditworthiness of the buyer, stay away from an installment sale.

Contingency payouts. Try to use a contingent payout *only* to bridge the “money gap” between you and the buyer. If you must go this route, be sure you and your lawyer understand and include the following in the purchase agreement:

- Will the earnout be based on profits or sales? On your company only or on the combined company with its synergistic higher sales and profits?
- Who is responsible for managing the business during the earn-out period?
- What accounting rules will define sales or earnings?
- How much of corporate overhead and financing costs will be charged to the new or combined business?
- If there’s a dispute on the earn-out amount, how will it be settled?

There’s more: Since earnouts involve uncertainties: (a) limit the contingent portion to no more than 20% to 30% of the total selling price, (b) try to make the formula and earnout a function of increased sales rather than profits, which are more difficult to determine, (c) set a minimum earn-out amount so you’re guaranteed some money, and (d) to avoid disputes, include specific, clear examples in the purchase agreement of how the formulas and payments to you are to be calculated.

How Much Is the Business Worth?

You can document and support your asking price by using the following valuation methods.

- *Reported net book value:* This value is prepared by your accountant; it's simply the company's total assets less all liabilities. To determine *tangible net book value*, subtract intangible assets, e.g., capitalized financing costs, from net book value.
- *Adjusted net book value:* This method increases the company's book value to the extent that the value of certain assets (principally real estate, equipment, and inventory) exceeds the cost basis of the assets as shown on the company's balance sheet. This approach usually increases the value of the assets and thus the company's book value.
- *Price-earning's multiple (p/e):* Here, you simply apply a multiple, say 12, to the company's net income. If the net income is \$100,000, the value of the company is \$1.2 million. The faster the company's growth, the higher the p/e. This is how most publicly held companies are valued.
- *Earnings before interest and taxes:* Referred to as EBIT, this method is similar to the p/e method described above. You determine the company's EBIT (earnings before interest and taxes) and apply a multiple to it, usually 4 to 8, depending on the company's growth rate, its profit margin on each dollar of sales, and other factors. *Note:* Some appraisers and analysts add depreciation and amortization expenses to the formula for what is referred to as EBIT-DA.
- *Replacement value:* This method writes up all assets to their replacement value and then subtracts the liabilities. It can substantially increase a company's value and is principally used when selling a business to company executives or to another company which wants to get into your line of business.
- *Projected or capitalized earnings:* This valuation method applies a present value rate of about 15% to the company's projected net income. Basically, it is *today's* value of a company's future net income, usually over the next three to five years. The value can be recalculated to include depreciation and amortization expenses for a total *projected cash flow value*. This method usually results in the highest value for a business whose earnings are expected to increase substantially in the near future. It is particularly appropriate for young companies which are growing very fast.

Your accountant can help you apply the valuation methods. But don't use only one

valuation method; to obtain an average value, calculate the value for several methods and then apply a "weight" to each method (e.g., 25% to each of four values).

Legal Work

Finally, there are legal matters that must be negotiated and settled. *Consider the following questions with your lawyer:*

- What happens if the buyer defaults on the payments due me? What actions can I take? Is there an arbitration clause in the contract? Do I want this clause?
- Who will prepare the legal documents related to the business' sale? As a general rule, it's best if your lawyer does it.
- Whose state's laws will decide legal disputes: the buyer's or my company's? Try to specify your state of residence. Otherwise, you may have to hire a law firm in the buyer's state to defend a lawsuit.
- Who is responsible for future liabilities, such as product liability lawsuits dating back to the time I owned the company? If you are, specify a maximum liability amount.
- What are the continuing obligations of the buyer in terms of my employment, consulting contract, fringe benefits, installment payments, contingency earnout, and so forth? Has my lawyer and accountant reviewed all of the agreements and properly protected me?
- Have I verified and reviewed with my lawyer the representations my company and I have made in the Purchase and Sale Contract? Have the words "to the best of my knowledge" been added to protect me against being sued personally or not receiving all the money payable to me? Are *all* the representations, e.g., accuracy of Financial Statements, attached to the agreement as Exhibits so there are no questions as to what the representations include?
- Is there a clause in the signed Purchase and Sale Contract which stipulates that its terms supercede all prior memoranda and letters, and negotiations?

While some of these issues may seem insignificant in relation to the value of the total contract, they can loom large during the final stages of negotiation...and in the future after the deal is closed.

You want a final and unconditional closing. Understand exactly how much you are

being paid for your business, its value in today's dollars, and the many tax and business considerations. Also, when negotiating, concentrate on the big picture: how much money, what form (cash, notes, stock), and when it will be received.

If you want no strings and no worries, sell your company for **all** cash. At the least, get 75% cash at closing. Settle for 50% *only* if you have excellent collateral and an iron-clad agreement with all possible problems provided for.

Last, consult with your advisers *before* starting negotiations or structuring the transaction. The sale of a business is a multi-faceted task which involves planning for taxes, pension and retirement money, compensation, continued benefits (e.g., life and health insurance), business form, and the final legal contract to be sure you get all of the money due you and your family with no or very few obligations going forward.

References:

- *Exhibit 1:* Tax Treatment for Sellers and Buyers — page 19
- *Exhibit 2:* Putting the Best Face on Your Company — page 20
- *Exhibit 3:* How to Adjust the Financial Statements for the Highest Selling Price — page 22
- *Exhibit 4:* Proven Ways to Increase the Value and Selling Price of a Business — page 25

Tax Treatment for Sellers and Buyers

- For the seller, goodwill is taxed as a capital gain and for the buyer, it's tax deductible over 15 years.
- Consulting and employment contracts are taxed as personal income at rates up to 39.6%; *for the buyer*, the cost is tax deductible as paid.
- Noncompete agreements are taxed as personal income at rates up to 39.6%; *for the buyer*, the value of the noncompete is deductible over 15 years.
- Stock sales usually result in a capital gain; *for the buyer*, the purchase price becomes its cost basis when the stock is sold.
- Asset sales can result in a combination of both income and capital gain taxation; *for the buyer*, asset sales usually result in increased cash flow through the writeoffs of equipment, real estate, and leasehold improvements.
- Some asset sales also can be taxed twice, once at the business level and then again when the proceeds are distributed to its owners; *for the buyer*, the seller's double taxation has no effect.
- *Bulk sales tax*: The *buyer* is responsible for the sales tax on most tangible assets purchased in an asset sale (exception: purchase of equipment used in manufacturing). *Note*: In most states, the *seller* is responsible for notifying the state sales tax authorities of the sale.

Putting the Best Face on Your Company

Considerable expertise in many different areas is required to close the sale or merger of a business. It's up to you to make certain that your business is presented to the right number of buyers, at the right time, and in the right light.

Don't do it alone: One of your first steps is to consult with your advisers. You also might consider hiring an investment banker to help you: (a) present your company, (b) value the business and recommend the asking price, (c) structure the transaction, (d) formulate negotiating strategies, (e) advise on business decisions made while your company is on the market, and (f) assist in closing the transaction.

Company profile: Before approaching potential buyers, you and your advisers should prepare written background information about your company, covering its history, products, financial profile, customers, niche, production, marketing, sales force, management, and the prospects for future growth. This document should emphasize the strengths of the business while placing any weak points in perspective.

An essential part of this overview should be a reconstruction of earnings, a must for closely held businesses since most owners tend to hold down taxable income to defer taxes. A reconstruction should add back to pretax earnings such items as excess salaries and fringe benefits paid to the company's owners, nonrecurring expenses, inventory reserves, excess market value of assets over the accountant's reported net book value, goodwill, and other items not reflected accurately or adequately in the balance sheet and income statements.

The basics: Any overview or profile of your company prepared for potential buyers should begin with a standard internal assessment of your company conducted with your advisers. This review should include the following:

- Analysis of the company's current and historical financial statements, form of business, and taxation.
- The company's special niche or position in the industry, whether for products or services, geographic areas covered, production efficiencies, distribution know-how, reputation, trade name, etc.
- Reported and adjusted book values (see page 16) and the replacement value of the company's assets.

- Financial position, e.g., debt-to-equity ratio, working capital position, operating ratios, annual growth rate, etc.
- Company's customer base and each customer's percentage of total sales.
- Depth, age, and experience of the company's management. Is the owner indispensable?
- Projected sales, profits, and cash flow.
- The present and future condition of the industry and its annual growth rate.
- Whether the company has any goodwill or other intangible values, such as licenses, patents, trademarks, favorable lease agreements.
- Market price and price-earning's multiples of stocks of other companies engaged in the same or a similar line of business.
- Adequacy and capacity of the company's facilities. Are they sufficient to accommodate projected growth? If not, has the need to raise capital for expansion been factored in?
- Review of the company's charter, bylaws, and other legal documents, such as employment contracts, lease agreements, and retirement plans.

Spin-off benefit: This analysis of selling a business also can be useful to owners in selling or transferring ownership to family members or others, raising capital, issuing stock options to key executives, effecting a buy-sell agreement, and planning for business continuity and estate taxes.

The key is to know what's involved in the process and how you would value your business *if you were buying it*. □

Knowing the importance of your company to the buyer can *substantially* increase the selling price.

How to Adjust the Financial Statements For the Highest Selling Price

The goal: To adjust the company's profits upward so you can apply the price-earning's (p/e) and earnings before interest and taxes (EBIT) multiples to the higher profits for a higher value and selling price.

The process: Before starting the valuation, you must adjust the company's financial statements. That's especially critical for closely held businesses because owners of these businesses typically keep *reported* profits as low as possible to minimize taxes. The techniques owners use to lower their company's taxable income include increasing salaries, declaring bonuses, setting aside more retirement money, starting and investing in affiliated businesses, and writing off bad inventory.

Fact: On average, a company's *adjusted* profits will be 80% above its *reported* profits. Its *adjusted* stockholder's equity (net worth or net book value) is usually 40% to 60% above *reported* equity. So don't penalize yourself today or limit the value of your business just because you made salary, tax, and cash flow decisions which lowered your profits in the past and reduced your stockholder's equity account. In most cases, the impact of those decisions can be explained and illustrated to potential buyers by showing them the adjustments you made to reflect the company's true profitability and equity position. And that should be done *before* starting the valuation or selling-out process.

Income Statement Adjustments. Adjustments to a company's earnings should add back to earnings: (a) excess compensation paid to the company's owners/officers and family members above reasonable amounts, (b) extraordinary tax writeoffs of bad debts, unusable inventory and equipment, etc., (c) unreasonably high fringe benefits, and (d) any nonrecurring expenses incurred in one year which benefit the company over future years, e.g., preparing and printing sales brochures, research and development costs, establishing a new sales office, etc.

Example of add-backs: If the company's *reported* pretax income is \$90,000 (\$60,000 after taxes) and these adjustments total \$70,000, its *adjusted* pretax income is \$160,000. To this figure, apply a corporate tax rate (say, 35% overall) to obtain the

company's *adjusted* net income of \$104,000 (65% times \$160,000). Thus, your company's *reported* aftertax income was *adjusted* from \$60,000 to \$104,000. Now, to determine the value of the business, let's apply a simple 10 price-earning's multiple (p/e) to both numbers:

$$\begin{aligned} \text{Reported Net Income: } & \$60,000 \times 10 \text{ p/e} = \$600,000 \\ \text{Adjusted Net Income: } & \$104,000 \times 10 \text{ p/e} = \$1,040,000 \\ \text{Added Company Value} & = \$440,000 \end{aligned}$$

The added value of \$440,000 represents a 73% increase in value above the value based on the company's *unadjusted* financial statements. That shows you the importance of adjusting the financial statements *before* starting the valuation process and setting a price tag on the business.

Balance Sheet Adjustments. Do the same to the assets on the balance sheet, e.g., inventory, real property, leasehold improvements, equipment, and investments in affiliated companies. The reported net book values of those assets also are usually *understated* and must be adjusted upward or downward to fair market or replacement value. The extra values are then added to the company's net worth or stockholder's equity account.

Example: Let's assume that on the company's latest balance sheet, your accountant reports that the company's net plant and equipment value (after accumulated depreciation) is \$220,000. However, you do some research on current pricing and you find that the current fair market value (FMV) of the plant and equipment (if sold as is) is \$300,000. Thus, you have an *increased value* of \$80,000, which would be added to the company's stockholder's equity account, which correspondingly increases the overall value of the business.

What about the replacement value? This computation is also important since it values the plant and equipment as if they had to be totally replaced today. With rising costs over the years, as well as depreciation of the assets each year, the replacement value should be substantially higher than the FMV since that value assumes the assets are sold today in their current used condition. Thus, using an assumed replacement value of \$400,000 in our example above, the company's increased value is \$180,000 (\$400,000 replacement value *less* the accountant's reported net book value of \$220,000). That \$180,000 represents an 82% increase above the accountant's reported value of \$220,000.

Who's interested in replacement values? Potential buyers of the company who

want to get into its line of business *or* company-employed executives who want to buy the business from you. *Your selling position is:* It would cost them \$400,000 to replace the equipment and get to where the company is today. Furthermore, the equipment is in place, de-bugged, and fully operational. Those are very strong arguments to use in valuing these assets above the accountant's reported net book value.

Final comments. *First*, if the company is a sole proprietorship, partnership, S corporation, or limited liability company, you must adjust the income statements as if it was a regular (C) corporation with applicable corporate, not personal, tax rates.

Second, if the company owns an affiliate, that affiliate must be valued separately. *Reason:* The value on the balance sheet is the company's net cost, which could be substantially lower than the affiliate's fair market value. Again, that excess value is added to the stockholder's equity account and increases the selling price. □

Adjust the company's profits upward so you can apply a multiple to higher profits.

Proven Ways to Increase the Value and Selling Price of a Business

It's not all numbers. As indicated in this Report, there are many factors which affect the level of the multiple and thus the resulting value placed on company profits. Knowing those factors will help you maximize the p/e and EBIT multiples to be applied to your company's profits and thus the value placed on the company. Here is a summary of the major ones to consider.

- #1. *Growth rate:* The growth rate of company sales and profits in comparison with our national growth rate and, in particular, the growth rate of the industry you are in. The higher the growth rate of your company and the industry in which it sells, the higher the multiple.
- #2. *Operating profits:* A company's operating profit as a percent of sales and its comparison with industry standards. For example, if the company earns 12% on each dollar of sales and the industry average is 8%, the difference of 4 percentage points supports a much higher multiple.
- #3. *Fundamentals:* Good profits and return ratios, excellent management, solid balance sheet, adequate facilities for growth, etc.
- #4. *Niche:* The company's special position in the industry, whether for products or services, geographic area covered, production efficiencies, distribution know-how, reputation, trade name, etc.
- #5. *Multiple sales opportunities:* The products or services have multiple markets and end-users, providing an opportunity for growth within current markets and from future penetration into new markets.

A special niche, be it a product, distribution method, location, or geographic area covered, can substantially increase the business' value.

- #6. *Proprietary products:* Proprietary nature of the products and services, e.g., compare a company which is solely a distributor of products versus a manufacturer which has proprietary products. The more proprietary the products and services, the higher the EBIT and p/e multiple to be applied to the company's profits.
- #7. *Customer list:* Breadth of the customer base, i.e., good distribution versus a heavy reliance on a handful of major customers. Also consider the *average* number of years these customers have been buying from the company, e.g., two years versus five years.
- #8. *Product mix and gross profit:* The greater the number of products your company sells, and the greater the gross profit (percentage return) on those products, e.g., 40% versus 20%, the better. The higher the return on sales, the greater the number of dollars that flow to profits and thus the greater the multiple that can be applied to those profits.
- #9. *Replacement value of assets:* View the company from the eyes of a prospective buyer. How much money would it cost the buyer to replace the business' assets and operations and how long would it take to get to where your company is today? Knowing this replacement cost data is critical to negotiating a good deal and getting a higher multiple (price) for the business.
- #10. *Interim results:* If they reflect a good increase in sales and profits, e.g., your six months' results show a 30% increase in profits, you can *annualize* the results and apply the multiple to the higher profits.
- #11. *Income projections:* The higher and more certain the projections, the higher the multiple you can apply to the company's profits.
- #12. *Growth capacity:* The company's current working capital, facilities, and number of employees are adequate to meet its sales and profit projections for the next few years.
- #13. *Same line of business:* When a buyer is rounding out a product line you already have or expanding to a geographic area you already cover. In these cases, you should first adjust company profits upward (costs lowered) to allow for the buyer's reduced costs of buying the company, e.g., duplicate accounting and legal fees, select administrative and sales expense, and lease/rental expenses if the buyer intends to consolidate your operations into his or her company's. In essence, you want to know the buyer's profit *after* acquiring your business.
- #14. *Intangible assets:* Many have already been written off and have a *zero value* on the company's balance sheet. These intangible assets can include: long-term customer and supplier contracts, high-traffic location, favorable leases, trained employees and a solid long-term management team, growth in the company's backlog, special manufacturing processes, licenses, franchise, trademarks, patents, copyrights, and/or an exclusive territory or product rights.

By carefully analyzing all facets of the company, you should find more tangible and intangible assets which were previously written off or for which the cash was already expended. Again, these assets can add greatly to the value of the business and its selling price. □

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