Chapter 14: Selling a Business: Terms and Financing

Terms and financing can make or break a deal. If the business cannot be financed it probably will not sell. Since most small businesses sell with seller financing terms, this seller financing becomes intricately related to the purchase price. This chapter focuses on the basics of negotiating and structuring seller financing.

Introduction

Besides tax and legal considerations, the financing of a company is the most important aspect of purchasing a business. Financing needs to be secured for both the equity as well as the debt. In many cases the debt will be handled by the seller, but not always. Most owners wish to walk away from the business. Equity is usually based upon the buyer's personal savings. Aside from the downpayment, working capital is needed, especially for an asset sale.

The equity of the buyer and his or her ability to bring working capital to the table are critical. A seller needs to be on guard against a buyer who is undercapitalized, borrows in order to make the down payment, and wants the seller to take a note. In this case the seller would be simply selling the business for a borrowed down payment.

Oftentimes a question arises as to whether an all cash or a down payment is best? From a tax standpoint, it is usually better for a corporation to borrow the difference between the purchase price and the down payment.

Tax Differences Between All Cash and Partial Debt Transactions

Assume that a buyer purchases a C corporation and purchases the business for $1,000,000. If he pays for the business with cash, then he will have additional taxes if he pulls out future proceeds in the way of dividends. On the other hand, if he puts $300,000 down, borrows the rest from a third party, and pays off the loan of $700,000 after seven years, he would own the business, debt free, with an investment of only $300,000. If instead he finances the entire purchase price with his own cash, and withdraws the $700,000, all or part of this amount could be viewed as a dividend. This amount would be nondeductible to the company and would be ordinary income to the buyer. If the $700,000 was taxed as a dividend and the buyer had a 37% marginal tax rate, then he would owe an additional $259,000.

Why Seller Financing Helps Sell the Business

The old adage "your price, my terms" is used more in business sales than in any other type of transaction. Failure to agree on a price is the main "deal breaker." From a seller's standpoint, he wants all cash. From a buyer's standpoint, he wants to put the least amount of money down. Obviously, some agreement can usually be reached through the use of seller financing. This course of action works best for businesses which sell for $2,000,000 or less.

There are many good reasons for the use of seller financing rather than bank financing:

- Most businesses' financial statements will not support the size of the acquisition loan;
- Bank terms usually add higher risk due to their variable interest rates and shorter term periods;
- Bank financing complicates a transaction and takes control away from both the buyer and seller.

Seller financing benefits the seller because she will receive more for her business, and the transaction can be closed much faster. In addition, buyers typically judge the business to be more sound if there is seller financing. The buyer believes that if the seller provides financing, then the seller has confidence in the business.

In summary, there are typically a number of different reasons why seller financing is helpful:

- the seller will usually receive more for his or her business;
- the business has a higher probability of selling;
- the note many be used by the seller to borrow money; and
- in many cases the tax ramifications are more favorable for the seller.

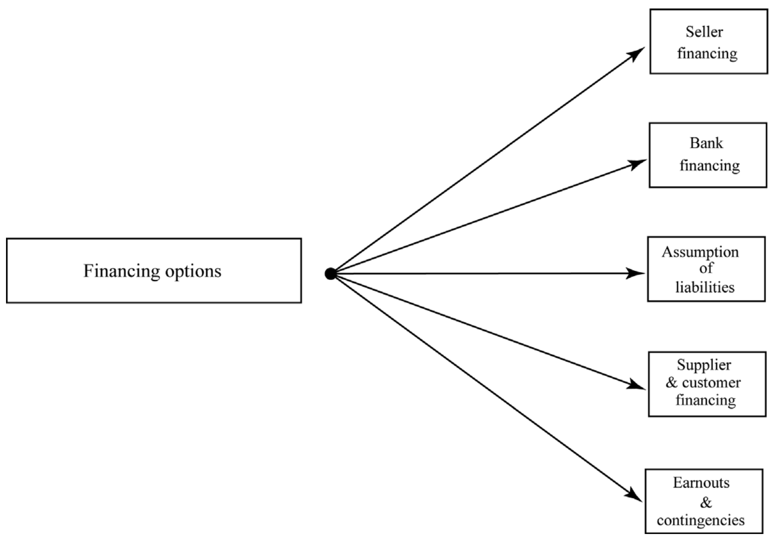
Financing the Acquisition

There are generally five basic sources of financing a purchase shown in Figure 14-1 on page 315.

Seller Financing

Substantial discounts are made for an all cash versus a seller financed sale. On average, businesses which sell for all cash are usually sold at 70-85% of the asking price, while those that have seller financing sell for an average of 85-90% of the asking price, assuming that the value is fair.

Figure 14-1: Five Basic Sources of Financing



Types of Notes

When structuring the transaction, there are a number of different types of notes, also referred to as the "Note and Security Agreement." Table 14-2 on page 316 provides an overview of various types of debt instruments which can be used as seller financing.

The various types of notes which can be written are infinite. The notes seen in Table 14-2 are the most common. The seller should know how the note will affect the seller's tax position. These financing agreements should be reviewed with a tax accountant or a tax attorney before signing.

Bank Financing

Bank financing is a broad topic. However, Table 14-1 provides a brief overview of the sources of cash which are available to small businesses.

Table 14-1: Conventional Private Sources of Financing

Source	Pros	Cons	Comments
Savings and Loans	Loan period may be longer (up to 15 years) than commercial banks.	Focused on real estate; will only lend if you have a track record.	Usually require personal guarantees or assets as collateral.
Commercial Banks	Wide range of options, such as equipment lending, seasonal credit lines, factoring, etc.	Usually only lend for 5 years; will only lend if you have a track record.	Usually require personal guarantees or assets as collateral.
Small Business Investment Companies	Offer some equity. Debt amounts range from $250,000-$3,000,000.	Usually only lend to businesses with a track record.	Funds are guaranteed by SBA.
Leasing Companies	Little or no down payment.	Interest rates may be high.	Finance of mostly secured assets.
Commercial Finance Companies	Loan to more risky businesses; don't require compensating balances.	Interest rates may be high.	Usually focus on asset based loans such as working capital (inventory and A/R), factoring, leasing, etc.

Table 14-2: Typical Types of Notes Used for Seller Carryback

Type	Explanation	Advantages	Disadvantages	Example
BALLOON PAYMENT NOTE	Buyer pays the seller a monthly amount based upon either straight interest or an amortized amount, with the balance due at the end of the term, typically 3 to 10 years.	Allows seller to receive monthly income over a short period of time	Only allows buyer to typically pay interest, with no paydown of principal. Buyer will need to find another source of financing at the end of the term.	(a) Buyer agrees to straight interest on a $750,000 note, at 9%, due in 7 years. Result is that buyer pays monthly payments of $5,625/month ($67,500/12 months) and has to pay the entire $750,000 at the end of 7 years. (b) Buyer agrees to same interest rate, amortized over 15 years, due in 7 years. Result is that buyer pays monthly $7,606/month, and pays down $230,758 so that he owes $519,241 at the end of 7 years.
PERIODIC REDUCTION PAYMENT NOTE	With this note, buyer pays more debt during the high sale seasons of a particular business.	Reduces payments for buyers during slow times of the year, allows for a faster payback.	May lead to litigation by seller if seller cannot cross-check buyer's books; more uncertain as to term of payoff.	Owner sells three roadside ice cream parlors which only operate in the East Coast from May 1 to October 31. Seller agrees to take back a $750,000 note, amortized over 7 years at 9% per year, with 20% of yearly payments being spread out over 6 months, and 80% being paid from May-October. Total yearly payments are $144,801. Buyer pays 80% of this over six months, from May-October @ $19,306/mo, and pays the other 20% over 6 months of the slow season @ $4,826/mo.
ADJUSTABLE RATE NOTE	This is a note pegged to an index, whereby interest rate rises or falls as cost of funds to a national mortgage organization increases, such as Federal Home Loan Bank District, or a bank's local cost of borrowing. Usually there is a cap on the rate, and the index is usually adjusted every 6 or 12 months. Term can be structured to extend if interest rates rise.	Allows sellers to receive higher interest rates as they increase; buyer may actually pay less when the index falls.	Buyers will have higher debt payments, resulting in cash flow squeezes, and if high enough, then the business may fold; seller will receive less if interest rates fall.	Seller agrees to take back a $750,000 note, rates are currently at 7% and is equal to the 11th district cost of funds, plus 200 basis points, with a reset every 6 months. The first six months would be at 9%. The next six months, the cost of funds increases by 25 basis points to 7.25%. Therefore, the interest rate to the borrower is now 9.25 (7.25 +2.0).

Table 14-2: Typical Types of Notes Used for Seller Carryback

Type	Explanation	Advantages	Disadvantages	Example
SHARED APPRECIATION NOTE	Primarily used in real estate transactions, but has similarity to venture capital transactions. Seller gives buyer a low interest note, in exchange for the seller participating in any upside if the business goes up in value, and is then sold.	Allows seller to participate in upside.	May not allow seller to maximize liquidity. Also, buyer may run the business into the ground, thereby minimizing residual or exit value.	Seller accepts offer to receive a $1,100,000 sale price, with a $750,000 note to carry back. Buyer agrees to pay 2% interest, amortized over 7 years, in exchange for giving the seller 30% of the appreciation in the sale price, for a term of 7 years, as dictated by a business appraiser.
GRADUATED PAYMENT NOTE	Allows buyer to pay smaller payments initially, and then gradually pay more as time goes on. This can be structured in any different way, with amortization, interest only, or some stepped-up formula.	Allows buyer to have an easier transition, will not affect his working capital, thereby increasing probability of success for the buyer and for the seller to be paid back.	If initial payments are less than the interest rate, then there will be negative amortization and the amount due will be higher than at the outset, as well as possible tax problems for seller.	Seller agrees to take back a $750,000 note, at 9% amortized over 7 years. However, the first six months will have interest only at 3% annually. Result is that monthly payments will be $1,875/month. At the end of six months, $11,250 will have been paid out. However, principal to be paid over the next 6.5 years is $772,926. Monthly payments will now be $12,067 per month. Balloon payment at the end of 7 years of $111,580.
STRAIGHT PAYMENT OF PRINCIPAL NOTE	This is a note where there is no interest paid and only the principal is paid back. This is usually used when the purchase price is too high.	Buyer gets to purchase the business and not overpay; seller gets to liquidate his business at his perception of the value.	Seller may have negative tax ramifications if this is done.	Buyer thinks that the business is worth $900,000 and wanted the seller to take back a note of $550,000. Seller thinks that the business is worth $1,000,000. Both agree on $1,000,000, but buyer puts down $250,000, and pays the seller back $750,000 over seven years, with no interest. Assuming that buyer was going to amortize the $750,000 at 9%, over 7 years, his monthly payment would have been $12,067. Now it is $8,929/month.

In general, the financing companies will loan on the assets at the following "loan to value" ratios, seen in Table 14-3, which is defined as the relationship, expressed as a percentage between the principal amount of a loan and the appraised value of the asset.

Table 14-3: "Loan to Value" Ratios for Financing Assets

Asset	Loan to Value
Land and Building	60-80%
Machinery & Equipment (Forced Liquidation)	30-70%
Inventory	25-60%
Accounts Receivable	70-85%