Chapter 15: 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 (Seller Financing)

There are generally five basic sources of financing a purchase shown in Figure 15-1 on page 389.

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.