This chapter appears in, *How to Value Your Business and Increase its Potential*, by Jay B. Abrams, McGraw-Hill, published September 2004.

Chapter 11

A Business Intermediary's Perspective

By Jim Levy

Retirement, divorce, partnership problems, burnout, illness, relocation, and company growth beyond the owner's capability or financial resources are typical situations motivating owners to sell their businesses. Commonly, businesses are sold to other family members, competitors, suppliers, or customers familiar with the business, as well as proactively marketed to entrepreneurs and corporate acquirers.

If you have received an offer to sell your business, how do you know what the price should be? Are there confidentiality issues that would compromise your business if you disclose proprietary information but do not close on the sale? These are some of the issues that should be considered before deciding how to proceed when presented with an offer.

There is a common misconception among business owners that the possibility of a sale occurs only when a buyer expresses interest in purchasing the business. That buyer is often a competitor, and competitors rarely pay premium prices. The reason that entrepreneur buyers will usually pay more than industry buyers is because of their need for its operating infrastructure, established accounts, ongoing cash flow, etc. On the other hand, competitors already have the infrastructure in place, and many facets of the business are likely to be redundant. They often believe they can recreate your business quite easily. It becomes difficult for them to justify even a reasonable purchase price. That being said, there are instances where competitors pay premium prices for strategic and/or synergistic opportunities. Also, there are certain industries in which industry buyers are almost always the best buyers.

Do not dismiss the option of proactively marketing your business simply out of fear of the unknown. It has been done successfully for decades by large and small businesses, covering virtually every industry. Proactively marketing your business is not only a realistic exit strategy, it is a deliberate process designed to find the best buyer and achieve the best price and terms.

VALUATION

Just as earnings fuel the value of most public companies, earnings usually determine the valuation of small businesses. In concept, most businesses sell in the range of 1.5 to 3.5 times earnings, expressed as "discretionary earnings," which is defined below. In return for paying that sales price, the buyer receives all of the assets of the business, except for cash and accounts receivable. The seller keeps accounts payable and other liabilities. Inventory is a separate topic that I will discuss later.

While some types of businesses are valued on revenue, revenue-based rules of thumb are not as common as many sellers and their advisers believe. Generally, earnings, or discretionary earnings, is the most reliable method for determining value. It is my personal experience that buyers usually expect around a 30 percent return on their investment after subtracting a fair salary and debt service. However, that won't apply to smaller businesses in which a reasonable salary represents a big chunk of the earnings. This return compensates one for the risk associated with a small business.

Discretionary Earnings vs. EBITDA

When discussing Fair Market Value, it is important to understand the definition of earnings. For small business sales, discretionary earnings are the relevant measure of earnings. Discretionary earnings are adjusted EBITDA (earnings before interest, taxes, depreciation, and amortization), plus owner's salary and appropriate add-backs. Add-backs are those nonessential expenses in the income statement that are credited toward discretionary earnings. Common add-backs include charitable contributions and personal expenses charged to the business.

Investment bankers, who sell larger firms, also use adjusted EBITDA. However, their adjusted EBITDA is different than the one described above. Theirs would add back only that portion of the owner's salary and related costs that are more than an arm's length salary. Thus, if an arm's length owner's salary is $100,000 and the owner actually took $300,000 salary, the add-back to discretionary earnings would be all $300,000, while the investment banker would add back only $200,000 to calculate his or her version of adjusted EBITDA. The difference between the two is the owner's arm's length compensation, which can make a significant difference between the two measures. In any case, the two terms are not interchangeable for valuation purposes.

EBITDA is not an acceptable basis for determining value of a small business. Methodologies for determining value are discussed at length in other chapters. The value basis represents the foundation of the sale, and an experienced Business Intermediary will have a solid understanding of business valuation to effectively communicate with sellers and negotiate with buyers. In general, the better the sales, earnings, profit margins, and trend, the higher the valuation multiple tends to be.

Understanding Value-Generating Characteristics

Understanding the factors that impact the valuation of your business can and should influence your business model and plan. Businesses that attract the most interest and highest valuations tend to have high customer retention and predictable cash flow.

For example, a contractor whose revenues are primarily generated by winning bids on public works projects has neither long-term customers nor a customer base to transfer to a buyer. The multiple for a business like this may be so low that its liquidation value may be its best value. (I gave this example to illustrate that how a company derives its earnings is important. It is possible that the company in this illustration can still have value drivers, such as consistent profitability, that support a high valuation.) On the other hand, a commercial insurance brokerage firm might have an exceedingly attractive valuation because of its high customer retention rate and annual premiums.

Similarly, an owner who dominates sales and management adversely affects the integrity of a business transfer, and in extreme cases the firm may not be salable at any price. In contrast, a business with management and sales responsibilities spread evenly among its employees is likely to achieve a better valuation. Precisely, the perceived stability of customers, employees, and vendors following the acquisition directly impacts the integrity of a business transfer. This is reflected in its transaction structure and ultimate valuation.

Capital Investments Prior to a Sale

Investing in new equipment or moving to another location one or two years prior to selling your company may not contribute to the value of your firm. The costs of these investments probably won't increase your valuation unless they've generated a corresponding increase in earnings on your year-end income statement(s). It is best to avoid making these sorts of unintentional charitable contributions.

The Mystery of Potential

I find it interesting that the more "profit challenged" a business is, the more the owner tends to tout its spectacular growth potential. In any event, one of the most common areas of misunderstanding is overestimating the value of growth potential. This is a complex subject that can be summed up as follows: If your historical sales and earnings have been rising and the trend is continuing, then your firm has proven growth potential, and it will probably command a premium valuation multiple. If not, buyers consider future growth a result of their own efforts and generally do not think it is fair to reward sellers for the buyer's work. If a seller insists that growth will be greater in the future than in the past, a buyer may be equally optimistic, but the valuation multiple will likely reflect the aggressive forecast. Pricing in unrealized potential by planning future expense saving and/or company building moves should lead a buyer to discount the valuation multiple to account for a risky growth forecast.

Using Equation 6.4, $FMV = 1.1 \times (1/r\text{-}g)$, the shortcut valuation from Chapter 6, if the seller insists on raising g by 3 percent above historical growth, the buyer may reasonably insist on raising r by 2 or 3 percent to compensate for the optimistic forecast of unproven growth. If we increase g and r both by 3 percent, there is no change in the valuation.

Mistaken Value Assumptions

There are objective and subjective methods of determining value, some of which were discussed above. However, Business Intermediaries and valuation experts consistently agree on a reasonable range of value. On the other hand, sellers and their advisers who do not have firsthand transaction or valuation experience often come up with values that are off the charts. This is unfortunate in that it can significantly skew the seller's retirement plans, estate planning, etc., as well as preclude the seller from selling when he or she should sell.

While small business owners often have demonstrated remarkable wisdom by guiding their firms through decades of challenging industry and economic cycles, they usually do not begin learning about the true value of their business or its value-generating characteristics until they decide to sell it. I am constantly amazed by the level of misunderstanding that business owners have in this regard.

Typical Transaction Structures

Most small business sales involve the sale of assets, not stock. Stock sales are the least preferred by buyers and are only done when necessary to minimize tax consequences for sellers. This is typically an issue when the company is a C corporation, which can lead to a seller being double-taxed on the gain. A primary reason stock sales are not popular among buyers is because of the transfer of potential liabilities after the sale. There are ways to mitigate the risk for buyers through the use of insurance for product and employee liabilities, but the sale of stock is usually done only as a last resort.

In an asset sale, the seller typically keeps the balance sheet items such as accounts receivables, accounts payables, notes, etc. Inventory can be included in or added to the selling price, depending on the type of business and value of inventory. As discussed below in "Preparing for the Sale," if the value of inventory is so high that it represents a significant portion of the price, it will likely be heavily discounted. It is best to sell obsolete inventory by any means available prior to marketing the business, because buyers are unlikely to pay you for it.

The most common transaction structures include a down payment of 40 to 60 percent, with seller financing secured by the business, and may or may not include the buyer's collateral for some or all of the note. This structure seems to provide the best balance in meeting the concerns of sellers and buyers. Sellers want a secure exit, and buyers want some security in the event of unforeseen problems following the acquisition. Buyers frequently prefer that sellers maintain a vested interest in the business to ensure its integrity and that the sellers are accessible for ongoing assistance as needed. Earn-outs involving a fixed percentage of revenues for a certain period of time are occasionally used in lieu of or in addition to seller notes. All-cash purchases may be discounted 20 to 30 percent or more, depending on the nature of the business. With all-cash purchases, both the time value of money and the added risk for the buyer exert downward pressure on the price. The Small Business Administration's (SBA) loan guarantee program provides an excellent avenue for sellers to cash out.

INTEGRITY OF FINANCIAL STATEMENTS

In any event, it is important to create a structure that will make it to the finish line. Transactions that fall apart before closing are frequently the result of unrealistic price and/or financing expectations and, generally, poorly planned transaction structures. Furthermore, I believe many of the horror stories of business sales gone bad resulted from inadequate down payments and excessive financing, with the buyers having very little invested in the businesses. That being said, for some types of businesses a low down payment may be necessary to accommodate certain risky business transfer issues. This would include, for instance, companies with a high risk of client or staff defections after a change in ownership. In this case, it should be a strong buyer with industry expertise and substantial resources.

A key facet in most business transfers is the quality of the Profit & Loss statement. From the buyer's perspective, accurate and consistent financial statements reduce an element of uncertainty in the process of ascertaining the continuity of profits. While the value of most businesses is fueled by historical earnings, financial statements of privately held companies usually reflect the lowest possible net profit, in order to minimize taxes. However, there is often an inverse relationship between tax savings and achieving the highest value when selling a business. The degree of impact depends on how tax aggressive you are. Let's use the following two tables to explain the potential impact.

Table 11.1 computes a valuation of discretionary income for a relatively conservative tax strategy. In the Tax Aggressive Scenario of Table 11.2, the seller has been charging personal expenses to the business to reduce taxes and now wants to add these back to discretionary earnings to increase the valuation. The first four add-backs are normal add-backs and are the same ones from Table 11.1 that total $145,000. The next four add-backs total $83,000 (amount not shown) and are very aggressive. These expenses include $40,000 for public relations for the owner's son, who is in college, along with other miscellaneous personal expenses. The "add-backs" create a potential problem of credibility. The crafty seller wants to eat his cake and have it too (the original form of the old saying). While technically there is nothing wrong with this, it will make some or many buyers nervous and possibly drive up their discount rate. The amount of the extra $83,000 in add-backs that is credited toward the purchase in Table 11.2 will ultimately depend on the decision of the buyer and his or her advisers after reviewing related documentation. Referring to Table 11.2, if this company is selling for a multiple of 2.5 times discretionary earnings, this seller stands to lose up to $207,500, or 25 percent of the purchase price as a result of questionable add-backs.

Also, the SBA does not allow add-backs for most personal expenses, which we'll get to below. Recognize the accuracy of

TABLE 11.1

Wonderful Company

	Year End
Sales	$3,000,000
Cost of Sales	1,980,000
Gross Profit	1,020,000
Expenses	870,000
Net Profit	**150,000**
Add-Backs	
Depreciation	15,000
Interest	19,000
Officer Salaries	100,000
Officer Payroll Tax	11,000
Total Add-Backs	145,000
Discretionary Earnings	**$295,000**

Table 11.2

Wonderful Company: Tax-Aggressive Scenario

Sales	$3,000,000
Cost of Sales	1,980,000
Gross Profit	1,020,000
Expenses	913,000
Net Profit	**$107,000**
Add-Backs	
Depreciation	15,000
Interest	19,000
Officer Salaries	100,000
Officer Payroll Tax	11,000
Public Relations	40,000
Insurance	17,000
Auto	12,000
Entertainment	8,000
Phone	6,000
Total Add-Backs	228,000
Discretionary Earnings	**$335,000**

your P&L is an important decision that can potentially impact the value of your assets. Understanding the potential consequences will allow you to make an informed decision that is best for your particular circumstances.

While we're on the subject of taxes, let's touch upon unreported income. For some types of businesses, particularly those involving cash transactions, it is not a matter of whether or not it exists, but how much. There are buyers willing to recognize unreported income in their valuations, but most buyers won't. Since the practice of underreporting income is illegal, it puts the seller at risk of being reported to the IRS by a disgruntled buyer during negotiations, or even after completing a transaction. It is best to avoid unreported income to achieve an optimum valuation and sleep soundly at night.

And Be Aware of . . .

Personal Expenses and Add-Backs

The Small Business Administration provides a source of liquidity for business owners. Its guaranteed cash flow–based loan programs through banks and financial institutions allow buyers to purchase businesses with as little as a 10 percent down payment. The lender's analysis for debt service capacity is usually based on the tax returns of the business over the past two to three years. Standard add-backs, such as interest, depreciation, and owner's salary are allowed, *but most personal expense add-backs are not*. The buyer's credit, collateral, living expenses, and business background are also factors impacting SBA lending parameters.

Funny Business

If you have employees who are overpaid, it's not easy to undo your act of generosity. It is unlikely that the new buyer would succeed at reducing their salaries. If you view your business from the standpoint of a prospective buyer, you may gain insight into matters that should be addressed early enough to prepare for a successful sale.

Excessive Inventory

Another important area impacting value is the inventory amount. If the inventory level is too high in proportion to the expected selling price, the excess amount may not be captured. Thus, mismanagement of inventory can have disastrous consequences on the sale proceeds. Since it can take months, if not years, to optimize inventory, it is an area that needs attention long before the sale of your business.

The Tax Consequences of a Sale

This can be a deal breaker and is an area that should be thoroughly assessed with your accountant as long as 10 years before a sale. (David Boatwright discusses this at length in Chapter 14.)

THE PROACTIVE SALE PROCESS

Sellers occasionally engage Business Intermediaries to initiate negotiations with one or more buyers designated by a seller. However, Business Intermediaries are usually brought in to proactively market businesses and find buyers, with the mandate of achieving the best possible price and terms.

It is almost always a seller's market, with good quality firms in short supply. Client companies usually have a clear history of sales and profitability. Most people view starting a business as an impossible and high-risk task. Thus, the prospect of acquiring a proven business model with cash flow from day one is very enticing. When you add the availability of cash flow– based financing for ongoing businesses, there are compelling reasons to purchase rather than start a business.

The First Steps

The Business Intermediary strives to identify the best buyers for your business. The process typically starts with a valuation followed by a discussion and agreement on a price range. Then the intermediary prepares an offering memorandum to profile the business and its industry.

The memo is a tangible tool used to document intangible assets and create a professional presentation that can inspire confidence, enhance the image of your firm, and entice buyers to act within a short period of time. In preparing the offering memorandum, it should effectively communicate the firm's profit-generating characteristics and highlight the value-generating characteristics that position the company for an optimum valuation. It should emphasize future profit-generating characteristics and the impact of industry and economic trends. The offering memorandum can range from one page to a comprehensive report, depending on the type and size of company and the quality of Business Intermediary services.

Locating Prospective Buyers

The next step involves advertising the business for sale without identifying it. Classified ads in local newspapers and on Web sites of businesses for sale are the most common forms of advertising. Some Business Intermediaries use mailings and networking for added exposure. The screening of prospective buyers varies dramatically. The Business Intermediary may screen prospective buyers verbally and require a financial statement and/or résumé.

Your business will be identified to selected candidates after they sign a Confidentiality Agreement. The first question prospective buyers usually ask me is why is he or she selling. Seemingly, the answer reveals the likelihood of hidden problems. Typically, at this stage buyers who continue to be interested will meet with the owner at the business after business hours. An experienced intermediary will have an intensive screening process to avoid parading numerous buyers in front of the seller. During this process, it is paramount for sellers to remain focused on running their business and continuing the best possible growth trend.

More on Confidentiality

Unlike the sale of real estate, the sale of a business is done confidentially. Most business owners are acutely aware of the importance of confidentiality, and it is probably the biggest reason that many owners do not consider proactively marketing their businesses. However, businesses can be sold discreetly and confidentially. The risks of dealing with prospective buyers are managed by carefully selecting and screening prospects. The business does not need to be widely "shopped." It can be shown only to carefully selected prospects.

There may be a decision not to include certain prospects, though they appear promising, due to the risks associated with providing those companies with confidential information. The identity of your business should only be disclosed to selected candidates after obtaining a signed Confidentiality Agreement. While you can expect to provide financial statements for recent years, along with other detailed information, proprietary information such as customer lists, vendor names, manufacturing processes, and so on, can be provided as one of the last steps before closing.

Some Business Intermediaries arrange buyer and seller meetings only after obtaining an acceptable offer indication. This offer is nonbinding, but it demonstrates more commitment on the part of the buyer and helps to identify unacceptable offers before additional information is divulged in a meeting with the seller. Maintaining confidentiality also requires controlling internal leaks. If you have partners, make sure you're all in agreement on who may be informed about the sale. During negotiations with a corporate buyer, be sure they have internal controls in place as well.

From Offer to Conclusion

If there is an offer presented, there will probably be a round of negotiations until both sides accept it. A deposit may or may not be required, depending on the size of the transaction and the sophistication of the buyer. Then the buyer, with the assistance of his or her advisers, starts due diligence to verify the accuracy of the books and records. The due diligence process can take two to four weeks or longer, depending on the business and the buyer. An on-site visit may be scheduled after business hours toward the end of due diligence. Depending on the nature of the business, the buyer may require interviews with key employees, sales reps, customers, etc. These interviews should be the last remaining contingency.

When the buyer completes due diligence, escrow is opened to manage the bulk sale requirements and other settlement items in the event of an asset sale. A bulk sale is the purchase and sale of a business or a major portion of the assets of a business. A bulk sale escrow provides a seller and buyer with an efficient process to ensure clean title transfer of the business ownership.

Escrow is primarily designed to protect the buyer from unknown liabilities, and it usually takes about 30 days. While escrow is common, it is not always used in every state or every situation. Some buyers are not concerned about unknown liabilities, and to save time and money, choose not to go through the escrow process. However, if real estate is involved and your state uses escrows, escrow should be used.

After the closing, the seller should expect to train the buyer for two to four weeks, depending on the nature of the business and agreement with the buyer. Free training is common for the first month or so,[1] and consulting fees are typically paid for longer periods of time.

WHY EMPLOY AN INTERMEDIARY?

Understandably, there can be a lot of trepidation on the part of the seller anticipating the sale of his or her firm. In a seller's mind, an offer from a familiar buyer beats the uncertainty of putting the firm on the block and paying the corresponding fees. But this convenient, reactive approach can result in leaving money on the table. Be sure to carefully evaluate your options.

The Business of Business Intermediaries

Let's begin with a brief explanation of titles employed by Business Intermediaries. Those selling main-street type businesses such as laundromats, dry cleaners, gas stations, liquor stores, small retail stores, etc., are almost universally known as Business Brokers. Many in the industry serving larger and more sophisticated companies and offering a higher level of services prefer to be known as Business Intermediaries or mergers and acquisitions (M&A) professionals. A skilled and conscientious Business Intermediary will launch a selling process designed to achieve the best possible price and terms, and maintain confidentiality. (But, of course, the quality of service and the degree of confidentiality provided by Business Brokers and Business Intermediaries varies, as in any profession.)

Business Intermediaries are set up to optimally service the small business client. While some intermediaries handle transactions of $10 to $20 million in value, the majority of transactions are under $1 million. Transactions valued at $10 million and higher are generally handled by investment banking firms (see Chapter 12 for an in-depth discussion of investment bankers).

Intermediaries are usually paid by sellers, and, in turn, represent the sellers' best interests. The intermediary should give full disclosure to prospective buyers of any misrepresentations about the business and advise them to retain an accountant and attorney.

Fees

A success fee of 10 percent is common for transactions up to $1 million or so. There is a growing trend toward initial fees ranging from $500 to $10,000, depending on the size and complexity of the business. These fees may or may not be credited toward the commission. The commission and fee structure is usually such that the seller's and the Business Intermediary's interests are aligned in achieving a successful sale.

Be aware that there are firms, even major ones, that lure unsophisticated small business owners into paying obscenely high initial fees by selling them on the prospects of achieving sky-high valuations. Business Intermediaries can enhance the value of your business, but they cannot do magic. If you have toiled for decades building your business, you might have an understandable, deep emotional attachment to your "baby," which means your perception of value could be unrealistic. Like any other investment decision, if it sounds too good to be true, it probably is too good to be true. Check with trusted advisers first.

Experienced Business Intermediaries understand small company valuations and are accustomed to dealing with imperfect financials. They must also qualify buyers based on their financial ability to perform, and they must assess a buyer's motivation and fortitude to close. There is a long road ahead of every first-time buyer who may be putting his or her life savings at risk. Initial enthusiasm can often turn into fear of impending failure as the finish line gets closer.

Selecting a Business Intermediary

The Business Intermediary can influence the ultimate results of a sale, so your selection is an important decision. Begin by assessing the intermediary's professional qualifications, including experience and technical knowledge. Many states require Business Intermediaries to have real estate licenses. While the overall reputation of the firm is certainly important, the firm experience is relatively irrelevant. There is a high turnover in the business, so look for someone with at least two years of experience, and make sure you know who will be handling the sale of your business. Understand how confidentiality will be incorporated into the sale process, and contact references. This tends to be a local business. Unless there is an industry expertise that the intermediary brings to the process, it's usually best to work with a local firm.

A directory of Certified Business Intermediaries, a designation developed by the International Business Brokers Association, can be found at www.ibba.org. The *CBI* or *Certified*

Business Intermediary designation is a convenient starting point for finding quality Business Brokers and Business Intermediaries. Alternatively, your accountant or attorney may be able to provide references.

CONCLUSION

The goal of selling a business for optimum value and terms is best realized when planned well in advance. Planning your exit strategy five years out will affect many of your strategic decisions today. Here are some questions to consider:

1. Can your business model be slightly changed to achieve a higher multiple?
2. Can you convert purchase orders into long-term contracts?
3. Is there an attractive acquisition opportunity that will increase your earnings?
4. Are you considering exit strategies in addition to tax strategies when preparing your tax returns?
5. Is your inventory at its optimal level?
6. Are you delegating management responsibilities?
7. Is your entity tax structure a potential impediment to realizing maximum proceeds from a sale?

Thoughtfully addressing these and other issues will help you achieve the best possible value for your business. Knowing the true value of your business will help you make informed decisions on matters ranging from determining the merit of capital investments to planning your retirement. Planning for a successful exit strategy can lead to improving the performance of your business and securing and building the value of your assets. Properly planning the sale of your business to attain the best valuation is one of the most important management decisions you will make.

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I thank Jack Sanders, Spectrum Corporate Group, for editing this chapter. Jack is a highly respected colleague and business intermediary.