

WHEN A BUSINESS CHANGES HANDS®

A Guide for the Sale of a Business

JUST A SHORT WHILE AGO . . .

. . . the idea that you might wish to sell your business would have been unthinkable. Now, though, you've begun to think about it, and the notion is not altogether pleasant. There is uncertainty, some doubt, a kind of lonely uneasiness.

It's normal. Your leadership of a business has involved a lot of energy and more than a little emotional attachment, so the changed role you are considering — that of seller — is quite unfamiliar. You aren't alone. No one is trained for this, and most business leaders do it no more than once in an entire career.

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All the principals of J.H. Chapman Group are experienced in changes in business ownership. All of us have led companies, either our own or those we led as professional managers for others. All of us have participated in acquisitions and sales of businesses large and small.

We have prepared this guide to pass on some of this experience, and to help smooth the way for changing the ownership of your business.

DECIDING TO SELL THE BUSINESS

Any number of situations can arise to change the outlook for a business or its owner. Some create opportunities; others present problems. Some lead the owner to think about selling the company.

In a family business, there may be no immediate family successor to management. Or, perhaps the owner needs or wants to create liquid assets from his equity in the business. He may want to slow down, or change careers, or he may be concerned about

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health. Perhaps he feels threatened by aggressive competitors who are operating in more favorable economic or labor locations. There may be family problems, or shareholder conflicts. Perhaps the owner has seen an offer for the business that seems too attractive to ignore.

Whatever the reason for considering the sale of the company, the process deserves the same attention and commitment it took to build the business. Maybe more. Second chances are rare.

ALTERNATIVES TO SELLING

Some of the problems and opportunities that arise may be dealt with in other ways. Perhaps it will not be necessary to consider selling the company.

Owners might bring in professional management from the outside to look after the family's interests. The election of S Corporation status will resolve another kind of problem by releasing profits for shareholder uses.

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Still other kinds of problems might be answered through a preferred stock recapitalization to reduce estate taxes, or through the sale of an interest in the company to an Employee Stock Ownership Plan. Perhaps buying out dissident shareholders' interests is the answer.

Evaluation of these alternatives often will confirm the validity of a plan to sell the company. Nevertheless, the need to change a present situation should not be confused with the need to sell the company. Management must examine every alternative with great care, and with as much objectivity as these often-emotional issues will permit.

USING PROFESSIONAL HELP

Selling a business is a complex and specialized task requiring the services of experts. Your investment banking firm provides a focal point for the gathering of these services, and leads the effort to gain for management the desired outcome of a transaction. The services normally provided by investment bankers start with helping you to decide whether the business should be sold. They also include advice on preparing the business for sale; preparing a written description of the company; establishing a sale price range; identifying the non-economic objectives of management; selecting and approaching the best purchase prospects; assisting in negotiating both price and terms; and facilitating the closing of the sale.

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The investment banker will work with your staff and with your company's legal and accounting experts, using every available talent to help accomplish the most important transaction the business will ever undertake. Your investment banker will gain a complete understanding of the business and its strengths, weaknesses and potential, and will help management address questions that may not yet have been brought to mind —such issues as the later roles of valued employees who have helped to build the business.

Your investment banker will ask you for a letter of understanding that sets forth the terms of the engagement and the compensation for the firm's services. This letter would be furnished by the investment banker and reviewed by your own legal counsel. Because great amounts of time will probably be spent in preparation for a transaction, some arrangement may be asked for that will compensate the firm for its investment of effort, and a portion of the compensation may be credited against the final fee.

Importantly, your investment banker should ask for the exclusive right to represent your company for some period of time. If he does not, chances are the firm is less than wholehearted in its effort to find the most attractive transaction for you.

Investment banking fees are based on the size and complexity of your business, and on the price obtained when it is sold. One fee structure used by some firms calls for fees amounting to six percent of the first \$1 million of sale proceeds, five percent of the next \$1 million and so forth, down to two percent of the amounts over \$4 million. Fees for very large transactions may be negotiated at lower rates. The price upon which the investment banking fee is based includes all of the consideration for the sale, including cash, interest-bearing debt assumed, securities (valued at closing), notes, contingent future payments and continuing compensation in excess of normal levels.

DETERMINING THE VALUE OF YOUR BUSINESS

This is the hard part. Once you've decided to sell your business, it will be necessary at some point to respond to an offer, so you will wish to be prepared with a careful valuation based on several kinds of analyses.

The first step is to re-examine the last three to five years' income statements and the current balance sheet. By its nature, your ownership of the company has caused the financial statements to treat some items differently than might have been the case otherwise; accordingly, each of these must be examined to see how the financials might appear on a reconstructed basis. Adjustments should be considered for income-statements items such as:

- Above-normal portion of owners' salaries
- Above-normal non-cash compensation items
- Additions to LIFO inventory reserves
- Extraordinary repairs or other expenses
- Excess personnel
- Other adjustment peculiar to your business

Balance-sheet items to be considered include:

- LIFO inventory reserve

- Excess of asset market values over book value, as with real estate and equipment
- Excess reserves against assets, as with reserves for doubtful accounts
- Over- or under-accruals, such as the funding of pension benefits

The value of your company to another owner is affected by many factors. Knowing how each of these relates to your industry and to your company will help you establish a realistic valuation.

They include:

- Trend and level of sales profits
- Industry position and market share
- Industry trends and outlook
- Prices of similar businesses recently sold or presently publicly traded
- Expected savings and/or opportunities for a new owner — synergy; consolidations; expansion
- Trademarks, brand identification, patents, special know-how available in the company
- Likely demand for the business
- Location of the business
- Capital required to maintain and increase profitability

Because of the many variables involved, arriving at an absolute value is most difficult. Thus, you would be well advised to develop a value range based on more than one method.

Valuation methods include:

1. Multiple of Earnings Method

The selection of a multiplier will include a review of available information on comparable companies in the industry. The method works like this:

FORMULA: Value = after-tax profits x selected multiplier

EXAMPLE: Value = profit of \$1 million x multiplier of 9, or \$9 million

2. Multiple of EBIT Method

FORMULA: Value = earnings before interest and taxes (EBIT) x selected multiplier

EXAMPLE: Value = EBIT of \$1,500,000 x multiplier of 5, or \$7,500,000

The value, determined using this method, includes interest-bearing debt. To obtain the value of the equity interest, deduct interest-bearing debt. For example:

Gross Value	\$7,500,000
Less Interest-Bearing Debt	1,400,000
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Value of Equity	\$6,100,000

In some situations, alternatives to EBIT are used, such as: EBITD — Earnings before interest, taxes, depreciation.

EBITDA — Earnings before interest, taxes, depreciation and amortization.

3. **Discounted Future Cash Flow Method**

FORMULA: Value = sum of the present values of the projected profit available for distribution during the projected life of the investment, plus the present value of the business at the end of the holding period.

EXAMPLE: (at 10% and 15%)

Year	Projected Income Flows	Present Value @ 10%	Present Value @ 15%
1	\$ 1,100,000	\$ 1,000,000	\$ 956,522
2	1,210,000	1,000,000	914,934
3	1,331,000	1,000,000	875,154
4	1,464,000	1,000,000	837,046
5	1,611,000	1,000,000	800,952
Ending Value	\$16,000,000	\$ 9,934,736	\$ 7,954,832
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Total		\$14,934,736	\$12,339,440

Assuming an investor requires at least 15% after-tax return on any investment, the most that investor would pay for the opportunity in this example is \$12,339,440. In this method, the rule is "the lower the return requirements, the higher the value".

4. **Book Value Method**

Here, the premium or discount is expressed as a percentage of the present shareholders' investment.

FORMULA: Value = book value (shareholders' equity) x multiplier

EXAMPLE: Value = shareholders, equity shown in latest interim or last year-end balance sheet x multiplier of 100%

5. **Adjusted Book Value Method**

This variation of the Book Value Method evaluates the actual assets and liabilities of the firm.

FORMULA: Value = book value, plus adjustments

EXAMPLE: Book value	\$5,000,000
LIFO reserve, \$3 million, less 34% for income tax	1,980,000
Excess of real estate market value over book value	3,000,000
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Total Value	\$9,980,000

6. **The Gut Feel Method**

FORMULA: None. Value is amount owner wants for the business.

EXAMPLE: "For \$15 million, I'll sell. Below \$15 million, I'll keep the business".

7. **Review of Industry Comparables Method**

FORMULA: Amounts for which similar businesses have been sold

EXAMPLE: A similar business was sold for twelve times earnings, or for twice book value.

Many other valuation formulas exist. Your investment banker can help you select the formulas and the multiplier factors involved in arriving at one or more price ranges for your company. Only rarely does one formula produce management's desired answer; more often, several should be applied along with the experience and expertise of your advisors.

GETTING STARTED

The process of selling your company can be both enlightening and rewarding. If it is done correctly, you will end up with not only the financial proceeds you had in mind, but a satisfying after-sale situation for yourself and for all the others who have helped your company grow.

Here is an approximate chronology of the sale of a business, together with our suggestions on the steps leading to a transaction:

1. **Be certain that you wish to sell.** If you wish to stay with the company after it is sold, you must be able to handle not being the final authority or decision-maker any longer. Some managers can work for others; some cannot. If you see no other desirable career choices for the years ahead, and cannot contemplate working for an acquirer, perhaps another means to accomplish your goals should be found.
2. **Engage professional help early.** Every step in the process will need expert handling, and a trained hand is needed to bring together the skills of your key staff and outside counsel. Make this selection as carefully as you would the choice of a new CPA firm or corporate attorney, and be certain to check references.

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3. **Decide what you wish your role to be after the sale.** How long do you want to stay with the company? In what role? How much autonomy will you require? Can you be happy and effective working for a large organization? How do you expect to be compensated for this role?
4. **Establish a value for your business.** Knowing what your business should be "worth" based on the various valuation methods is one thing; knowing what to expect, or what you are willing to accept, is quite another. Your investment banker

can help you determine the price objective, and should be aware of your willingness to accept less. Perhaps surprisingly, about as many owners ask too much for their businesses as those who price them too low. An inadequate price may lead to your great dissatisfaction later, while a price too high may poison the market for your company. Realism should rule your thinking.

5. **Target prospective buyers.** Your business should not be "shopped around", but it may be advisable to look at more than one bidder's offer. Determine whether it will be more effective to have a private sale than an "auction". Again, your investment banker can help.

Next, the most likely purchase prospects should be identified, listed and studied. Among the factors to be considered in building your list are:

- The buyer's business; knowledge of your industry and his relationship to it
- Competitive situation; historical competition between your company and his
- The buyer's acquisition interests and his success in making acquisitions work
- Prospect's financial strength and ability to fund the acquisition
- The resulting combination: industry position; relative strengths; power of the combination
- Buyer's history of treatment of acquired employees
- Degree of autonomy of acquired enterprises
- Buyer's reputation for ethical conduct

Among the types of prospective purchasers to be considered are public companies; individuals; larger private companies; buying groups; and your own management people, possibly aided through a leveraged buyout or venture capitalist.

Your company may be particularly valuable to a buyer who can make more of it than you can. For example, a buyer may be able to expand sales by using its sales force (or yours), and eliminate duplicate functions. Such prospects will be at the top of the list. Your management group may be better off with an investor group as a purchaser, where inside people are given the authority to continue to manage the company. The same is true, of course, in the case of leveraged buyouts.

6. **Prepare offering information.** At an early stage of considering your company, a prospective buyer will need a brief and comprehensive package of information about your company, including:

- Financial statements for the past three to five years, and for the most recent interim period
- Two- or three- year projections
- Description and history of the business
- Description of products, selling methods, markets and customers
- Plant and equipment analyses
- Labor relations information
- Samples of product brochures and sales aids
- Organization chart and descriptions of key personnel

Highly sensitive information, such as customer names, should not be included. Distribution of the information package should be controlled carefully.

The offering information may be given to the prospective buyer either before or after the initial meeting with you; however, before receiving the offering information, the prospect should sign a confidentiality agreement which protects you against unauthorized and detrimental use of the information.

7. **Contact prospective buyers.** Early contacts with prospects should be at the highest possible level. Those at lesser levels of responsibility may encourage you to believe that a transaction can result, while their senior management has no such thing in mind. This initial contact, which is generally carried out by your investment banker, should provide enough information to determine a buyer's level of interest, but without necessarily revealing your identity or the intensity of your interest in selling.

Of course, your investment banker will determine early on that the prospect has the financial means to carry out a transaction of this size and type.

8. **Meet with the prospective buyers.** In this first meeting, the buyer and seller become acquainted and set the tone of future dealings. In order to maintain secrecy, discussion may take place away from the office of the buyer and seller. When it can be done discreetly, such a meeting may take place on your premises, where a buyer prospect can tour your facilities.
9. **Perform the required due diligence work.** The prospective buyer and his legal, accounting and other experts will want to gather additional information, examine records and speak with key members of your staff. You will likely insist that secrecy be maintained at this early stage in order to avoid upsetting employees, customers, competitors, and suppliers. In order to match your need for secrecy with the buyer's need for timely information, the due diligence process may be divided into two phases:
 - Phase I: The prospective buyer is provided all the information you are willing to provide at this stage, and that you are able to gather without compromising secrecy.
 - Phase II: After the signing of a letter of intent or a comprehensive contract, the prospective sale is usually revealed and the buyer is permitted to complete his investigation. At this stage, there will be no secrets.

It is important to remember that no contract or letter of intent is likely to be completely binding on the buyer until the investigation has been completed and the results found to be satisfactory.

10. **Execute a letter of intent.** In order to reduce the risk of a misunderstanding, and to take a major step toward completing the sale, you and the buyer may decide to sign a letter of intent. This is a letter of no more than about five pages which:
 - Discloses the names of buyer and seller
 - States the price and terms
 - Sets forth assets to be purchased and liabilities to be assumed
 - Describes other major matters on which you've agreed
 - Clearly states whether the letter is intended to be binding on you or on the buyer
 - Outlines a timetable for the acquisition
 - Lists any contingencies

A letter of intent should deal with all significant matters, but should not be prepared as a kind of "tentative contract" that includes every detail of the proposed transaction. The letter of intent normally allows only seven to ten days for your response, at most. When it is executed by you and the buyer, your company will not be shown to other prospects for two or three months. This provides ample time for the buyer to complete his investigation, resolve any contingencies and document the agreement. Although it is not intended to be a binding commitment to sell or to buy, the letter of intent should be reviewed by your legal and financial experts before you sign it.

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11. **Negotiate.** Remembering that the approximate price and terms have been discussed even before a letter of intent was prepared, you as the owner should be able to discuss and negotiate most of the specific matters that will lead to agreement. Nevertheless, some matters involve sensitive emotional issues — particularly when they deal with close family members or long time employees — and may be negotiated by your investment banker under your instructions. This use of your skilled investment banking representative may keep the emotional issues out of your direct dealings with the acquiring management, leading to more favorable after-sale relations with the new owner.
12. **Execute a comprehensive contract.** In order to make certain that both the buyer and seller are protected properly, a comprehensive and detailed contract must be prepared and signed. Very often, negotiations on the fine points of such a contract are carried on right up to the time final agreement is reached and the document is signed.

The final contract will include such items as:

- The seller's representations and indemnifications
 - Collection of receivables
 - Undisclosed liabilities
 - Minimum level of equity at the closing date
 - Unfunded pension benefits

- The buyer's guarantees, secured by
 - Personal or corporate parent signature
 - Letter of credit
 - Collateral, possibly the assets or stock of the company being acquired
 - Denial of right of buyer to make any offsets against amounts owed to the seller

- Representations and indemnifications by the seller as to
 - Environmental compliance
 - Tax filings and payments
 - Undisclosed and/or unknown liabilities

- Identity of those who will pay for
 - Legal, accounting and other costs of the sale
 - Income tax of the selling corporation
 - Investment banking fees
- Disposition of seller's automobiles, aircraft, boats and other personal items
- Allocation of purchase price among the assets sold
- Terms of your employment with the buyer (possibly covered in a separate agreement)
 - Period of employment
 - Compensation
 - Insurance entitlements
 - Required amount of time on the job
 - Responsibility and authority
 - Covenant not to compete

13. **Secure financing.** Some buyers have insufficient funds to purchase a business without outside financing, and even the best buyer for your business may need financial assistance to complete the transaction. Some buyers expect to finance some of the purchase price by securing financing from the seller or from outside sources. In such a leveraged buyout, you may expect that the buyer and his lender will need information on which to base credit decisions, and that your letter of intent will include a contingency related to the ability to finance the transaction.

14. **Close the transaction.** The sale will be consummated at a formal closing session, probably in an attorney's office. Documents will be signed and the consideration paid. This closing typically occurs about two or four months after acceptance of a letter of intent.

TAX ASPECTS OF ALTERNATIVE STRUCTURES

Most sellers prefer a sale of stock because it is simple and because it may avoid significant additional taxation of the proceeds. Publicly owned companies often are willing to buy stock; individuals and privately held companies, however, almost always insist on buying assets.

A sale of assets by a corporation usually results in taxable income and income taxes at the corporate level because of:

- Gains on sale of personal property, such as equipment
- Gains on sale of real estate
- Recapture of LIFO inventory reserves

It is important for the buyer and seller to work together to achieve all possible tax benefits for both parties. Often such tax savings are the key to closing a gap between the seller's price and the buyer's ability to pay. Such tax savings may result from:

- The advantageous allocation of sale price among the assets being sold
- The seller's acceptance of significant compensation or covenant not to compete in lieu of part of sale price

In a tax-free exchange, the securities of the buyer are exchanged for securities of your company — say stock for stock. If properly handled, such an exchange is not taxable and defers the payment of tax on the gain until you sell the buyer's securities. In a tax-free exchange, your tax basis for the buyer's stock you receive is the same as the basis for your stock of your company. Most sellers tend to prefer cash, rather than taking securities — even despite the acceleration of income taxes — for these reasons:

- Possible restrictions on the sale of such securities
- The resulting lack of diversification in the seller's personal investment portfolio with exposure to unacceptable losses in value
- Possible lack of marketability of the buyer's securities
- The inability of a minority owner to exercise any degree of control

The following is an example that compares these three types of transactions:

	Stock Sale	Asset Sale	Tax-free Exchange
Gross sale proceeds	\$ 12,000,000	\$ 12,000,000	\$ 12,000,000
Less corporate income tax	-	3,000,000	-
Sale proceeds to selling shareholders	\$ 12,000,000	\$ 9,000,000	\$ 12,000,000
Less selling shareholder income tax (assuming tax cost of \$100,000 and 20% tax rate)	2,380,000	1,780,000	-
After-tax proceeds to selling shareholders:			
Cash	\$ 9,620,000	\$ 7,220,000	-
Securities	-	-	\$ 12,000,000

In many transactions, amounts that might otherwise have been treated as sale proceeds are allocated to types of payments that are tax-deductible, either immediately or over a period of time, to the buyer and ordinary income (instead of capital gain) to the seller. Examples of such types of payments are covenants not-to-compete, earnouts (shares of future profits), additional salaries, and bonuses. Such allocations may either increase or decrease the income taxes of the buyer and the seller and the total of the income taxes of both. It is very important that you consult competent tax counsel in order to understand, calculate and minimize the tax consequences of the sale of your business.

Deferred collection of part of the sale price frequently is required in order to conclude the sale and may result in proportionate deferral of income tax. The seller should receive sufficient assurances of collection such as guarantees, collateral or a letter of credit. A proportionate amount of the income tax may be deferred until collection of the deferred amounts.

Sale to an ESOP (Employee Stock Ownership Plan) may yield important tax, business and emotional benefits. Nevertheless, the many complications, including changes in tax laws, require that such sales receive careful study by tax and financial counsel.

TERMS OF SALE

If you accept a buyer's notes in partial payment for your interest in your company, you must satisfy yourself that the buyer will be capable of meeting this financial obligation. This requires examination of his financial information before the sale and periodically thereafter. As additional protection, you should secure one or all of the following:

- The guarantee by individuals or the parent company of a corporate buyer
- Letter of credit from a financial institution guaranteeing performance on the notes
- Collateral — possibly the assets or stock of the company being sold
- Denial of right of the buyer to make any offsets against contingency amounts owed to you

IMPORTANT ROLES FOR YOUR ATTORNEYS AND ACCOUNTANTS

Your attorney and CPA play critical roles in the sale of your business. They have the special skills and knowledge of your business to provide invaluable assistance, and should be involved early in the process.

Your attorney will be called on to:

- Provide information needed by the buyer and your investment banker
- Review and approve the letter of intent
- Review, approve and assist in negotiating the final contract
- Provide and review numerous documents required for the closing
- Make certain all documents connected with the sale assure the agreed performance
- Attend and assist with the closing of the sale

Your accountants should:

- Provide financial information needed for the investment banker's analysis and valuation of your business
- Provide financial information needed by the buyer
- Advise on the income tax consequences of alternative sale structures and sale price allocations
- Advise on unique balance sheet and income statement items which may affect contract provisions
- Review the letter of intent and contract for tax implications

ABOUT YOUR NEW LIFE

Many sellers remain in top management positions with the companies they used to own. Some manage related businesses within the acquiring company, and even find new upward mobility in the management of the acquirer.

Some who sold their companies for reasons of age, health or other personal reasons leave the enterprise completely.

Because many successful companies are the products of entrepreneurial minds, however, most acquired managements tend to stay with the companies they built only for a transition period of a year or two.

consider
carefully
what you want
to do with
your life

They find that they are temperamentally unsuited to operating their companies as parts of larger corporations, and no longer feel the entrepreneurial drive that made them successful.

For this reason, it is essential that you consider again and again — and well in advance of the determination to sell your company — precisely what you wish to do with your life after your company is sold to other interests.

The principals of J. H. Chapman Group, L.L.C., are prepared to help you work through this decisionmaking, and to advise you on ways to avoid a sale by making other changes in your business. If your determination to sell the company continues, we are here to help you make that change too.

J.H. Chapman Group, L.L.C.®

J.H. Chapman Group, L.L.C. is a unique investment banking firm offering a full range of financial and management services tailored to the policy directives and needs of specialized/qualified industries with domestic and foreign interests.

Founded on the premise of knowledge, experience and expertise, J.H. Chapman Group, L.L.C. is led by highly successful investment banking professionals and management specialists from diversified sectors of the business and financial communities.

NETWORK OF RESOURCES Each of the principals of J.H. Chapman Group, L.L.C. has owned a company or worked in the capacity of chief executive officer or chief financial officer for major corporations. All principals have considerable expertise in negotiating corporate mergers and acquisitions, securing corporate financing and structuring and implementing divestitures in a broad variety of fields — including the food and food-related industries, restaurant chains, non-food consumer products, apparel, retailing, office products, manufacturing and distribution.

Research and resource capabilities of the firm are enhanced by each member's personal network of relationships and professional affiliations, established through many years of experience in their respective fields, with key financial and business institutions.

SCHEDULED SERVICES J. H. Chapman Group, L.L.C. clientele includes major national and international corporations. Specializing in middle-market transactions, J.H. Chapman Group, L.L.C. effectively fills the void left by many other investment banking firms by offering a wide range of services for transactions in the \$10- to \$250-million price range.

ACQUISITION, MERGER, SALES OR DIVESTITURE OF BUSINESSES Providing project research; securing buyer/seller; negotiation on behalf of buyer/seller; structuring transactions — including leveraged buy-outs and venture capital.

FINANCING Securing financing for acquisitions and existing entities through regional, national and international banks; sellers; secured lenders; venture capital firms and individual investors.

STRATEGIC ALLIANCES Arranging strategic partnerships and co-ventures through a network of major clients.

FEES Fees structured by task and negotiated prior to agreement.

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