Chapter 12: Selling and Buying a Business: Introduction

Most sellers know little about the relationship between cash flow and value. When earnings are down, the business value falls along with it. If earnings are up, value is up. If you cannot finance the business, you cannot sell it. Buyers pay for the past performance of a company and not its potential or "pro-forma" income stated by the seller. Another misconception is that buyers continually think that they can purchase a business with little or no equity.

Introduction

In general, the steps to selling a business are rather straight forward, but are usually difficult to execute. In general, the steps which are usually taken, depending upon whether you are a buyer or seller, are:

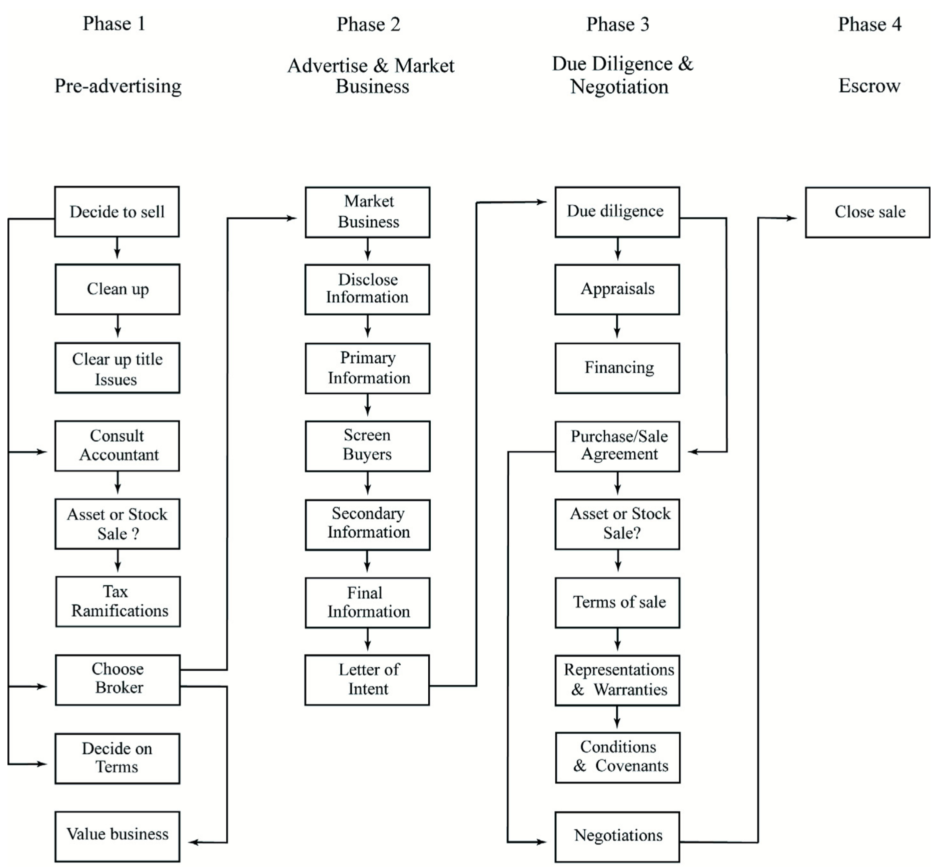
(1) decide on value of business
(2) execute or receive a letter of intent
(3) conduct due diligence (do your homework/research)
(4) provide or a receive a purchase sale agreement
(5) negotiate
(6) close the sale

Obviously there is more to these steps, such as tax issues and financing. A summary of the phases of a sale are summarized in Figure 12-1 on page 266.

Theory vs. Reality

Considerations such as marketability, financing, and personalities have a significant impact upon the transaction price. Most buyers have never heard of a Gordon Growth Model, Excess Earnings Approach, Capital Asset Pricing Model, and so on. For businesses under $10,000,000 in value, there is no formula or right price. Ultimately, price and terms are correlated and each affects the other. One cannot quantify the irrational characteristics of a buyer and seller.

Figure 12-1: Phases of the Sales Process



Buyer Expectations

When searching for a business, buyers look at a business from a point of view which is completely different than that of a seller. For a seller to be successful in selling his or her business, it is vital to understand the concerns of a buyer. These concerns and buyer red flags can be seen in Table 12-1 on page 267.

Table 12-1: Buyer Concerns and Red Flags

Items Buyers Look at	Red Flags
Survival	Can I support my family?
Financial Records	Obsolete records deter buyers. If "due diligence" is more difficult, then buyers will place a larger discount upon the value of the business. Businesses are more marketable if cash flow statements, profit and loss statements and balance sheets are prepared monthly and year to date, with percentages. If acquirer is a publicly traded company, then the SEC may require an audit of company. If this is too expensive then the potential acquirer will move on.
Financial Health/Operations	Small customer base deters buyers; ratios should be similar to or better than industry standards; inventory should maintain proper turns; choosing between FIFO or LIFO accounting is less significant than obsolete inventory.
Liabilities	High liabilities increase the risk and lead to negative cash flows in downturns, thereby decreasing assets and making bank financing difficult. Buyers wonder if they can operate differently or whether most of the cash flow will go to servicing interest and principal. Lower liabilities leave more money for the seller.
Sales and Marketing	A bad marketing program or lack of one will deter buyers. As a result, only those buyers with a strong sales background will pursue the company. A $1 increase to the bottom line will add $2-5 or more to the business value.
Non-Business Investments	These personal investments may be difficult to clear from the overall business and may deter buyers.
Owner Perks	"Skim" cannot be sold, and a low earnings figure reduces taxes but also reduces the value of the business more than the tax savings. If the seller is cheating the IRS, then the buyer figures that he is probably next in line.
Key Individuals	The owner cannot be the only key to operations. Buyers are always concerned that sales people or other critical personnel may exit after the purchase of the business. Some or all customers may vanish after the seller leaves if these are seller relationships. This is particularly true for professional practices.
Emergency Preparedness	What happens if an owner becomes disabled? Is personnel being cross trained on a revolving basis?
Family Members	Buyers do not want businesses with too many family members as management. Buyers already have a family. They just want a business.
Partners/Spouses	Is there a buy-sell in place? Has the other person/persons agreed? If the business is selling because of a divorce, most buyers will move on.
Governmental Regulations	Are licenses and permits up to date? If the business has toxic waste, are all taxes paid? If the business has sterilization lots for FDA compliance, is all paper work in order? An audit by the FDA can stop a business immediately. Are payroll, sales taxes, federal and state taxes up to date?
Rules of Thumb	Used by CPAs & sellers, but not by buyers; buyers seldom (if ever) think in terms of the IRS "ARM 34" or "excess earnings" formula, or any reasonably close variation thereof. However, owners' accountants frequently use it, often with an unrealistic total capitalization rate of 10% to 15%.
Pricing	Publicly traded comparables for analysis of small businesses are almost meaningless; buyers know that high price to earnings ratios of publicly-traded stocks are irrelevant, and even though Charlie down the street sold his business for $1,350,000, (or so he says), this similar business can't be priced or paid for on Charlie's word. In examining historical earnings, buyers emphasize the most recent years and months, with little weight on earlier years, regardless of the shape of the historical earnings curve.

Table 12-1: Buyer Concerns and Red Flags

Items Buyers Look at	Red Flags
	Return on investment is usually considered by buyers to be a cash-on-cash return of post-debt service and post-salary, based on the cash down payment plus the working capital required; finance theory gives various ways of computing ROI (return on investment), but buyers generally use this method. A few sophisticated buyers will use Internal Rate of Return calculations; a few know of the Capital Asset Pricing Model, betas, small stock long-range rates of return, and similar matters. Book Value, and unfortunately not Adjusted Book Value, is usually a consideration with buyers, but is seldom the main factor in developing an offering price, except when earnings will not support an earnings-based purchase price (turn-around or new businesses). For profitable businesses, most buyers will not pay for more than several times book value, regardless of rates of return or ROI, even in service businesses. Book assets are the least risky values and are essential as collateral for future debt-funded growth or working capital.
Discounted Cash Flow	Discounted future income of high-growth companies is seldom used by buyers in setting a price unless the future growth portion of the earnings is paid mostly on a contingent basis (earnouts, profit sharing, stock value increase, etc.) Sophisticated buyers use future projections in setting price and terms.
Cleanliness of Operations	This can deter a buyer immediately. If the facility is clean, then the books are probably clean, or reasonably so. If the facility is messy, then so is management and the attitudes of employees toward the business.

Seller Characteristics

Generally, sellers of businesses can be divided into six groups:

(1) the “blue sky” group;

(2) those who obtain a sale price in order to maintain their income or life-style;

(3) those who think they should win the lottery or be compensated $2,000,000 for all of their hours of work;

(4) those who think that they should be substantially compensated for their assets which they purchased at liquidation prices at auctions;

(5) those that value their business based upon faulty consultant information (also formula sellers); and,

(6) realistic sellers who understand the process of selling a business.

The “Blue Sky” Seller

First, the blue-sky group thinks that they should be compensated for a large amount of goodwill or “blue sky” over what the business is worth. This may make sense. However, the company needs to be profitable, not be in a commodity industry, and be able to have returns over and above the industry average return. I have seen many sellers insist on being compensated for blue sky (goodwill), even though they are losing money.

The “Maintain Life-Style” Seller

Second, many business owners have made a good income from their businesses and therefore are accustomed to a particular life style. When they realize that they will earn a lower yield from the proceeds of their business sale, they tend to increase the sale price until they can back into the return desired.

The "Payback" Seller

Third, many owners have worked all of their life at a business and feel that they should be compensated for all the time which they have put into the business. Since sellers have put thousands or "millions" of hours into the business, they need to withdraw all of those hours, similar to a bank withdrawl. Oftentimes, a seller cannot forget the amount of time and expense involved in a certain project.

The "Assets are Worth More Than Cash Flow" Seller

Fourth, there is the seller who wants the buyer to know about all the great deals on the assets, that he or she purchased in the way of machinery and equipment at auctions, and how valuable they are today. As discussed in Chapter 9 on machinery and equipment, the liquidation value of equipment is substantially different from value "in use." Business brokers cannot compensate an owner for both the sale of his business, and a second time for the assets. If the assets are contributing to the cash flow of the business, then they cannot be separated. A seller may want to sell the company but keep most of the assets. This is just not possible, unless the price is reduced by the value of the assets taken by the seller.

Usually new assets translate into more cash flow, although this is not always the case. Sometimes a seller will have invested heavily in new capital equipment, which does not make a dent in the cash flow.

The "Bad Counsel and Formula" Sellers

Fifth, sellers are often misinformed. They may believe that pricing is based upon the price earnings ratio of publicly traded companies (aftertax, and not pretax) or some percentage of annual gross sales, and/or receiving bad information from an accountant or attorney who is not familiar with the market or valuation. An attorney, accountant or financial planner is not going to say to his client, "I don't think that your company is really worth much," since these professionals may fear losing their clients.

Even worse than bad advice is the belief that a company should sell pursuant to some rule of thumb. After an owner uses a formula, it is difficult to make him or her to change his or her mind. These sellers are the most dangerous since they will stick to a preconceived value regardless of how unrealistic the value may be.

Realistic Sellers

Finally, there is the realistic seller who wants to obtain a fair price for his or her business and understands value and the selling process. Only about 15-20% of all businesses eventually sell because both the buyer and seller are realistic.