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:

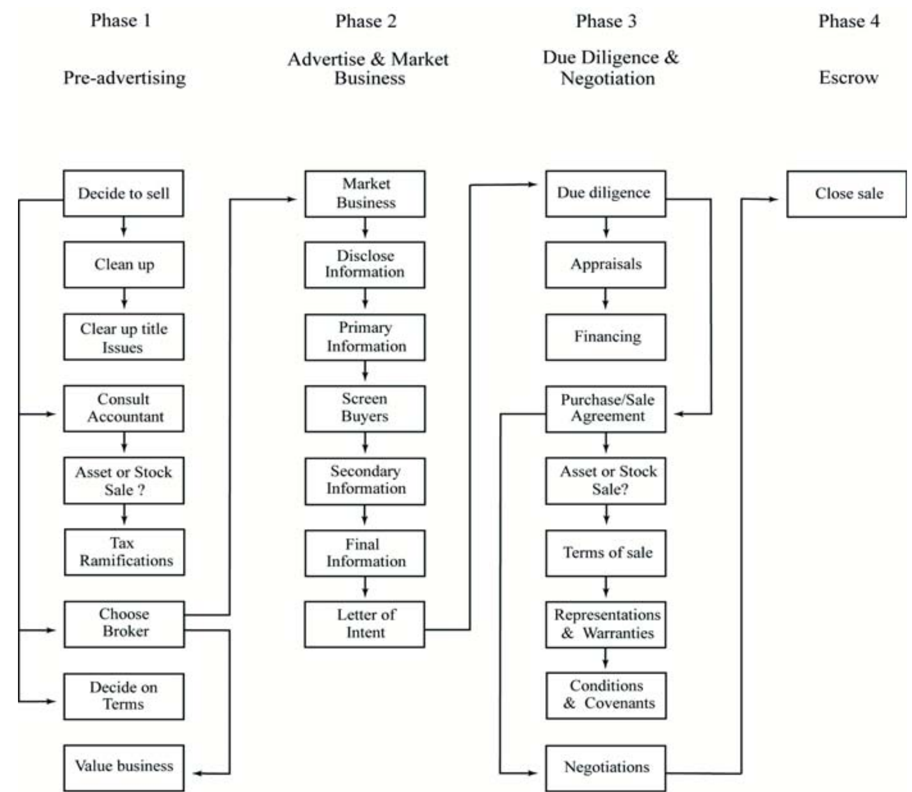
(1) decide on value of business
(2) execute or receive a letter of intent
(3) conduct due diligence (do your homework/research)
(4) provide or a receive a purchase sale agreement
(5) negotiate
(6) close the sale

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.

Buyer Versus Seller Expectations

Yield Returns

Buyers are now smarter than ever, due to the vast amount of information available. Buyers purchase based upon cash flow, nothing more, nothing less. Buyers know how to value a company that is making money. They do not know how to value companies which are losing money.

For the most part, the decision to buy is based upon yield. For example, if a seller is generating $100,000 in EBITDA, and he wants to sell the business for $3,000,000, then he expects that a potential buyer is willing to accept a return of 3.3%. This is unrealistic. A buyer would invest in T-bills and have a higher yield with no business operating headaches. Buyers want equity yields of 25-35% for medium sized businesses and 35-50% if the business is a sole proprietorship.

Managing Expectations

Many sellers adamantly disagree with the buyer about the value of a business. In many cases, the seller just will not admit that the business is not worth what he thinks that it is worth. In summary, it is critical to first agree on the realistic value of a business.

Marketing Time

A seller should understand that it takes approximately 4-12 months to sell a business, and this usually means with seller financing. As a result, it is important to sell a business when its cash flow is strongest. A business may lose $3-$5 in value for every $1 decline in pretax profitability. However, I would say that a great deal of the calls that I have received want to sell their business in a hurry (e.g., 30-60 days) and these businesses are distressed or barely profitable. Furthermore, the sellers want all cash. In summary, it is always best to sell the business when it is most profitable.

Preparing to Sell

Assuming that a seller has completed the valuation of his company and reviewed the tax implications of the sale (see “Asset and Stock Sale” on page 329) he must then prepare the company for sale. This can be as simple as gathering documents, or as complicated as settling lawsuits. Ultimately, the company must look clean and ready to be sold. No buyer wants surprises. While every business has problems, they must be minimized as much as possible.

Obviously, sellers want to get all cash for the sale. However, this is not so easy. One problem is selling a business when the economy is weak. If this occurs, then the seller will probably get less for the business than if she waited until the economy picked up. In addition, if the trend is up in sales growth, earnings, etc., then the business will sell quickly for a higher price.

Table 12-2 provides a list of what needs to be accomplished for getting top dollar for a business.

Table 12-2: Pre-Sale Tasks

Tasks
Equipment and Facilities
Paint interior and exterior, or scrub off dirt, scrub restrooms
Resurface lot
Repair or replace machinery and equipment
Make sure that inventory is well laid out and organized
Renegotiate real estate lease with multiple options
Financial Statements
Organize receivables, payables, accruals, audits, gather open purchase orders
Contracts
Compile contracts with suppliers and customers, insurance, banks, etc.
Take inventory and keep current
Get rid of old inventory and label bins and shelves in an orderly fashion
Taxes
Pay past due taxes
Contingent liabilities
Settle lawsuits
Settle tax disputes
Settle grievances, such as labor, pension or insurance claims
Hire key employee/s, make sure that most employees have been cross trained

Fixing equipment and facilities is important. A buyer will make a mental note when walking through a company and using the restrooms. If the operation is messy by appearance, then the rest of the company will also appear sloppy. Overall, buyers will be disturbed and will either pass on purchasing or offer the seller less than the asking price. If equipment is not operational, then the seller must either discard it or repair it. If the building is leased, then the landlord should be asked to paint it. If a lease is critical to the business, then the seller should renegotiate it with lots of options to extend the lease.

Financial statements and accounting records are important to tidy up. In the accounting office it is advisable to make sure that all records are alphabetized and headings are neatly written or typed. A qualified accountant or bookkeeper should set up the books. If the seller is operating on a cash basis, the accountant or bookkeeper should convert the records to an accrual basis. When I was running a medical manufacturing company, my old boss Jim used to swear on either having an audit done every year, or have a well known accounting firm audit or review your company for three to five years before selling. Aside from audits, the actual due diligence will be to simply have all contracts neatly gathered. There is nothing worse than having a company spend their time just trying to find the documents. A buyer would wonder how they ever stayed in business.

Lawsuits or disputes need to be cleared up or settled. You don't want to continually explain that the lawsuits against the business are minor. If a stock sale takes place rather than an asset sale, then there is significantly more liability to a buyer (see "Asset and Stock Sale" on page 329).

Why Disclosure is Critical

The most important task of all is to provide a full disclosure. If the seller has paid employees under the table or if he has given kickbacks, then the seller should tell the buyer. In summary, only after screening the buyer should she be informed of the major problems or issues concerning the business. There are two reasons for doing so: (1) minimizing the chances of getting sued for fraud; and, (2) avoiding a waste of time with a potential buyer.

Rules of Thumb

Rules of thumb have been discussed to valuing a company (see "Rules of Thumb" on page 88). Business rules of thumb are based upon the market approach to value (some multiple of income) and are generally used after considering the value of a business based upon the income approach. Rules of thumb are great, assuming that all things are equal, margins are high, and so on. Obviously, if a rule of thumb shows that a pretax return on investment is between 5-10%, then this formula would be inappropriate. Once again, a buyer would rather park his or her money in the bank than take on a rather low return on investment.

Rules of thumb are generalities and the assumptions are:

- Average business revenue multiplier, either monthly revenue multiplier (MRM), or annual revenue multiplier (ARM);
- No consideration of geographic areas;
- No debt consideration (leverage);
- No consideration of all the risk attributes of a business;
- No consideration of return on investment (cash flow).

A summary of some rules of thumb appears in Table 5-14 on page 90.

However, rules of thumb are for valuation purposes and not for pricing a business. When a seller and buyer transact, then the business will be sold based upon a number of issues such as seller carry-back of debt (financing part of the business for the buyer), earnouts, margins, geographic location, stock or asset sale, and financing. The final value for the selling price will always be different from that of an appraisal. Finally, it is used more for sellers than for buyers and is most applicable for businesses which are worth $1,000,000 or less, or where only sales figures are known.

There are two general methods of establishing rules of thumb: (1) industry and specific business rules of thumb; and, (2) rules of thumb based upon actual transactions.

First, industry rules of thumb are based upon rumors within an industry. In addition, they are loosely connected with actual transactions. Second, comparable sales are usually not dated even when used years from a valuation date. While equipment and real estate must have comparable sales, businesses do not need recent comparable sales. This is due to the differences between valuing businesses versus real estate and equipment. Over time most real estate, more than equipment, increases in value as inflation increases. On the other hand, the inflation increase for a business is usually factored into its sales and expenses. The capitalization rates and/or multiples are relatively constant.

In summary, rules of thumb have to make economic sense and be reasonable for the buyer. They are often unreasonable and therefore need to be adjusted downward. This must be considered. A better technique is to see if you can support your family, pay down debt, and earn a salary (see "Rule of One-Third" on page 326).

Making an Offer/Letter of Intent

Assuming that a buyer is interested in a business, the buyer should send a *letter of intent*, sometimes called *an agreement in principle*. The letter is an agreement, in principle, meant to be an overview of the major terms prior to issuing a purchase/sale agreement. The letter of intent is usually not legally binding, assuming that the letter states this and there are clauses which allow the purchaser to exit if due diligence turns up big surprises. In general, the letter is simple and straight forward. It is typically about one to three pages and is meant to be informal and non-intiminating. Sometimes buyers or attorneys go overboard and make a very long letter. This typically spooks the seller. The letter of intent is important since the purpose is to psychologically commit both buyer and seller to get the "ball rolling," and to have the seller take the business off of the market.

Both buyer and seller should sign the letter of intent and it should not contain much *legalese*. The contract should state that it is not a binding contract, and that neither buyer nor seller should be accountable for costs of due diligence. The letter is most often drafted by the buyer, but this is not always the case.

Figure 12-2: Example of Letter of Intent

September 3, 20X1

Mr. Ian McGregor
President
TwoTone Paint
PERSONAL AND CONFIDENTIAL

Dear Mr. McGregor:

This letter is an offer to purchase certain assets from you at your plant in El Segundo, California, and in Ontario, California. The assets to be purchased include inventories, equipment, land and buildings, chemical formulas, fixtures, tools, tooling, advertising material, manuals, customer lists, tradenames, and any and all necessary materials and records to run the business. Accounts receivable and cash will not be purchased, and will remain the property of TwoTone Paint.

In addition, I will purchase the accounts payables and accrued liabilities of the company, not to exceed $271,000 as of the date of closing. Inventory will not be any lower than $329,000 at the time of sale. Any adjustments in these two liabilities and one asset will be reflected in the purchase price.

The purchase price will be $1,800,000, based upon the balance sheet as of June 1, 20X1. The changes in the balance sheet items will be reflected in the purchase price, and final price, on the day of closing.

The terms of the sale will be cash in the amount of $531,000 at the time of sale, and $1,269,000 by means of my promissory note in the sum of $1,269,000, plus interest at the rate of 9.38% per year, payable in 72 equal monthly payments of $23,000 per month, including principal and interest. A balloon payment will be made at the end of 72 months. This note will be secured by the assets being purchased. This note will be personally guaranteed, assuming that I agree to purchase the corporation.

This agreement is contingent upon the following:

- The completion, to my satisfaction, of my full due diligence investigation;
- The assignment of all contracts and assets;
- Having the financial statements reviewed by my CPA, and all documents of the company reviewed by my attorney, and having these be acceptable to me;
- My ability to obtain financing acceptable to me for this purchase; I have no more than two weeks to begin an application, and no more than 6 weeks to get a written loan commitment;
- Being able to secure a covenant not to compete from you, as well as an allocation of the purchase price; and
- My being able to obtain a new lease from the owner of the building at your third location in Chicago.

We agree not to contact the lessor, customers, suppliers, or employees without your approval. Assuming that we cannot close the sale prior to December 1, 20X1, then all information provided to us will be kept in the strictest confidence.

This letter is not intended to be a legal contract or document, but simply a statement of our intent to move forward. This agreement will not be binding upon either of us, even if we change our minds or spend significant amounts of money on reliance upon this letter. If you agree to this letter and conditions, then please sign in the space below and return one copy to me within two days.

Cordially,

John Castleman

ACCEPTED:
TwoTone Paint

By: ___________________
Ian McGregor

Some thought should be given as to whether or not to include or exclude certain issues from the letter of intent. Some of these items can be seen below:

- How much will the buyer pay? In general, the breakout of the assets (assuming an asset sale) is not specified in this document, but in the purchase/sale agreement.
- What are the terms and financing?
- Will the transaction be an asset sale or a stock sale?
- Will the buyer retain ownership of phone numbers, and name of the business?
- What will be the date of the closing, and where?
- Which costs will be pro-rated? (rent, taxes, utilities, etc.)
- Are there contingencies? For example, is the sale contingent upon financing, or a review of the financials by a CPA, or a review of contracts by the attorney, the ability to obtain a new lease from the landlord, etc.?
- How much of a deposit (earnest money) will there be, and who will retain the deposit in trust? If the deal fails, then does the buyer receive his deposit back, or does the cash go to the seller?
- Will there be adjustments to the sale price for changes in balance sheet items such as accounts receivable, inventory, etc.? Do you need to establish clauses for sellers which liquidate or purchase too much inventory between the time of the acceptance and the time of closing the sale?
- Which facts must be correct in order to close? Are contracts to be in place, or will the seller have to maintain a certain sales level for the transaction to proceed?
- Are there caps on liabilities and floors on assets, as of the date of closing?

An example of a letter of intent can be seen in Figure 12-2. This letter is merely an example.

Upon receipt of such a letter, the seller should issue a confidentiality agreement before disclosing major facts about the business. This is important, since letters of intent do not usually encompass confidentiality agreements. If the buyer refuses to sign a confidentiality agreement, then it is time to find a different buyer.

Franchise Opportunities

Many buyers believe that by putting a downpayment of $35,000, $250,000, and so on they will get immediate goodwill which will attract customers. Sometimes this is true, but other times it is not. Probably the worst thing that the buyer can do is to be an absentee owner (a quick way to lose money). Oftentimes these businesses demand 50-80 hours of work per week. Essentially, the buyer purchases a job.

Positives of Franchises

The positive aspects of a franchise are that these businesses usually have tried what works and what does not and give the buyer a successful formula.

Sometimes the franchise gives national advertising and the format is relatively standard throughout the country or world. Some franchises provide in-house assistance for site location, staff hiring, supply sources, feasibility studies, and so on. Sometimes financial assistance can be obtained and equipment can be leased or financed through the company. Economies of scale exist in buying power for supplies. There is also territorial protection in some cases, although this is rapidly changing. Finally, the odds of succeeding are greater in a franchise, all things being equal.

Negatives of Franchises

On the other hand, there are significant negatives which need to be noted. The most notable is the franchise fee off of the top. Sometimes 5-6% of sales royalty can translate into as much as a 40-50% decrease in net earnings. Furthermore, there are sometimes assessments, and additional fees for advertising. In addition, there is usually a large renewal fee every 5 to 10 years. In some instances the economies of scale for purchasing supplies is negated if the franchisor sells inflated inventory and supplies over and above what the franchisee can obtain.

The buyer also loses a great deal of control. Let's assume that the business can get additional revenues by painting trucks, but the franchisor only allows cars to be painted and not trucks. The franchisor can terminate your agreement with them. This relates to the franchisor's ability to terminate you if you have problems paying the franchise fee, have quality standards issues, the term of the agreement has expired, or for any reason. Sometimes it is difficult to obtain hard statistics on the performance of other franchisees. This makes feasibility difficult to calculate before purchasing a business.

In addition, let us say that you do not want to work past six and not on weekends. This may not work. Also, while territory is protected, it is also limited. This is a problem if you want to expand. Sometimes promises are not kept as to training. Most importantly, if the buyer needs to sell out because of burnout, family problems or health issues, the new buyer often times needs to be approved by the franchisor. Sometimes this is not a problem, but in many cases it is.

Due Diligence

When conducting due diligence for considering purchasing a franchise, some of the same concerns need to be investigated as that of a non-franchised business (see Chapter 13). In general, written documentation should be obtained to support claims and promises. Red flags include:

- Seller not wanting to provide statistics and references
- Evasive answers to hard questions
- Big promises
- Hard sells by sales persons involved with the franchisor

Other problems can occur after signing on board. The franchisor may redirect ear-marked advertising dollars to his own operating funds. The franchisor may sell used equipment (this happens more than you think - the markup to the franchisor is sometimes 400% when this is done).

When reviewing contracts, it is important to focus on issues of initial fees, continuation fees, schedules for payment, lease arrangements, suppliers, protection of territories; training; breach of contracts; and, quality standards. As usual, an accountant and an attorney should be consulted before signing anything.

Summary

The reason why franchises have been so popular is that the franchisor expands his business by helping the franchisee obtain a good return on investment with limited capital. Overall, the bottom line is to ask what the franchisor can do for the buyer that the buyer cannot do for himself. Next, the franchisee must be on the lookout for unscrupulous franchisors.

Financial Intermediaries & Business Brokers

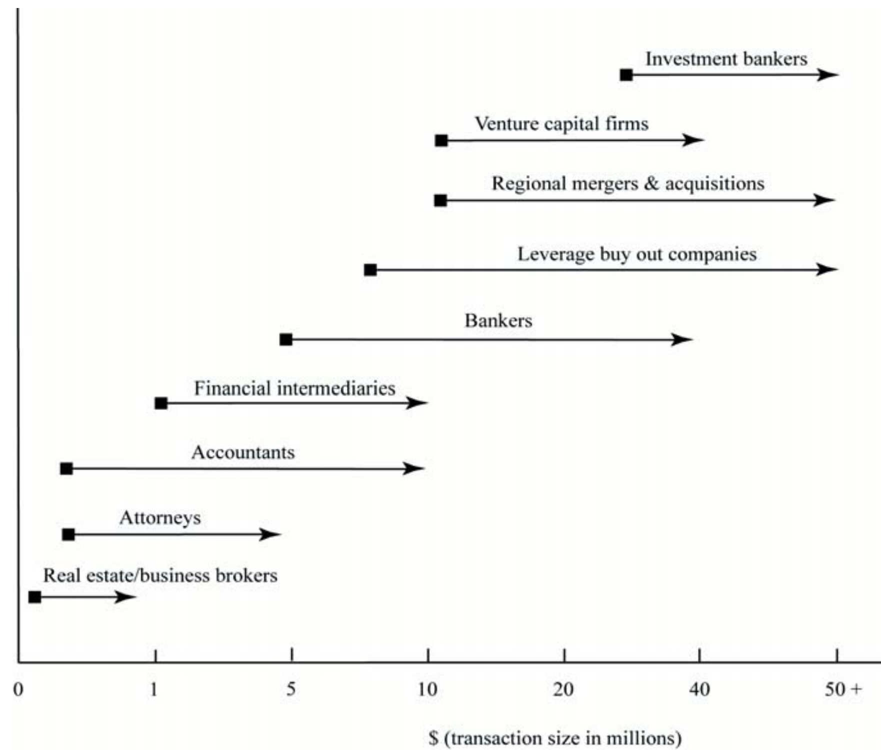
Whether or not to use a financial intermediary or broker is an important decision. Business brokers or financial intermediaries can play an important role. They are typically different from commercial real estate brokers. For real estate transactions, finding the deal constitutes 80-90% of the process, and the negotiation process constitutes the remaining 10-20%. For business sales, the complete opposite is the case. Knowledgeable brokers and intermediaries can save a buyer or seller months of labor. Brokers can screen a buyer, find a business, and objectively value the company. Sellers may over or undervalue the company and spend undue time screening buyers instead of focusing on maximizing the cash flow of the business.

Various broker sources can be used to find businesses and/or sell businesses. The following can serve as broker sources:

- Independent brokers
- Professional brokers (sometimes called financial intermediaries)
- Venture capital firms
- Leverage buyout funds
- Personal contacts
- Professional organizations such as bank trust departments, large law firms and CPAs, and
- Merger and acquisition departments of investment banks

Figure 12-3 on page 278 depicts the types of transactions which are typically handled by the afore-mentioned financial intermediaries.

Figure 12-3: Deal Size for Various Financial Intermediaries



Business brokers are the most readily available resource. They are most often called "business opportunity brokers" and have real estate sales or brokers licenses and usually work in real estate offices. These brokers typically specialize in selling liquor stores, bars, and small retail stores. They are generally listed in the yellow pages of telephone directories and in newspapers. Most brokers work on behalf of the seller. They may work with a buyer if there is a commission involved for searching for a particular type of business. Business brokers obtain listings through cold calls and advertising. As a result, many of the listings may be heavily "shopped."

Some business opportunity brokers are highly qualified, while others are not. It is difficult to screen out their experience. Selling a business is not like selling a house or commercial property. Many who work in real estate offices cannot read financial statements. Overall, check out their financial background. It must be noted that business brokerage is virtually unregulated, and only a few states require licenses. As a result, the client needs to verify the qualifications of the broker or financial intermediary.

Financial intermediaries and merger/acquisition specialists typically work with companies which have annual sales ranging between $1 to $35 million. A

good intermediary has either owned or operated a business and is very knowledgeable of the value drivers and complexities of a business, such as financial issues, working capital issues, or just being able to make payroll. Overall, these individuals have access to companies which have either a market niche or a strong management team where the business does not rely as greatly upon the owner.

Venture capital (VC) firms are usually looking for an exit to a firm which they have been funding for the past 3-5 years. Venture capitalists are usually sophisticated buyers and sellers. As a result, a buyer would pay a high price if purchased from a venture capital company. In addition, earnouts or financing would be highly unlikely. These firms require immediate liquidity.

Other sources include leverage buyout (LBO) firms, personal contacts, other professionals, and investment banks. Ultimately, personal contacts and professionals may be the best resource.

From a buyer's standpoint, it is helpful to have a business broker since they know of businesses which are for sale. Obviously it is possible to buy a business without the help of an intermediary, but the search process may take between 12-36 months. For larger businesses, it would be helpful to pay one or two intermediaries to seek out the appropriate business which suits the buyer.

Russell Robb, in his book *Buying Your Own Business* indicates that there are a number of mistakes which buyers make with intermediaries. These mistakes are summarized in Table 12-3.

Table 12-3: Mistakes Buyers Make with Intermediaries

Mistake	Comment
Retainer	Intermediaries are obligated to show good companies to their existing retainer clients before all others. Buyers who do not pay retainers finally understand the importance of retainers when they do not see enough business opportunities.
Patience	Deals take between 3-12 months to close. Rushing the transaction will lead to mistakes which will later be regretted. Many deals tank once or twice before closing. Don't worry, the intermediary will maintain the momentum.
Direction	An intermediary cannot decide on the company type or industry. It is the duty of the buyer to qualify this.
Financing in Place	Telling an intermediary that acquisition equity is in place when it is not.
Provide Buyer's Documentation	Make sure that you have an intermediary write up your qualifications, and provide a mini-business plan. This can help sway the seller, especially if there is seller financing involved.
Define the Intermediary's Role	Tell the intermediary exactly what you want: communicate often or less often, etc.
Recognize the Need for Hand Holding with the Seller	Understand that many brokers need to be sensitive to the seller's concerns for employees, customers, and the business in general.
Quickness	The quicker the buyer can close the deal, then the less chance that there is of the seller to change her mind.

Source: Robb, Russell. *Buying Your Own Business*.

From a seller's standpoint, it is also helpful to have a business broker. Oftentimes it is useful to have these professionals do the following: screen out the inquiries of potential buyers (see Table 12-4) writing a thorough selling memorandum for potential buyers; valuing the company; hunting for buyers; slowly disclosing data; helping the seller write a business plan for the history of his business; and, receiving offers and negotiating the transaction.

Table 12-4: Typical Buyers

Bottom fishers	Time wasters
Predator competitors	Investors
Questionable individuals and sharks	Liquidators
Those with high expectations	Appraisers
Those with no money	

Commissions

Most business brokers and intermediaries require a small retainer. This retainer allows the intermediary to cover the expense of marketing the business. Some sellers pay nothing until the sale is closed. However, many sellers are just curious to know what their business is worth and to have someone work on a transaction for nothing. A quick way to separate serious sellers and buyers is to require a retainer, which would later be subtracted from the fee once the sale has taken place.

Table 12-5: Typical Brokerage and Financial Intermediary Commission Breakdown

	Standard Business Broker (Representing Both Parties)	Lehman Formula (Representing One Party)	Lehman Formula (Representing Two Parties)	Stuttering Lehman (Representing One Party)	Stuttering Lehman (Representing Two Parties)
$0-$1,000,000	12%	5%	10%	5%	10%
	$120,000	$50,000	$100,000	$50,000	$100,000
$1-$2,000,000	12%	4%	8%	5%	10%
	$240,000	$40,000	$80,000	$50,000	$100,000
$2-$3,000,000	12%	3%	6%	4%	8%
	$360,000	$30,000	$60,000	$40,000	$80,000
$3-$4,000,000	10%	2%	4%	4%	8%
	$400,000	$20,000	$40,000	$40,000	$80,000
$4-$5,000,000		1%	2%	3%	6%
		$10,000	$20,000	$30,000	$60,000
$5-$6,000,000		1%	2%	3%	6%
		$10,000	$20,000	$30,000	$60,000

Dollar figures represent maximum amount of the range. Each level is added to the previous level.

With respect to commissions, some brokers and intermediaries utilize a Lehman formula, or some variation. However, the use of a formula depends upon the buyer and seller, as well as the size of the business. As usual, everything is negotiable. Table 12-5 shows differences in commissions if one utilizes a Lehman formula.

Therefore, if a company were to sell for (a) $650,000, (b) $1,788,000, or (c) $4,000,000, then the total commission rates can be seen in Table 12-6. As you can see, the larger the transaction, the smaller the commission.

Table 12-6: Business Brokerage and Financial Intermediary Commission Breakdown

Selling Price	Standard (Representing Both Parties)	Lehman Formula (Representing One Party)	Lehman Formula (Representing Two Parties)	Stuttering Lehman (Representing One Party)	Stuttering Lehman (Representing Two Parties)
$650,000	12%	5%	10%	5%	10%
	$78,000	$32,500	$65,000	$32,500	$100,000
$1,788,000		4.56%*	9.12%*	5%*	10%*
		$81,520	$163,040	$89,400	$178,800
$4,000,000		3.5%*	7.0%*	4.5%*	9.0%*
		$140,000	$280,000	$180,000	$360,000

*Percentages equal weighted averages of those percentages shown in Table 12-5.

Some of the commission fees may appear exorbitant. However, this is how an intermediary makes a living. Many transactions typically fall apart after a great deal of effort and usually only two out of ten companies will sell. While this does not affect the buyer or seller, the intermediary either has to start over or to move on to another transaction.

Alternative fee structures could be:

(1) a negotiated fee based upon the difficulty of the transaction
(2) a flat percentage
(3) an hourly rate plus expenses, with a ceiling
(4) a larger fee if the transaction closes, coupled with a floor or minimum fee for non-completion

A flat fee minimum is always recommended. Eliminate people who only want to inquire information from a broker. Minimizing “tire kickers” is critical, so that a broker can focus her time on companies which really need the broker’s help.

There are other conditions which need to be considered by a buyer or seller. Some of these conditions are:

(1) if there is a retainer, would it be deductible from the gross fee once there is a transaction?

(2) are advertising expenses paid for by the broker or the seller?

(3) is the agreement exclusive or non-exclusive?

(4) is there a cap or floor on the commission?

(5) is there a time period (e.g., 18 months) for the agreement?

(6) if the buyer ends up working for the seller, does the broker still receive a commission?

The following example shows some of the methods for calculating commission fees.

Brokerage Commission Example

Let's assume that the client has agreed to pay a broker a 10% commission on the sale of his business, and the balance sheet is shown in Table 12-7.

Table 12-7: Sample Balance Sheet

Assets		Liabilities	
Cash	$ 10,000	Accounts Payable	$ 220,000
Accounts Receivable	350,000	Accrued Expenses	250,000
Machinery & Equipment	650,000	Long Term Debt	870,000
Real Estate	780,000	Book Value	450,000
Total Assets	$1,790,000	Total Liabilities/Equity	$1,790,000

The brokerage agreement states that the seller will pay (1) either a minimum of $10,000 or a maximum of $150,000, regardless of either a stock or asset sale; (2) if the purchase is an asset sale, then the commission is based upon the assets plus any liabilities assumed by the buyer; (3) if the sale is for stock, then the commission is based upon all of the assets plus all of the liabilities of the corporation plus the value of any consulting agreements or noncompete agreements and for goodwill. What is the brokerage fee due to the broker?

(1) If the broker sells all of the assets, except cash, then the brokerage commission would be $150,000 and not $178,000 [($1,790,000 – $10,000) x 10%], since $150,000 is the maximum.

(2) If the broker sells the machinery and equipment, real estate and long term debt, then the commission would be $230,000 ($650,000 + $780,000 + $870,000) x 10%.

(3) If the broker sells the stock of the company and the seller has agreed to pay a $150,000 maximum, the potential commission would have been $358,000 [($1,790,000 asset value + $1,790,000 liability/equity value) x 0.10]. It must be noted that most sales are asset sales, and this situation is more the exception than the norm.