

## ***Sale of a Business: How an Owner Got the Price She Needed***

### **The Problems to Overcome**

- Offer in Today's Dollars Was Low
- Only 55% Cash at Closing
- No Interest or Collateral on the Note
- Insufficient Money to Retire

*The seller:* A distributor of industrial pumps in the Midwest. Revenues of \$750,000, net income of \$40,000, and stockholder's equity of \$225,000.

*The buyer:* A West Coast company, in the same business as the seller, who wanted to expand its product lines and get sales representation in the Midwest.

*The problems:* The buyer and seller, although generally in agreement, were having problems structuring the deal. The owner didn't feel she was getting sufficient cash to retire and she was concerned that there was no guarantee on the future payments to be made to her and her husband who also was employed by the company. The buyer, on the other hand, was fully at the limit of what he could afford to pay for the business.

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This business owner recently asked us how she should *restructure* the sale of her business to obtain more money and to protect the future payments promised to her. She had a bona fide offer for the company but there were some problems with the buyer's Letter of Intent. *The major problems:*

**#1.** The total price of \$550,000 was 14 times profits of \$40,000 and 2.4 times stockholder's equity (assets less liabilities) of \$225,000. That was fine. However, \$300,000 (55%) of the \$550,000 purchase price was payable over five years — *without interest*. Using a 10% interest (present value) rate, we computed today's value of the \$300,000, non-interest bearing, Five-Year Note, which was payable at \$60,000 a year (\$5,000 a month). The value of the \$300,000 Note was \$235,000

in today's dollars and represented a *discount* of \$65,000 or 22% off the \$300,000 face value of the Note.

Although the buyer understood our position and concern, he really did not see how he could come up with more money. (*Note:* The \$550,000 purchase price was already approved by the buyer's board of directors, so a request for more money was a potential deal killer.)

**#2.** The price was *not* enough money to allow the seller, age 63, to fully retire. While she wanted to sell the business, she also wanted and needed to work a few more years to build up her and her husband's retirement fund.

**#3.** A subsidiary of the buyer was purchasing the business and there was no provision in the Letter of Intent for the parent company to guarantee the \$300,000 Note. Furthermore, the Note was not secured by the assets being acquired.

The solutions to these problems were fairly simple, although they did take several months to fully negotiate and put in place. *Here's the outcome.*

**Problems #1 and #2** were solved by taking a different approach to the entire deal. The owner sold *only* six of the company's eight product lines, which represented about 70% of the business. The remaining two lines generated sufficient income to phase her and her husband into retirement. In fact, the income from the two product lines she kept was **much more** than what would have been received in interest payments on the Note if she had sold all eight product lines.

The buyer also agreed to purchase the six product lines for the same \$550,000 price; thus, the buyer did not have to lay out more money than originally planned. For the six product lines sold, the seller signed a noncompete agreement for eight years. On the two product lines she kept, the buyer received a *right of first refusal* when this owner decides to sell the lines in the future. This gave the buyer additional security that it would eventually own the entire product line and gave the seller assurances of more income from the sale of the two lines when she and her husband finally retire.

In addition, the owner received a salary of \$5,000 per month for one year (\$60,000 total) to advise the buyer during the transition period, principally to

maintain relationships with the seller’s current customers. She also received \$7,000 a year for five years (\$35,000 total) for medical insurance needs. The total of \$95,000 paid by the buyer in the monthly salary and in medical insurance premiums is tax deductible when paid. In an overall 40% tax bracket, these payments cost the buyer only \$57,000 after-tax (60% times \$95,000).

The owner also kept a company-owned car, valued at \$14,000, and a \$150,000 life insurance policy with a cash value of \$18,000. The buyer didn’t object to the owner keeping these assets since he was primarily interested in the operational aspects of the business.

In total, this owner received the following from the restructured sale of her business:

Cash at Closing	\$250,000
Five-Year Note	300,000
Consulting Contract	60,000
Medical and Insurance	35,000
Company Car and Life Insurance	<u>32,000</u>
Cash and Assets	\$677,000
Value of Two Product Lines *	<u>200,000</u>
Total Value	<u><u>\$877,000</u></u>

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\* Owner’s estimate based on \$225,000 sales from the two product lines not sold to the buyer.

Based on the \$877,000 restructured selling price, this owner received \$327,000 more money, a 59% increase over the \$550,000 originally offered by the seller. From the buyer’s perspective, its out-of-pocket cash stayed at \$550,000 plus the \$95,000 in consulting and insurance, which was tax deductible by his company.

**Problem #3** was the most easily solved. The parent company of the buyer agreed to guarantee the \$300,000 Note and secure it by the assets its subsidiary was buying from the seller. To protect the seller, a formal Uniform Commercial Code filing was prepared and filed against the acquired assets and product lines.

## Seller Oversights

- A *Confidentiality Agreement* was not requested by the seller. This owner gave the buyer her company's financial statements for the last three years and customer list for the last year *without* having such an agreement signed to protect the information.
- She didn't analyze the synergies from the combination of the two companies. If she had, she would have projected more than \$150,000 in profits for the buyer, rather than her \$40,000 profits. That's because the buyer would easily absorb and thus eliminate many of the current owner's overhead expenses.
- More cash at closing should have been negotiated. As a general rule, the minimum cash downpayment for the purchase of a business should be in the area of 75% (this transaction was 55%). There are exceptions, particularly for the purchase of a company by executives within the business who may not have the resources to pay a lot of cash upfront. In these cases, an installment pay-out can represent up to 50% of the total purchase price.
- She assumed the buyer's credit was good. But the fact remains that *she had zero collateral*.
- Although a Letter of Intent to buy a business is important in the selling process, it's best to get all your needs on the table verbally at the beginning of negotiations. *Axiom*: Once the deal is *in writing*, it's much more difficult to change.
- *The position*: "This deal does not provide sufficient money for me and my spouse to retire" is a *powerful* negotiating approach. These words were the key to obtaining more money for the seller.

To compensate you for the risks of starting your own business and for working so many years to make the business a success, you deserve the highest selling price possible and the best protection on any money payable to you over future years. *Don't act alone*. Your advisers can help, but only if you consult with them *before* negotiating and setting a price on the business.

For 20 *Negotiating Ideas and Strategies*, please see the next page. □

## ***Selling Your Businesses:*** **20 Negotiating Ideas and Strategies**

■ *Stay focused:* Concentrate on the big issue — The Price: how much, in what form (cash, note, stock), and when you will get the money (at closing and/or over a period of time).

■ *Know your adjusted profits:* Reconstruct your financial statements *before* putting a price tag on your business. Know your *adjusted* pre-tax and after-tax income after reasonable owner salaries and benefits. Know *both* the fair market and replacement values of your assets.

■ *Value to buyer:* Know your company's value to the buyer; it may well be in excess of the value calculated by various other methods. *Example:* The buyer wants to get into your line of business to round out his product line; buying your business saves him start-up time and money. In cases like this, you should even *rework* your sales, costs, and profits to reflect the buyer's overall numbers after acquiring your business.

■ *Get more benefits:* When the cash purchase price is not sufficient, a good alternative is to build in a lot of benefits. *Examples include:* Ownership or use of a company car, life insurance policies, a consulting salary during the transition period, higher interest rate on any deferred payments, elimination of outstanding personal loans made by the company, and an allowance for medical and health insurance.

■ *Escrow ownership and collateral:* This transaction involved the sale of the company's assets and the assumption of all liabilities. If it was a stock sale, you would escrow the shares and release them as payments are made on any money due you which was not paid at closing. You may even want to effect a *voting trust* on all the shares to protect yourself if the buyer defaults on the

payments due you. Or, as illustrated in the case study, you can take a first lien on the assets purchased by the buyer. When doing so, be sure to spell out the assets sold and include intangible assets, e.g., your customer list, patents, trademarks, etc., which can be a powerful deterrent for the buyer to miss payments due you.

■ *Noncompete agreement:* If you are ready to retire, don't worry too much about it. But, if you're younger, such an agreement is very important. *What to do:* Restrict the noncompete to three to five years and to the geographic area your company currently covers. In addition — and very important — specify that the noncompete agreement becomes *invalid* if the buyer defaults on any payments due you.

■ *Buyer's after-tax cost:* Know the buyer's after-tax cost for buying your company. Many times, it's only 60% to 70% of the total purchase price. Trade off a higher selling price against more tax deductions for the buyer, particularly deductions for salaries, consulting, deferred compensation, and fringe benefits. (*Note:* Noncompete agreements and certain intangible assets, such as goodwill, are not current deductions and must be written off by the buyer over a 15-year period. Thus, buyers will want a low value placed on these items.)

■ *Value of goodwill:* You are better off selling goodwill rather than a covenant not to compete or a consulting agreement. The sale of goodwill is taxed as a long-term capital gain, whereas noncompete and consulting agreements are taxed as personal income.

■ *"Market" your company:* Be prepared to profile your company in writing, fairly and concisely. Stress the strong aspects of your business and its potential for growth and profits.

## **Negotiating and Dealing with the Buyer**

■ Establish a cooperative relationship based on trust, right at the outset. Be reasonable, informed, and prepared to do business.

■ Have alternatives and counteroffers ready in advance. Good deals are built on a series of concessions and compromises.

**When a negotiation comes to a dead end,  
back up and try an entirely new approach.**

■ Don't open negotiations if you don't have some evidence that the buyer has sufficient resources to purchase your business. As a general rule, if the buyer's resources are marginal, you will have trouble negotiating a good price. It's not unreasonable to request the buyer's most recent financial statement to verify his or her capacity to buy your company.

■ Don't nitpick on small details. Make a listing of your requests in order of priority and work on them in that order.

■ Don't overclose and don't oversell. When it's time to end the discussion, do so. That point is usually after the price is determined: how much, in what form (cash, notes, etc.), and when it will be paid. Leave the rest of the details of the deal to your professionals.

■ Procrastination and delays kill many deals. When both sides are in basic agreement, move quickly to a closing.

■ If real property is involved in the sale of your business, separate it from the business and *price it independently*.

■ Avoid contingency deals where the payout to you is dependent on your company's future profits and/or sales. Remember that you have given up control.

■ *Remember this also:* The worst negotiating position for a seller is when he or she has to sell. Even if this is the case, the best approach is to be receptive to offers *without* appearing in a hurry to close the deal. You can be accessible and responsive to a prospective buyer without appearing unduly anxious.

■ It's usually worth the added expense to have your lawyer draw up the legal contracts. That way the other side has to "chop away" at the agreement to make any changes.

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

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If you would like more information on this subject, please see **Report #06: *Selling a Business: Structuring and Negotiating the Best Deal with a Case Study, How to Adjust the Financial Statements, Ways to Increase the Value and Selling Price, and the Options to Get Paid*** (28 pages) and **Report #16: *Buying a Business: How to Do It with a Case Study, Acquisition Guidelines, Due Diligence Checklist, Spread Sheets for Preparation of Condensed Financial Statements, and Return, Liquidity and Leverage Ratios to Identify Problems*** (37 pages).

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This *Action Report* was written by Thomas J. Martin, president and publisher of *The Business Library*. Tom assisted this business owner in renegotiating and closing the sale of her business. He is a valuation expert and the author of several valuation books. Over the last 30 years, he has presented scores of workshops for business associations, accounting firms, banks, insurance companies, and other organizations on financing, valuing, buying, and selling businesses. □