PART I

ADVANCE PLANNING

Chapter One

Preliminary Considerations

Selling a business is a complicated, time-consuming, and at times, emotional experience. You should give consideration to all of the following factors before seriously embarking upon the sale process.

UNDERSTANDING YOUR MOTIVES

It is important that you understand your motivation for selling your business. Your motivation will dictate the nature of your buyer and the structure of your transaction.

For example, if you are no longer interested in operating your business, you do not want to sell to a financial buyer or to have an earnout. An earnout is a provision in the agreement of sale that would measure the purchase price in whole or in part by the future profits of the business.

A financial buyer will typically not have the management in place to run your business and will expect you to remain to operate the business under a long-term employment or consulting agreement. You would not want to agree to an earnout unless you are in control of the business because otherwise, your final purchase price could be significantly reduced by poor performance of the managers installed by the buyer.

Understanding your motives to sell your business also helps you avoid what is called "seller's remorse." In general, seller's remorse results from the significant change in lifestyle that the sale of your business can bring, together with the emotional attachments that you have toward the business. Truly understanding your motivation will help you get through a very natural period of doubt and uncertainty concerning the wisdom of selling your business.

The following are some typical reasons for selling, which are usually a mix of personal and business:

- You are tired of working so hard and are ready to retire.
- You have no children who are interested in taking over the business.
- You have children who want to take over the business, but they are not competent to operate it.
- New competitors are moving into your business area, and you do not have the capital with which to fight them.
- You would like to have enough money in the bank so that you can support your lifestyle for the rest of your life.
- You need more capital resources than you can acquire to grow the business.
- Your business is going downhill, and you would prefer to sell it before it reaches the bottom.
- You were just divorced, and you retained the second-best lawyer in town. Unfortunately, your ex-spouse retained the best lawyer in town, and you owe your ex-spouse a huge amount of money.
- Your partner just died, and you do not have enough life insurance to buy out your partner's family as required by your shareholder agreement.
- You just died, and you did not maintain enough life insurance to pay death and inheritance taxes.

The preceding are only the major motivations; many other reasons may exist. At the beginning of the decision to sell your business, you may have one set of motivations and by the time the process is through, you may have dropped those motivations or added new ones.

What is important, however, is that you fully understand your motivations to sell your business and that you allow those motivations to continually guide the logic of your sale.

ASSEMBLING YOUR PROFESSIONAL TEAM

Your first step should be to assemble an outstanding professional team to advise you.

Most businesspersons select their professional team on the eve of their sale. This is far too late in the sale process. By selecting your professional team several years before the target date for your sale, you can obtain their guidance in the presale years as to methods of minimizing the obstacles. Your professional team will help implement the advance planning recommendations contained in Chapters 2 through 6.

M&A Attorney

The first person on your team should be an attorney specializing in mergers and acquisitions, an M&A attorney. This person might not be your regular attorney, who may be inexperienced in this area. You must carefully interview your attorney to learn about his or her expertise. Ask your attorney how many mergers and acquisitions he or she has handled in the last three years and what size businesses they were.

If a public company is a potential buyer, does your attorney have securities law experience? Has your attorney ever handled the sale to a public company where stock was part of the purchase price consideration?

If you do not get favorable answers from your personal attorney, look elsewhere. Most large corporate law firms maintain groups of attorneys who specialize in M&A. Select someone who not only is well experienced in M&A but also has good business sense and is someone with whom you have a good rapport.

The requirement that your attorney have good business sense cannot be overemphasized. You will need to make delicate trade-offs during negotiations, which require business and legal judgment from your lawyer. You need a lawyer who thinks like a businessperson but also has the necessary legal skills to protect you. It is a mistake to hire a lawyer who is a good scrivener but cannot properly translate legal risks into business risks and assist you in evaluating their importance.

During the sale negotiation, it is not unusual to instruct your attorney to play "bad cop" while you play "good cop." The good cop–bad cop negotiation strategy helps insulate you from the angry emotions of the buyer. This is particularly helpful if you expect to work for the buyer, but is also useful if you want to maintain a distance from the give-and-take of the bargaining. Be certain that your M&A attorney can play the bad cop role but also knows when to stop playing it.

Be wary of attorneys recommended to you by an investment banker or business broker involved in your sale. These attorneys may be experienced in M&A, but they also may feel beholden to the person who recommended them. Carefully interview such attorneys to determine if they are sufficiently independent that they could recommend that you (1) terminate the investment banker or business broker or (2) not proceed with an agreement of sale that is against your interests but would result in a fee to the recommending investment banker or business broker.

Tax Attorney

In addition to an M&A attorney, you will need a tax attorney. This is true even if you have a good tax accountant. Unless the tax consequences of your sale are simple (which you cannot know in advance of its structuring), you will want to double-check any tax advice you receive with a second tax professional. Tax attorneys and tax accountants sometimes approach tax issues differently, and you should solicit the views of both.

If your business is a C corporation for federal income tax purposes, one of the first questions to ask your tax consultant is what the tax consequences would be of changing to an S corporation. There are serious tax disadvantages to selling a C corporation, which are discussed in Chapter 11.

It is worthwhile to weigh the costs of changing to an S corporation five years prior to your sale target date versus staying a C corporation for the same five years and suffering the adverse tax consequences when you sell. This, of course, does not necessarily apply if you have a C corporation that is qualified under Section 1202 of the Internal Revenue Code, which is discussed more fully in Chapter 11 under the heading Fifty Percent Exclusion.

Accountant

It is generally not necessary to select a new accountant in order to sell your business. Most accountants can perform this task.

Some business owners use their accountant to negotiate the business terms of the sale. Caution should be exercised in doing this. Inquire how many sales transactions your accountant has previously negotiated, as well as their size and complexity. Discreetly inquire from other clients of your accountant as to whether they were satisfied. You must be discreet, because you do not want to announce to the world your decision to sell your business.

Your accountant and your personal attorney may be losing a significant portion of their revenues if your business is sold. Be sensitive as to how important your fees are to them.

> **WARNING** Be careful in using any accountants or lawyers with an economic interest in killing your sale. Have a heart-to-heart talk with them before engaging them, and, in case of doubt, look elsewhere.

Investment Banker or Business Broker

As early as five years before your sale target date, you should consider obtaining advice from an investment banker or business broker. The advice should primarily cover the following areas:

- an estimated value of your business as it currently exists and the factors that affect that value (see Chapter 2)
- the likely buyers for a business such as yours

You should seek this advice even if you intend to sell the business yourself and do not expect to retain an investment banker or business broker.

The purpose of this advice is to help guide you in the growth and development of the business during the years prior to the sale target date. If negative factors about your business are identified by the investment banker or business broker, you should take steps to eliminate them to the extent possible.

For example, if you are advised that you have a weak management team, you should consider strengthening your management structure during the years prior to sale. Likewise, if you are advised that your overdependence on a single customer will materially reduce your ultimate sale price, you can make efforts to diversify your customer base in the years prior to sale.

The investment banker or business broker you select as an advisor need not necessarily be the same one you choose to sell your business (see Chapter 6). You should select your investment banker or business broker based upon their familiarity with your industry and the quality of their advice.

CHAPTER TWO

MAXIMIZING THE SALE PRICE

It is important to understand how your business will be valued in order to avoid setting either too low or too high a sale price. The following are methods of valuing your business, along with techniques to maximize that value.

UNDERSTANDING THE METHOD OF VALUING YOUR BUSINESS

You can increase the value of your business if you understand how buyers are likely to value it. Likewise, by understanding the valuation method, you may be able to remove assets from your business prior to sale that do not affect the valuation, thereby effectively increasing the total sale consideration you ultimately receive.

An appraisal of your business, which specifies the primary valuation methods and factors, should be sought from a qualified appraiser well in advance of the expected sale date. Such an appraisal could cost as little as $5,000 to $10,000. Select the appraiser by reputation and personal recommendation.

In general, an appraiser from an investment banker or business broker with *actual* experience in selling businesses in your industry is the most valuable. What is important is not so much an appraisal of what your business is currently worth but rather an understanding of the primary methods of valuation and valuation factors. Someone who actually sells businesses in your industry is best qualified to provide this information.

If you cannot find anyone with such experience, look for appraisers who are members of recognized appraisal groups that require an examination. The prestigious American Society of Appraisers and the somewhat newer Institute of Business Appraisers (typically, certified public accountants) are examples of such groups. The Institute of Business Appraisers does not require any specific valuation experience, in contrast to the more rigorous requirements for the American Society of Appraisers, which requires five years of experience for the designation accredited senior appraiser and two years for the accredited member designation.

These different professional requirements usually are reflected in the cost of the appraisal, with members of the American Society of Appraisers generally charging significantly higher fees.

Appraisal

Appraisal is an art, not a science. Take all appraisals with a large grain of salt. The larger your business, the less likely that the appraisal will be accurate in assessing your business' total valuation. Businesses that are worth more than $5 million to $10 million tend to attract financial as well as strategic buyers. The presence of financial buyers tends to drive up the price.

No one can accurately predict what you are worth to a particular strategic buyer. The strategic buyer may find that the value of your business to them far exceeds the result of any standard valuation formula. Your customer list, sales force, and market identification may blend so well with the market direction of the strategic buyer that a high sale price can result.

The balance of this section presents some of the more common methods used to evaluate a business.

Businesses worth less than $1 million tend to be valued using the rule-of-thumb formulas and the asset accumulation methodology, which are discussed in the sections that follow.

Buyers of businesses worth $5 million or more tend to use the Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) method combined with a comparable transaction analysis. If no significant earnings exist, a discounted cash flow methodology will be used. It is not unusual for the investment banker to also use a discounted cash flow analysis to double-check the valuations obtained using the EBITDA or comparable transaction method.

Caution should be exercised in using any formula to value your business. Every business is unique and thus, using only formulas can give you a very misleading picture of your value because they are not tailored to your particular business. There is no substitute for an appraisal performed by a competent investment banker or business broker.

However, even the best appraisal cannot take into account the value of your business to a specific buyer. For example, a strategic buyer who can lay off all of your back-office employees might be willing to pay an absurdly high price for your business because of the cost savings of the layoffs. Without knowing the pro forma effect of combining your business with the business of a specific buyer, any appraisal becomes little more than an educated guess.

Rule-of-Thumb Formulas

Potential buyers have a variety of rule-of-thumb methods for valuing businesses, depending on the nature of the business. For example, vending machine businesses are typically valued based on the number of locations. Cable TV businesses are typically valued based on the number of subscribers. The accounting income shown by these businesses is only of secondary importance to the buyer, because the buyer will change the business to conform to the buyer's model, thereby making your financial results irrelevant.

Rule-of-thumb valuation methods are more typically used for smaller businesses (usually valued at less than $5 million), particularly where there is a perception that the financial information is not completely reliable. However, rule-of-thumb formulas are occasionally used for larger businesses as well.

If you are in a business that uses these rules of thumb (e.g., vending machine locations or cable TV subscribers), consider increasing your locations or subscribers prior to sale. Thus, by understanding the valuation method for your business, you can increase the likely sale price.

Some valuation experts have criticized this method of increasing valuation because it ignores profitability. They argue that a cable TV system, which is valued at $3,000 per subscriber, can easily add new subscribers by cutting prices or giving away free services. Adding new subscribers at a loss per subscriber should not, they argue, increase the value of the cable TV system.

Some common sense must be used to increase the value of businesses that are valued on a rule-of-thumb basis. If our hypothetical cable TV system, by cutting prices, can cause new subscribers to sign up and still have the lowered "teaser prices" cover the additional costs of these new subscribers, then adding new subscribers is a good strategy. However, if the cable TV company cannot charge prices to new subscribers that will cover the incremental costs of these new subscribers (except for a very short period of time), it is not a good idea to add subscribers by reducing overall profitability.

Many rule-of-thumb formulas exist for valuing specific industries. The following are examples:

Insurance agencies	1 to 2 times annual gross commissions
Real estate agencies	.2 to .3 times annual gross commissions
Restaurants	.3 to .5 times annual gross sales
Travel agencies	.05 to .1 times annual gross sales

Buyers do not apply these rules of thumb universally, as the rules ignore the profitability of the specific business.

First find out the formula for valuing your business. Then attempt to maximize the elements of the formula for the year in which your business will be valued and, if possible, prior years. Typically, this is the year prior to sale.

EBITDA Method

A number of businesses are valued by buyers based upon accounting earnings or income. Indeed, one of the most common methods of valuation is the so-called EBITDA method. This involves the determination of your accounting earnings before interest, taxes, depreciation, and amortization (EBITDA), and multiplication of the EBITDA by the relevant multiplier to obtain a business valuation.

Table 2.1 is an example of the EBITDA method.

Your EBITDA is then adjusted to remove expenses and revenue that will no longer be carried forward into the new business. These adjustments can be quite substantial for a closely held family business.

Most closely held businesses are operated to minimize income taxes. As a result, excessive compensation and perquisites may be

TABLE 2.1 EBITDA CALCULATION

EXAMPLE	
Revenues	$10,000,000
Cost of sales	(8,000,000)
Gross profit	2,000,000
General and administrative costs	(500,000)
Depreciation	(100,000)
Amortization	(50,000)
Interest expense	(250,000)
Total expenses	(900,000)
Net income before taxes	(1,100,000)
Income taxes (40%)	(440,000)
Net income after taxes	($ 660,000)
CALCULATION OF EBITDA	
Net income after taxes	$ 660,000
Interest	250,000
Income taxes	440,000
Depreciation	100,000
Amortization	50,000
EBITDA	$ 1,500,000

provided to the owner and his or her family in order to reduce taxes. The excessive compensation and perquisites are really forms of disguised dividends.

The true cost of replacing the owner and his or her family with a high-level executive usually results in a substantial addition to the EBITDA.

Some buyers will subtract from the adjusted EBITDA any required yearly capital expenditures.

Multipliers

The adjusted EBITDA is then multiplied by a multiplier to obtain an overall valuation for the business (also called "enterprise value"). The multiplier typically ranges from 4 to 6 times adjusted EBITDA, particularly for financial buyers. However, the multiplier has gone below 4 and substantially above 6, depending upon whether it is a buyer's market or a seller's market for the sale of businesses. A multiplier above 6 is more typical for strategic rather than financial buyers.

Multipliers of 20 or more are not unheard of for strategic buyers of companies with strong market niches.

The multipliers are derived from comparable company valuations, including the multipliers applicable to public companies in the same industry. For example, if a public company in your industry has a total market valuation (based on its stock price) of 10 times its EBITDA, this multiplier could be the starting point in determining the appropriate multiplier.

This multiplier would then be discounted by the fact that your company was smaller and had less market dominance.

Many business owners incorrectly assume that the multipliers applicable to larger companies in the industry apply to their smaller company. The multipliers for less dominant companies in an industry are significantly smaller than for dominant companies.

A further discount to the multiplier may be applied to reflect the lack of liquidity of your stock in the hands of the buyer (that is, if no public market exists for your stock).

General

If your business has long-term debt, the overall valuation of your business will be reduced by the market value of this debt (including the current portion of long-term debt). The market value can be greater or less than the principal amount of the debt. For example, long-term debt that bears an interest rate below current interest rates for comparable maturities will have a market value less than its principal amount.

The overall valuation of your business obtained by multiplying the adjusted EBITDA by the applicable multiplier is called the "enterprise value." If your business has no long-term debt, then this figure is the valuation of your business.

Your business will be expected to have a normal amount of working capital at the closing date of any sale. Your working capital is the excess of your current assets (e.g., cash, accounts receivable, inventory, and prepaid assets) over current liabilities (e.g., accounts payable, loans due within one year, accrued payroll, etc.). If your working capital is below normal, this will reduce your ultimate sale price. If your working capital is above normal, you can usually negotiate on a dividend of the excess working capital before closing, which in effect increases your ultimate sale price.

If you have nonoperating assets in the business, the buyer may permit you to remove assets from the business before the sale closing.

Businesses that are likely to be valued on the EBITDA basis should consider methods of increasing their accounting income during the one or two years prior to sale. This requires advance planning.

WARNING Many businesses have inventory cushions. This is an illegal method of minimizing taxes by underreporting the ending inventory. The result of underreporting ending inventory is to increase the cost of sales, which in turn reduces taxable income. Many businesses that have an inventory cushion find that whatever savings they had in taxes over the years by underreporting their taxable income are partially or completely offset by the fact that they never get paid by the buyer for their inventory cushion. The seller merely gets paid for the inventory that was reported. It is not usually possible to eliminate an inventory cushion in one year. Several years are required for this purpose.

For each $1 that you increase your EBITDA during the valuation year, you should arguably receive an additional $4 to $6 in sale price.

Discounted Cash Flow Method

Under this method of valuation, you look at future cash flows projected from the operations and discount them in accordance with time and risk factors. The higher the risk, the higher the discount factor.

The discounted cash flow method begins with a projection of revenues and operating profit. These projected financial results are then adjusted for nonrecurring and nonoperating items of income and expense and are reduced by taxes. The projected operating profit estimates after taxes are then further adjusted by adding back depreciation and amortization and deducting net investments in working capital and capital expenditures.

At the end of a given period, typically five or ten years, a "terminal" or "residual" value is calculated for the business. This terminal or residual value is then combined with the discount cash flows to produce an overall valuation for the business (the enterprise value).

The two most common methods of calculating residual value are the perpetuity method and the multiplier approach. The perpetuity method capitalizes the final year's projected cash flow by a discount rate as if it were an annuity. The multiplier approach applies a multiplier to the final year's cash flow. Because the residual value is typically a large figure, the underlying assumptions in the calculation must be carefully examined.

The net equity value of the business, including the residual value, is then determined by deducting the market value of interest-bearing debt and adding the market value of nonoperating assets that remain in the business. An example of this calculation is contained in Table 2.2.

Obviously, a cash flow ten years from today is not worth the same amount to the investor as a current cash flow. Thus, the formula tends to give little current value to cash flows that are too far in the future.

The sale price of your business using the discounted cash flow valuation assumes that a normal amount of working capital remains in your business at sale closing. As explained, using the EBITDA method, the sale price is typically adjusted for excessive or inadequate working capital at sale closing. Similar adjustments are required under each of the valuation methods discussed in this book.

Discount Factor

The discount factor applicable to the cash flows is arrived at by using various formulas, one of which is the capital asset pricing model (CAPM). The CAPM sets the discount rate at the weighted average cost of equity and debt capital.

The capital asset pricing model estimates the future cost of the corporation's equity through a multifactor equation and then determines the after-tax expected future costs of the corporation's debt.

TABLE 2.2 FLOW VALUATION

Discounted Cash Flow Valuation (in multiples of 1,000)						
	Year 1	Year 2	Year 3	Year 4	Year 5	Terminal Value
Revenues	$30,000	$45,000	$50,000	$55,000	$62,000	
EBIT	3,264	3,825	4,322	4,884	5,519	
Income taxes (cash basis)	1,110	1,301	1,469	1,661	1,876	
Net operating income	2,154	2,524	2,853	3,223	3,643	30,358
Cash flow adjustments						
Plus:						
Depreciation	1,392	1,800	2,034	2,298	2,597	
Less: Net change in working capital	(405)	(731)	(168)	(204)	(244)	
Capital expenditures	(1,966)	(3,675)	(4,161)	(4,398)	(4,697)	
Free cash flows	1,175	(82)	558	919	1,299	
Net present value at 12.0%	1,049	(65)	397	584	737	17,226
			Total corporate value			$19,928
			Less: Market value of debt			(12,528)
			Shareholder value			$ 7,400

The final step is to compute the weighted average cost of capital, which is the weighted average cost of both equity and debt.

The weighted average cost of equity is computed by using the following equation: $re = rf\,B(rm - rf)$, which can be defined as follows:

re	=	expected future cost of equity
rf	=	risk-free rate of return
B	=	the beta factor, which is a measurement of market risk, with the value 1 equaling a normative risk. (One court has defined the beta factor as "the nondiversified risk associated with the economy as a whole as it affects this firm.")
rm	=	the market risk premium for this particular business

The rm factor, together with the beta factor in the equation, has the effect of discounting the future cash flows by the risk of their nonoccurrence. The greater the risk of the projected cash flow not occurring, the higher the expected future cost of equity.

Your historical financial results are only relevant to this discounted cash flow method to the extent that they give credence to the projections of future cash flow. However, if your business is likely to be valued by this method, assets that do not contribute to your cash flow can be safely removed from the business without affecting its valuation.

Comparable Company Method of Valuation

The comparable company method of valuation typically involves comparing your company to the market capitalization and multiples of certain financial criteria (such as net income; projected net income; earnings before interest, taxes, depreciation, and amortization, revenues; and book value) of comparable public companies. Market capitalization refers to the public trading price of the stock multiplied by the number of outstanding shares. Thus, if a comparable public company had a public trading price of $20 per share and there were two million shares outstanding, the overall market capitalization of that comparable public company would be $40 million.

The market capitalization method of valuation contains a number of limitations. The trading price of shares of a public company does not normally reflect any control premium unless the company is expected to be sold shortly. Consequently, the public trading price may significantly understate the overall value of the comparable public company in a sale situation where a control premium is paid for the shares.

In addition, it is difficult to compare a publicly held company with a privately held company. Shares of public companies typically trade at a price that reflects the liquidity available to shareholders, which is not available to shareholders of a privately held company. As a result, privately held companies tend to sell at a discount compared to comparable publicly held companies.

Comparable Transaction Method of Valuation

Where information is available on the sale of comparable companies (whether public or private), this information is very valuable in assessing the value of your company. However, great care must be taken in using this information. Because every company is unique, significant differences may exist between your company and the so-called comparable company.

One of the major problems with this method is the lack of sufficient information to be able to judge how "comparable" another company is to yours. For example, your company may have one customer that accounts for 15 percent of your sales—a negative factor. You may not be able to determine whether the so-called comparable company has this same negative factor. Therefore, information on the sale price of the comparable company may be difficult to assess. Consider all such information with a certain measure of skepticism.

Asset Accumulation Method

This method involves accumulating the going concern value of each of the specific assets of your business. This includes off-balance-sheet assets, such as customer lists, product market identification, value of your trained workforce, goodwill and other intangible assets, in addition to your balance-sheet assets. In computing going concern value, three standard appraisal methods are utilized:

- cost approach
- income approach
- market approach

The replacement cost is usually the most favorable method to the seller of valuing both balance sheet and off-balance-sheet assets.

The values of your balance-sheet and off-balance-sheet assets are then combined to calculate the total value of your entire business. The major advantage of this valuation method is that if you eliminate specific assets from the sale (for example, accounts receivable), you can easily adjust the total sale price. This valuation method is more typically used in valuing smaller businesses than midsized and larger businesses.

Asset liquidation value serves as a minimum valuation figure, regardless of whatever other valuation method may be used. Thus, if the rule-of-thumb formula for your business is 1 times annual sales, and your liquidation value is higher, you should receive the liquidation value.

Valuing Goodwill and Other Intangible Assets

As noted, the asset accumulation method of valuation permits you to separately value such goodwill and intangible items as your customer relationship, your market reputation, and your trained workforce. If you have other intangible assets, such as patents, trademarks, and copyrights, they can also be considered as separate assets to be individually valued.

Several classifications of intangible assets are as follows:

- *Technology-related* (e.g., engineering drawings and technical documentation)
- *Customer-related* (e.g., customer lists and customer relationships)
- *Contract-related* (e.g., favorable supplier or other product/service contracts)
- *Data processing-related* (e.g., computer software, automated databases)
- *Human capital-related* (e.g., employment agreements, noncompete agreements, a trained and assembled workforce)
- *Marketing-related* (e.g., trademarks and trade names)
- *Location-related* (e.g., leasehold interests, certificates of need)
- *Goodwill-related* (e.g., going-concern value)
- *Engineering-related* (e.g., patents, trade secrets)

- *Literary-related* (e.g., literary copyrights, musical composition copyrights)

As previously noted, three common methods of valuing both tangible and intangible assets are the cost approach, the income approach, and the market approach.

In valuing intangible assets, the seller usually obtains the highest valuation using the replacement cost method. However, few buyers will pay full replacement costs. Buyers will argue that if they are requested to pay 100 percent of the replacement costs, they might as well actually replace these intangible assets. The seller's counter to that is "time is money," and replacement of these intangible assets could take years. Despite this counter by the seller, only very motivated buyers will pay 100 percent of replacement costs.

As a result, goodwill and other intangible assets typically sell for some significant discount from actual replacement cost. Many buyers refuse to pay anything for goodwill, particularly if the business does not have superior earning power or is incurring a loss.

Intangibles, such as patents that actually produce royalty income to the seller, can typically be separately valued on an income approach using a discounted cash flow method of valuation.

Some sellers believe that they should be separately paid for their goodwill and other intangibles even if a macro financial method of business valuation is used, such as the EBIDTA, discounted cash flow, comparable company, or comparable transaction valuation methods. Unfortunately, each of these methods values your business as a whole and therefore, any goodwill items are included as part of the valuation. Thus, goodwill is not added to the enterprise value computed under these methods.

Goodwill and other intangibles are valued separately under the assets accumulation method and certain formulas discussed further on, including orderly liquidation.

The assets accumulation method or other valuation methods discussed in the following section, which permit separate valuation of goodwill, are usually used because the EBITDA and other macro valuation methods do not produce as favorable a price to the seller.

Other Valuation Formulas

A myriad of other valuation formulas are used today.

If your business is asset intensive, some have suggested that your business value is equal to your hard assets plus goodwill. Hard assets refer to the total fair market value (which can be replacement cost) of your fixed assets and equipment, leasehold improvements, accounts receivable, and inventory. Your goodwill is your discretionary cash for one year—that is, the amount of cash you received as salary and dividends.

Another formula used for smaller businesses focuses on the seller's discretionary cash per year and multiplies this figure by 2.2727 to arrive at a sale price.

None of these formulas or the many others currently in use are universally applied. What is important is that you understand the particular valuation formula most likely to be applied to your business.

MINIMUM VALUE FORMULAS

The minimum value of your business is the higher of (1) its value-to-service acquisition debt or (2) its liquidation value.

Acquisition Debt Value (Leveraged Buyout Analysis)

If your business produces positive cash flow earnings before interest, taxes, and depreciation amortization (EBITDA), that cash flow can service (that is, pay interest and principal) a certain amount of acquisition debt for the buyer. The amount of acquisition debt that can be so serviced is the minimum value for your business, particularly to a financial buyer.

For example, assume that the excess cash flow of your business (EBITDA) is $500,000 per year, and that, based upon current interest rates, that $500,000 is sufficient to pay the interest and principal due on $3 million of bank debt, which matures over a five-year loan term (exclusive of the balloon principal payment in the fifth year, which can be refinanced). The minimum value of your business would be $3 million, particularly to a financial buyer.

There is a limit to the amount of debt senior lenders will provide for a given business without an equity component. Therefore, once that debt limit is reached, your cash flow must be high enough to be able to attract equity investors.

In this sense, you can determine the minimum value of your business using a leveraged buyout analysis (see Chapters 14 and 19).

Liquidation Value

Some businesses are worth only the liquidation value of their assets. Liquidation value refers to the price that would be received in an orderly liquidation, not in a fire sale. These businesses are typically not producing positive cash flow and have no prospects for doing so.

SPECIFIC FACTORS THAT AFFECT VALUATION

Let us assume that your business has an identical EBITDA to one of your competitors, and in your industry, businesses generally sell for 5 times EBITDA. Should both businesses sell for the same price? Not necessarily.

EBITDA is merely the beginning of the valuation process. Certain specific favorable and unfavorable factors to your business increase or decrease the multiplier of 5. Table 2.3 gives some examples.

These specific valuation factors will affect all of the valuation formulas, not just the EBITDA method.

You must analyze the strengths and weaknesses of your business and be prepared to point out the strengths and acknowledge the weaknesses, which the buyer will probably discover in its due diligence process.

The valuation of your business will also vary with the nature of the buyer. Financial buyers (e.g., leveraged buyout funds) will typically pay less than strategic buyers, as more fully discussed in Chapter 8. Strategic buyers who, by definition, are already engaged in your business, have the ability to reduce your work force, particularly your back office, and can consolidate operations with their own. These post-sale cost-saving activities can increase your value to a strategic buyer.

Your valuation can also vary based upon the needs of the buyer. A financial buyer who needs to demonstrate progress in the use of the investment funds to their fund investors may overpay for your business. Likewise, a strategic buyer who wants access to a particularly important customer of yours may be willing to pay more for your business to obtain such access.

Table 2.3 Factors That Influence Valuation

Factors Increasing Valuation	Factors Decreasing Valuation
1. Strong customer relationships at all levels	1. Weak customer relationships and frequent turnover
2. Proprietary products or services	2. Lack of proprietary products or services
3. No single customer accounts for more than 5% of revenues or profits	3. A single customer accounts for over 15% of revenues or profits
4. Strong management team (important mainly to financial buyers)	4. A weak management team (so-called "one-man-show syndrome")
5. Excellent employee turnover and relations	5. Poor employee turnover and relations
6. Consistent revenue and earnings trends	6. Inconsistent revenue and earnings trends
7. Plant and equipment in good repair	7. Plant or equipment has been neglected and requires significant repairs
8. Intellectual property assets, which are legally protected	8. Lack of legally protected intellectual property assets

RECENT SALES OF BUSINESSES

Appendix 1 contains examples of sales of businesses of all types and sizes with a sale price of between $10 million and $1 billion.

Appendix 2 contains examples of sales of businesses with sale prices ranging from $500,000 to $10 million. Appendix 3 contains examples of sales of businesses with sale prices ranging from $100,000 to $500,000. Appendices 2 and 3 use the abbreviation SDCF to refer to the seller's discretionary cash flow, which is the equivalent of EBITDA plus the owner's salary and nonbusiness-related expense.

The information in Appendixes 2 and 3 has been supplied by BIZCOMPS, which collects information from business brokers throughout the United States. BIZCOMPS also supplies similar information on businesses sold for less than $500,000. The contact information for BIZCOMPS is: Jack R. Sanders, P.O. Box 711777, San Diego, CA 92171; 858-457-0366.

Other computerized databases include the following:

- *Mergerstat Review*, an annual and monthly publication of merger and acquisition transactions (www.mergerstat.com)
- Thomson Financial Securities Data (www.tfibcm.com)

The special considerations involved in valuing Internet businesses are discussed in Chapter 21.

INCREASE YOUR NET BOOK VALUE

Regardless of what valuation is placed on your business, some buyers will not, at closing of the sale, pay more cash for your business than its net book value. Any excess of the sale price over the net book value is deferred by such buyers. Net book value refers to your total assets less your total liabilities as reflected on your financial statements. This is the same figure as your shareholder equity as reflected on your financial statements. The balance of the purchase price is then deferred.

The theory of some buyers is that your net book value or shareholder equity approximates the liquidation value of your business. The buyer does not want more than that amount invested in cash on the acquisition at closing.

As the seller, your counterstrategy should be twofold: (1) to use different accounting methods in preparing your balance sheet than you use in preparing your tax returns so as to maximize net book value and (2) to reflect undervalued assets on a pro forma statement of your adjusted net book value or shareholder equity.

Your accountant will typically choose accounting principles that minimize your taxable income for tax purposes. However, it is not necessary to use these same principles for financial reporting purposes.

For example, you may use accelerated depreciation of your equipment for tax purposes to reduce your taxes. However, you should use straight-line depreciation of equipment in preparing the financial statements given to the buyer, with a footnote disclosing the different depreciation method for tax purposes.

The effect of using straight-line depreciation will typically significantly increase your net book value, because your equipment can be reflected at a high book value. Other accounting changes can be suggested by your accountant to increase your net book value.

It is preferable not to adopt new accounting methods on the eve of a sale. Therefore, good advanced planning should include adopting such accounting methods many years before the sale.

After you have exhausted using favorable accounting methods to increase your net book value, you should supplement your financial statements with a description of written-off or undervalued assets and add the value of these assets to your net book value or shareholder equity on a pro forma basis. These off-balance-sheet assets can add significantly to the value of your business.

For example, you may in the past have purchased $1 million worth of machinery that has been fully written off through depreciation charges. The machinery may still be worth $500,000, but it does not appear anywhere in your financial statements. Add this $500,000 to your net book value as shown on your financial statements in a column called Pro Forma Adjusted Net Book Value or Pro Forma Adjusted Shareholder Equity. You may have purchased land years ago for $100,000 that is now worth $500,000. The $400,000 appreciation should be added to your pro forma net book value or shareholder equity.

Many businesses expense small tools—that is, they run the cost of tools through the income statement and do not capitalize them as an asset. Under some accounting conventions, a small tool could be one costing less than $500. Determine the market value of these small tools and increase your pro forma net book value or shareholder equity by this figure.

Comb through your business assets to be certain that you have reflected them all at their market value.

REMOVING UNPRODUCTIVE ASSETS FROM YOUR BUSINESS

Once you understand the method most likely to be used to value your business, consider removing, prior to sale, assets from the business that do not affect its value. Each dollar of asset value that you can remove from the business prior to sale without affecting the buyer's valuation is an additional dollar in your pocket. This is an excellent way of increasing your overall sale consideration.

For example, if you owe your business money, your debt is an asset of the business. However, if the buyers use the EBITDA or discounted cash flow valuation method and do not include interest income on the debt in computing your valuation, they have assigned a zero value to your debt. Accordingly, you should be able to remove your debt from the company (or forgive it) prior to the sale without affecting the buyer's valuation. The same may be true of life insurance on your life and your automobile, which is not necessary to operate the business.

However, rather than waiting until you are negotiating with the buyer to remove these assets, it is wiser to remove them at an earlier time so this issue never becomes a point of negotiation with the buyer.

MINIMIZE YOUR WORKING CAPITAL NEEDS

A typical agreement of sale will require the seller to leave a normalized amount of working capital in the company after the sale closing. If the amount of working capital at the closing exceeds this normalized figure, the seller can remove this excess from the company once the buyer's accountants have verified the excess after the closing has occurred. In effect, this ability of the seller to remove excess working capital from the company is a method of increasing the real purchase price to the seller.

On the other hand, if the working capital at the closing is less than this normalized figure, the seller may have to contribute the dollar amount of the deficiency back to the company. This contribution is usually accomplished by having the buyer escrow a portion of the purchase price paid at closing and using the escrowed amount to repay the deficiency. To the extent a deficiency exists, this is in reality a reduction of the seller's purchase price.

The normalized amount of working capital is usually obtained by looking at the average amount of working capital maintained in the business over some time period and negotiating a normalized figure for working capital. The time period could be a few years or, if your business is seasonal, it could be the same fiscal quarter of the year immediately prior to the year in which the closing occurs.

If you minimize your working capital needs during the years prior to the sale of your company, you may be able to convince the buyer to permit you to remove any excess working capital from the company, thereby increasing your effective purchase price. You can minimize your working capital by a variety of methods, including aggressive collection of accounts receivable and maintenance of minimum cash and inventory levels.

PROTECT YOUR INTELLECTUAL PROPERTY

One of the specific factors in the valuation of your business is whether you have legally protected intellectual property assets, such as patents, trademarks, and copyrights. Your intellectual property assets will assist the buyer in protecting the business from competition and, therefore, makes the business more attractive to the buyer.

Most businesspeople do not know that they even have intellectual property assets to protect. For example, even if you have a nontechnology business, you may still be able to obtain a business method patent on some process or methodology that you use in conducting your business. Likewise, you may have trademarks, service marks, and trade dress that you use in your business that should be legally protected.

Long before your sale target date you should hire a patent or intellectual property attorney to help you identify your intellectual property assets. The process of obtaining patents can take three or four years; it is never too early to begin such a review.

MAKE YOUR FINANCING ASSUMABLE

If you receive bank or other financing for your business, you can make your business more valuable to a buyer by inducing the lender to agree in advance that the financing will be assumable if your business is sold. This is particularly valuable if you have long-term indebtedness at favorable interest rates and terms and is less valuable if your indebtedness is all short term. The buyer's ability to assume long-term financing will increase the value of your business to the buyer.

Most lenders will resist assumability clauses in the financing documents unless they are properly hedged. For example, the bank may require the potential buyer to have a minimum net worth or satisfy other financial tests set forth in the financing agreement, in order to allow the automatic assumption of the debt by the potential buyer. The bank may also require you to remain liable on the debt.

BIGGER IS GENERALLY BETTER

Larger businesses tend to sell for higher multipliers of EBITDA (for EBITDA valuations) and lower discount rates (for discounted cash flow valuations). You cannot analogize a business worth less than $5 million with a business in the same industry worth more than $50 million. The business worth over $50 million always sells for a higher multiplier and lower discount rate. Likewise, you cannot analogize a business worth $50 million with one worth $500 million in the same industry.

This is understandable because buyers prefer larger sized businesses, which are more dominant in their field, and financial buyers are typically not interested in businesses worth less than $10 million.

What this suggests is that a good way for you to build your valuation prior to your target date is to yourself engage in strategic mergers. By building up your business during the presale years through mergers and other acquisitions, you will be a much more attractive target when it comes time to sell.

Eliminating deal killers and impediments to the sale will also increase your business valuation, as discussed in Chapter 3.

VALUATION VERSUS NET SALE PROCEEDS

The appraised valuation of your business is only a starting point in determining your net proceeds from the sale of your business. Different buyers have different methods of appraising businesses and that appraisal could significantly differ from your appraisal.

Even assuming that the buyer is willing to accept the appraised value of your business and use that appraised value as the purchase price, the net sale proceeds you actually receive from the sale will be reduced by the following (as explained in subsequent chapters):

- federal, state, and local income and transfer taxes (see Chapter 11)
- provisions of the sale agreement that require the seller to retain all liabilities other than those specifically identified (see Chapter 18)
- provisions in the sale agreement that require the seller to indemnify the buyer post-closing for events or circumstances that occur before closing (see Chapter 18)

CHAPTER THREE

ELIMINATING DEAL KILLERS AND IMPEDIMENTS

Once you have made a decision to sell, you should immediately examine your business, with the help of your M&A attorney, to determine whether you have deal killers or other impediments to a sale. These deal killers or other impediments may require many years to resolve successfully. Again, it is important that you make these evaluations many years before your sale target date.

If you have a business of any significant size, a potential buyer will likely hire a law firm and an accounting firm to perform due diligence on your business, as more fully discussed in Chapter 7. Any discovery of defects in your business will be used by the possible buyer to reduce your valuation. A smart seller will hire an M&A attorney and an accountant to identify such defects and attempt to correct them well before attempting to market his or her company. This will avoid embarrassment to the seller in the negotiation process and will help increase the ultimate purchase price of the company.

DEAL KILLERS

The following are typical examples of deal killers if the resulting contingent liability is large in relation to the value of your business:

- employment-related liabilities
- environmental liabilities

- litigation liabilities
- federal, state, and local tax liabilities, including sales and income taxes
- unfunded pension obligations and multiemployer pension plan liabilities
- product warranty obligations of unreasonable scope or length

No buyer is going to assume these liabilities willingly if they are of a material indeterminable amount. Even if you do not require the buyer to assume these liabilities, they may still prevent the sale of your business.

For example, if the property on which your plant is located is environmentally contaminated, the purchase by the buyer of the property subjects the buyer to environmental liability as the owner. This is true even though the buyer did not cause the pollution.

If your business has large, unresolved litigation liabilities, the buyer may be concerned about purchasing your assets because, at least under some state laws, liabilities can be imposed upon the buyer even though the buyer never agrees to assume them. This is particularly true if the buyer continues the same business under the same name and products of the business that caused personal injury.

Many businesses misclassify employees as independent contractors. The resulting liability for payroll taxes, interest, and penalties can, if this practice is carried on long enough, create a very large contingent liability.

The existence of large, unresolved contingent liabilities that could potentially exceed your assets may indicate that your business is insolvent. If so, a sale of assets to the buyer at less than its fair market value could be legally challenged by creditors in the future.

It is, of course, possible to wait to resolve these deal killers until a buyer is found. However, by the time you clean up your environmental contamination or even get a firm estimate on the cost, the buyer may have disappeared. Therefore, it is wiser to handle these issues prior to the potential sale of your business.

If you cannot get rid of the deal killers prior to the sale of the business, it may be possible to set up escrow arrangements for the protection of the buyer and nevertheless proceed with the sale. These escrow arrangements would typically require objective proof of the largest amount of the contingent liabilities, and the buyer would undoubtedly require that same amount of the sale proceeds to be escrowed.

If you handle your deal killers prior to the sale, it is likely that you would spend much less money to resolve these contingencies than the buyer would require in an escrow. By waiting until the point of sale to handle these problems, you will create a high escrow to give the buyer a significant margin for error in its estimate of the cost of cleaning up your problems. Therefore, it behooves you to clean up these problems prior to sale.

However, do keep in mind that some deal killers cannot be escrowed away. These must be resolved well before you proceed with the sale of your business.

OBTAIN AUDITED OR AUDITABLE FINANCIAL STATEMENTS

It is advisable to obtain an audited financial statement for at least the year in which your company will be valued. This is typically your last full fiscal year.

It is also advisable to obtain an audit for the two prior years as well. This is especially true if your business will likely be valued on an EBITDA basis, if your business trends are important to the buyer, or if you may sell to a public company.

An audited financial statement provides the buyer with a greater assurance of your financial results. This is particularly true if your auditor is a large international auditing firm. However, even if your auditor is a one-person office, that audit report is better than giving the buyer an unreviewed financial statement or a so-called compilation report.

Using a prestigious auditing firm tends to reduce the buyer’s due diligence. It also creates a certain aura about your company that is conducive to a sale. Large buyers are particularly enthralled by a prestigious auditing firm, as their own audits are usually performed by these firms. They incorrectly view the auditing firm as having some liability to them if the financial statements are wrong. In most states, your auditor has no such liability unless he or she was negligent and actually knew that you intended to furnish the financial statements to the buyer. However, you need not mention that fact to your buyer.

If you normally use a good regional accounting firm, there is probably no need to change auditors on the eve of sale.

Your decision to save money on an audit may reduce the number of potential buyers for your company, particularly public company buyers. Even if you do not obtain an audited financial statement, you should at least obtain an auditable financial statement for the three years prior to sale. An auditable financial statement permits you to complete the audit retroactively at the time of sale.

Public Company Buyers

Public company buyers will generally require audited financial statements from your company if the acquisition is significant (over 20 percent) to them in terms of assets or income or if their investment and advances to your company exceed 20 percent of their total consolidated assets.

If any of these tests yield a result greater than 20 percent but less than 40 percent, one year of your audited financial statements is required by the Securities and Exchange Commission (SEC). If the impact is over 40 percent but less than 50 percent, two years of audited financial statements are required. If the impact on assets or income is over 50 percent, three years of audited financial statements are required. These requirements are relaxed for buyers that are small-business issuers.

Because the public company buyer must abide by these SEC rules, your failure to obtain an audited financial statement can be a deal killer.

It is not a good idea to go to your brother-in-law's auditing firm. The SEC requires that your auditing firm be independent as defined in their rules.

CREATE A TAX–FRIENDLY BUSINESS ENTITY

If you have a C corporation and sell its assets, you will have two levels of tax obligations. The first is a tax at the corporate level on the corporation's gain from the sale. The second is a tax at the shareholder's level on the net proceeds received by the shareholder. As discussed in Chapter 11, this could result in paying more than 50 percent of the sale proceeds to the U.S. Treasury and to state and local taxing authorities.

An S corporation that sells its assets will significantly reduce the tax bite, as the S corporation generally does not pay a corporate-level tax.

If you have a C corporation, you can switch to an S corporation and, provided you do not sell corporate assets within ten years after the conversion, you can avoid a corporate level tax. If you sell corporate assets within the ten-year period, you can still avoid corporate-level tax on the increase in your company's valuation after the conversion.

If you have a limited liability company, you should be aware that your entity will not qualify for a tax-free stock-for-stock merger, consolidation, or similar tax-free reorganization. For example, if General Electric was willing to acquire your business in exchange for its stock, the stock would be taxable to you.

Therefore, unless you are positive that you would never consider a stock offer from a buyer, consider transferring the business assets of your limited liability company to an S corporation well before your projected exit date. If you wait to form an S corporation until the eve of your sale, the IRS could collapse the transaction and ignore your S corporation. This will result in your taxable stock transaction, which could mean that you owe more taxes than you have cash to pay them.

Some consultants argue that you can always sell stock of a C corporation or equity interests of a limited liability company, so why bother to convert to an S corporation? Many buyers will not purchase stock or equity interests because of the fear of hidden or unknown liabilities and the less favorable tax result to the buyer. Even if a buyer is willing to purchase stock or equity interests, the buyer will usually discount the price because of the extra risks and the less favorable tax results.

MAKE YOUR ASSETS TRANSFERABLE

Some of your most valuable assets may be nontransferable without the consent of a third party. For example, most leases are not transferable without consent of the landlord. Neither are most licenses, such as those for patents, trademarks, and other intellectual property.

Good advance planning would suggest that you attempt to make these leases and licenses assignable to a buyer of your business well in advance of the actual sale. If you wait until the agreement to sell your business is signed, the lessor or licensor may well demand additional consideration from you because this individual is aware that you need his or her consent to consummate the sale.

However, if you obtain such consent within the normal course of negotiating or administering the license or lease, the landlord or licensor will be less likely to try to negotiate additional consideration, as you are not under the gun.

Some sellers seek to avoid these consents by selling the stock of their business or by using direct or triangular mergers. This works only if the lease or license does not contain a change-of-control clause and if the buyer is willing to engage in a stock purchase or reverse merger (see Chapter 10). A change-of-control clause in a lease or license is a clause that treats a change in control of your company as a direct assignment of the lease or license.

Most lessors and licensors will resist any blanket permission to transfer your lease or license unless you remain liable for the performance by the transferee. Even then, they may not agree in advance to the transferability of the lease or license. This is particularly true if the lease or license has nonmonetary obligations on your part that will not necessarily be performed satisfactorily by an unknown transferee (for example, a clause in a license requiring the licensee to promote sales of the licensed product).

At a minimum, you should attempt to have the lessor or licensee agree not to withhold their consent to a transfer unreasonably.

SIMPLIFY CORPORATE STRUCTURE

Some businesses are organized with an unusually complex corporate structure. The complexities of the corporate structure can delay and sometimes impede the sale of the business. It is best to have an M&A attorney review your corporate structure to determine if there are methods of simplifying it to facilitate a potential sale.

AVOID BURDENSOME LONG-TERM COMMITMENTS

If you expect to sell your business within a year or two, you should carefully consider the effects on the sale of entering into long-term contracts that will have to be assumed by the buyer. For example, a five-year contract tying you to a particular supplier may make your business less valuable to a potential buyer. Likewise, committing your company to purchase very expensive equipment shortly before the sale could also reduce the value of your business to a potential buyer and impede the sale.

CHAPTER FOUR

PROTECTING YOUR BUSINESS

You must carefully consider how you will protect your business and your proprietary information during the sale process. You should begin thinking well before your target sale date.

MAINTAINING CONFIDENTIALITY OF YOUR DECISION TO SELL

The process of selling your company can last from several months to several years. It is important that you maintain confidentiality of your decision to sell throughout the process.

The sale of your company may have adverse effects on your key employees, customers, and suppliers. Competitors may use your decision to sell as a tool to obtain your customers. It is best that your decision to sell not be publicly disseminated until absolutely necessary.

There are three methods to maintain the confidentiality of your decision to sell:

- Limit the information to trusted advisors, such as attorneys, accountants, investment bankers, or business brokers.
- Require your professional advisors to approach only potential

buyers who are approachable on a no-name basis and who will likely maintain the confidentiality of your sale's decision once your name is revealed.

- Require potential buyers to sign confidentiality agreements.

It is important that your professional advisors institute their own internal procedures to protect the confidentiality of the sale process. For example, you may receive a bill from an attorney that specifies exactly what legal services the attorney performed for you and contains the following notation: "Advice concerning sale of your business." Once that bill is submitted to your bookkeeping department for payment, you have effectively blown your confidentiality; your accounts payable clerk now knows your secret and it will not be a secret for long.

Early in the process your professional team should use a code name for the project that will not cause suspicion. The use of terms such as *consultation concerning project X* merely invites suspicion. It is better to use a code name that does not invite suspicion, such as *business planning* or a similar nondescriptive name.

Secretaries and assistants of your professional advisers must be brought in on the secret because they may be talking to secretaries at your place of business. Require your professional advisors to sensitize their own employees to avoid having them inadvertently disclose your sale intentions.

At some point in the sale process, you will no longer be able to maintain the confidentiality of your decision to sell. The ideal is to maintain such confidentiality until the closing of your agreement. However, that is not always possible. Leaks may occur, and rumors may be started.

Long before it is no longer possible to maintain complete confidentiality, you must plan how and to whom the disclosures will be made. It is important that you control the process.

For example, key employees will have to be informed of the secret at an early stage as serious buyers will want to talk with them. How to give incentives to key employees is discussed later in this chapter.

In addition, you may wish to personally visit a few key customers before making any general announcement. You must carefully think through when and how you will approach such customers.

PROTECTING YOUR PROPRIETARY INFORMATION

Maintaining your decision to sell as confidential is not sufficient. You must also make advance plans as to how you will protect the confidentiality of proprietary information of your business from potential buyers who are performing due diligence. Your proprietary information includes customer lists, trade secrets, methods of marketing, and so on.

There are three methods of maintaining the confidentiality of proprietary information:

- Give potential buyers only enough information to permit them to make a purchase decision, but no more.
- Require potential buyers to sign confidentiality agreements.
- Require buyers to agree to refrain from hiring your key employees.

Several methods can be used to limit the information available to what potential buyers absolutely need. For example, if names and addresses of your customers are sensitive information, the potential buyer may initially be satisfied with obtaining the list of the top twenty-five customers without receiving their actual names and addresses. Rather, the list could identify each customer with a code name (e.g., customer A), indicate the state in which the customer is located, and specify the amount of revenues attributable to that customer during the last fiscal year. Your customers' zip codes could also be revealed without stating their actual names or addresses.

Obviously, at the time of signing the agreement of sale, and certainly no later than closing, the buyer will want the actual names and addresses of the customers.

Certain unscrupulous potential buyers use the due diligence process to gain valuable information concerning your business. These buyers do not really intend to purchase your business and are using the due diligence process as a vehicle to obtain a competitive advantage. Sometimes you can identify such unscrupulous potential buyers by carefully checking them out. Potential buyers with unsavory reputations should be avoided.

It is important that you require each potential buyer to sign a confidentiality agreement, which creates a monetary deterrent for using your proprietary information (e.g., liquidated damages) and entitles you to injunctive relief and which includes a clause restricting the hiring of employees. See Appendix 4 for an example of a confidentiality agreement.

Your M&A attorney will assist you in preparing a confidentiality agreement. It is likely that the potential buyer's attorney will have some changes that must be negotiated. You should resist any changes that place an early termination date on the buyer's duty of confidentiality (e.g., one year from the date of the agreement). If you must agree to a termination date, make certain that it is long enough so that the information is probably stale (e.g., two years from the date of the agreement) and be sure that the termination clause contains the following conditions:

- the return to you (or destruction of) all information previously given to the potential buyer
- the assurance that there has been no breach of the potential buyer's duty of confidentiality prior to the termination date

WARNING It is crucial to restrict potential buyers from hiring past, present, and future employees of your business for some period of time—at least one year. Hiring your employees is a simple way of gathering sensitive information about your business. Indeed, as key employees are interviewed by potential buyers during the due diligence process, they may be overtly or subtly solicited for employment with the potential buyer. From the potential buyer's point of view, it is much cheaper to hire an employee to capture a portion of your business than to pay you for the business. Be certain that the potential buyer agrees not to hire employees, even if the buyers are solicited by an employee.

SPECIAL PROBLEMS OF SELLING TO CUSTOMERS, COMPETITORS, AND SUPPLIERS

Selling to a customer, competitor, or supplier creates unusual confidentiality problems.

For example, unless you have a proprietary product, you would not want customers to know your profit margins. They can use this information to reduce the price they pay to you in the future. Therefore, unless you have a method of disguising this information, or a proprietary product, you should refuse to discuss this information prior to closing with a customer.

A competitor would love to know your customer list and the prices they pay, among other things. You should refuse to supply this information prior to closing, whether or not the competitor signs a confidentiality agreement. If you provide such information and the competitor uses it unfairly, you will probably never be able to prove that the competitor ever breached the confidentiality agreement.

Suppliers can also be troublesome buyers, although not as troublesome as customers or competitors. However, you generally would not want a supplier to know your customer list, your resale markup on your purchases from the supplier, or what you pay to competing suppliers, unless the supplier could not possibly harm you with that information.

Occasionally, the problem of selling to customers, competitors, or suppliers is handled by giving the information to an investment banker for the buyer, with the written agreement that it will not be disclosed to the customer, competitor, or supplier until after the closing. However, this can still be a dangerous solution because of your inability to *prove* that the investment banker intentionally or inadvertently leaked the information.

INCENTIVES FOR KEY EMPLOYEES

Potential buyers will want to speak to your key employees prior to signing the agreement of sale as part of their due diligence. Therefore, your decision to sell the company will be brought to the attention of this group of persons at some point in the process.

It is important that these key employees be given the incentive to help promote the sale. If they are not, their natural tendency will be to become concerned about their job security and their future with your company. Moreover, these key employees will begin to think about the full implication of your decision to sell and the effect it will have upon their lives and their futures. This may cause them to think about other possible alternatives for their careers. Keep in mind that whatever bond you may have created with your key employees through the chemistry of your leadership, it may change once you have announced your decision to sell.

The incentive to your key employees must be both affirmative and negative:

- affirmative, in order to align the employees' interest with yours in the implementation of the sale
- negative, in order to disincline the employees from leaving or becoming potential competitors

The affirmative incentives usually consist of some form of termination bonus equal to a meaningful percentage of the employee's base salary. Typically, anywhere from 50 percent to 100 percent of the base salary should be paid. The bonus should be payable only in the event of sale. This affirmative cash incentive can be created immediately, before the potential buyer commences his due diligence with these key employees.

Other types of affirmative incentives must be implemented earlier. One example would be a stock option granted at an early point in time that could be exercised only in the event the company is sold or goes public.

The advantage of a stock option granted several years before the potential sale occurs is that there is no charge against the income of the business for the grant of the option or its exercise, provided that on the grant date the option price is at least equal to the fair market value of the stock at that time.

The disadvantage of a cash termination bonus equal to a percentage of base salary is that in the year of sale, your earnings are reduced by the amount of the bonus. This reduction may or may not be important to the buyer.

In contrast, the exercise of the stock option that had been originally granted years previously does not reduce your year-of-sale earnings. This is true even though the employee could exercise the stock option at a price significantly below the current market value of your stock.

A cash termination bonus is simpler to implement than a stock option plan and should be used in situations where the reduction in the year-of-sale earnings is not material or is unimportant to this buyer.

Negative incentives could take the form of an agreement not to compete or not to solicit customers or engage in other hostile acts in relationship to your company. It may not be possible to obtain this type of agreement on the eve of the sale of your company, as it requires a voluntary act by the employees to execute such a noncompetition or nonsolicitation agreement and some special consideration under state law to make it enforceable.

Therefore, it is necessary to obtain a noncompetition agreement from key employees several years before your sale decision and preferably when the employees are hired. To make such a noncompetition or nonsolicitation agreement enforceable, you should seek counsel from attorneys specializing in this area. Many state laws require some form of special consideration to be given to employees for this purpose if the agreement is signed during the course of employment. For example, in some states you might be able to implement this type of agreement at the same time you are implementing your normal increases or bonuses.

The length of time of the noncompetition or nonsolicitation agreement should be kept sufficiently short so that there is no difficulty in having a court enforce it. Typically, one year is sufficient to protect a buyer and will usually be enforceable if the scope of the limitation is reasonable under the circumstances. Noncompetition or nonsolicitation agreements protect the seller prior to a sale and facilitate a sale to a potential buyer.

Another alternative is to work out a severance plan for employees that requires them not to compete with the company or solicit customers during the period of the severance payments. Severance payments to less-important employees can be limited to one or two weeks, whereas the payments to key employees can last as long as one year. Severance payments can be expensive and therefore should be limited to a period sufficient to permit you or the buyer to cement a new relationship with customers handled by a key employee. Typically, six months to one year is sufficient.

Chapter Five

Personal Considerations

Personal tax considerations should be foremost in planning the sale of your business. Advance planning will enable you to minimize the following taxes.

MINIMIZING ESTATE AND DEATH TAXES

Long before the target date for the sale of your business, you should consider methods of minimizing estate and death taxes on the transfer of sale proceeds to the next generation. These taxes can be higher than your income tax. The combined federal and state income tax rate can be over 40 percent; in contrast, estate and death taxes can be over 50 percent.

Estate planning to minimize these taxes should take place in the years prior to the sale of your business. It is preferable to make gifts of rapidly appreciating property, such as the stock of the corporation that owns your business. The gift has the effect of preventing the appreciation of stock from being taxed in your estate at death. One common method of minimizing these taxes is by making annual lifetime gifts to your children and grandchildren to take advantage of the annual exclusion. The annual exclusion permits gifts having a value of $11,000 per donee each year ($22,000 if you have a spouse and so elect) without using your lifetime exemption.

You can make gifts above the annual exclusion amount ($11,000 to $22,000 per donee each year) without paying any gift taxes during your lifetime. This can be accomplished by using your lifetime exemption, which permits $1 million of taxable gifts ($2 million for married couples) to be made without paying any gift tax.

To the extent that you make gifts above the annual exclusion plus the lifetime exemption, you will pay a gift tax. However, the elimination from your taxable estate of the future appreciation of the stock that you give away (plus the amount of the gift tax you pay) may result in sufficient estate and death tax savings to be justified.

Before making gifts for which you must pay a gift tax, you should carefully weigh future estate and death tax savings against the following disadvantages: (1) you lose the use of the amount of gift tax you must pay (including interest), and (2) if the stock you gifted would otherwise have been retained by you until your death, there are higher capital gains taxes, which must be paid by your children and grandchildren on their sale of the stock. If you would have otherwise kept the stock until your death, your children and grandchildren would, for federal income tax purposes, have received a step up in their tax bases to an amount equal to the fair market value of the stock on the date of death (or alternate valuation date) and therefore would not pay any long-term capital gain tax except on postdeath appreciation.

Discounts

The value of your stock gift may be significantly discounted by the "minority interest discount" and a "lack of marketability discount" if the stock is of a closely held corporation. The minority interest discount reflects the fact that the minority shares of a closely held business do not have the ability to control the business.

Although the discount depends on the facts and circumstances of each situation, the combination of the minority interest discount plus the lack of marketability discount can result in total discounts of up to 50 percent of the fair market value of the stock on the date of the gift. It is important, however, that the gift not be on the eve of the sale of the company. Rather, the gift should be made over several years prior to the sale.

Gifts of stock of the corporation owning your business should be made sufficiently before the sale so that you can obtain the benefit of a very low valuation for the gifts. This permits you to transfer a greater percentage of your wealth to the next generation while minimizing the estate and death taxes.

For example, if you sell the stock of the corporation that owns your business for $1 million and you give away 10 percent of the stock on the eve of the sale, it is likely that the value of the gifted stock will be $100,000. However, if three years before the sale you fund a trust for your children with 10 percent of the stock, it is likely that you will be able to sustain a substantially lower valuation for the same stock gift. Thus, by making gifts at an earlier point in time, you can increase the percentage of your wealth that can be transferred to the next generation without tax.

If you make gifts of stock, you should contractually retain the right to force the donees to sell the stock if you decide to sell your shares. These contract rights are sometimes referred to as drag-along clauses.

Family Partnerships

The selling shareholder should also consider forming family limited partnerships to reduce estate and death taxes. A limited partnership could be formed in which you would be the general partner and your family would be the limited partners. Stock of your corporation would be given to the limited partnership as a gift.

As general partner, you would continue to control the stock owned by the limited partnership and would have full voting rights and the ability to sell the stock. Your family would hold limited partnership units. It is arguable that the limited partnership units might permit a further discount on the value of the gifted stock over and above the minority interest discount and the lack of marketability discount.

Family limited partnerships do not work with Subchapter S corporations. Instead, you can divide the stock of your Subchapter S corporation into voting and nonvoting stock and give the nonvoting stock to your family.

Recently, limited liability companies (particularly ones formed in Nevada, a low-tax state) have been utilized instead of limited partnerships. In contrast to a limited partnership, a limited liability company affords greater protection for family members against personal liability for debts of the limited liability company and does not require a general partner who is personally liable for such debts.

Charitable Foundations and Charitable Remainder Trusts

If you are charitably inclined, you should consider establishing a charitable foundation or charitable remainder trust and funding it with a portion of the stock of your corporation. The advantage to you is that when the stock is sold, the charitable foundation or charitable remainder trust does not pay any federal or state income tax on the gain resulting from the sale.

In addition, your gift of stock to the charitable foundation or charitable remainder trust produces a federal income tax deduction on your personal tax return. To the extent that you cannot absorb the tax deduction in a single year, your charitable deduction can be carried forward for the next five years.

The charitable foundation permits you to control future charitable gifts by using the gross sale proceeds without diminishment by income taxes. You and/or members of your family can be the trustees of the foundation. However, no portion of the funds can benefit you or your family—except indirectly by relieving you of your future personal charitable obligations.

The charitable remainder trust permits you and your family to receive an annuity for a term of years or for their lives from the trust. At the end of the term of years or upon the death of the noncharitable beneficiaries, the remainder is paid to a charity or charities designated in the trust instrument or chosen by the trustees (which could include you and/or members of your family). Because the charitable remainder trust does not pay federal income taxes on the sale proceeds, the income produced by the gross sale proceeds is approximately 17 percent higher than the income you would have received had you personally sold the stock to the buyer and paid a 17 percent tax on the gain (15 percent long-term capital gain plus an assumed rate of 2 percent state income taxes, net of the federal income tax benefit).

The major disadvantage of both the charitable foundation and the charitable remainder trust is that you lose the ability to receive any portion of the sale proceeds from the stock that you have given away (except that you can receive an annuity from a charitable remainder trust), and hence you have lost ownership of a portion of your wealth. In addition, your income tax deduction for the gift to the charitable foundation or charitable remainder trust will be equal to the fair market value of your stock only if distributions are made from the charitable foundation directly to public charities within fourteen months after the stock is given to the charitable foundation, or if the charitable remainder trust may make distributions only to public charities.

General

It is not recommended that you give away so much of your wealth that you have to depend on your children for your future. Reducing estate and death taxes is not a sufficient reason for jeopardizing your lifestyle.

It is best to make gifts of assets that are passive assets, that is, assets that are not critical to your business. For example, if you lease business real estate from yourself or from a separate partnership that you control, give away a minority interest in that real estate or partnership. Another ideal asset to give away is life insurance on your life that has cash value.

Any wealth transfer of an appreciating asset (such as stock of your corporation) should be accomplished sufficiently prior to the actual sale date so that a low valuation for the gift can be obtained, thereby permitting you to maximize the amount of the wealth transferred.

An excellent time to make gifts of stock is right after a leveraged recapitalization (see Chapter 19). If you engage in a leveraged recapitalization, your business will have taken on a substantial amount of senior debt and you will have withdrawn a substantial amount of equity, thereby depressing the value of your stock.

MINIMIZING STATE INCOME TAXES

The sale of your business will generate income to you that will be taxed at the state and local level. A number of states, including California and New York, have very high personal, state, and local income taxes.

Currently state and local income taxes are deductible for the purpose of computing your federal income tax, except that the deductions are limited for higher income individuals. In addition, some business owners incur federal alternative minimum tax on the sale of their business, and state and local income taxes are not deductible for purposes of computing federal alternative minimum tax. Moreover, even after the benefit of the federal income tax deduction, state and local income taxes can still be a significant amount.

For example, if you are a resident of New York City, you are in the 35 percent federal income tax bracket, and you sell your business for a gain of $10 million, the combined federal, state, and city taxes you pay can exceed $4 million (even after considering any benefit of your federal income tax deduction for the state and city taxes). If you are a New York City resident, New York state and city income taxes on the gain can exceed 12 percent of the gain.

One method of avoiding these taxes is to consider changing your state of residence and domicile prior to the sale. For example, both Florida and Nevada have no state personal income tax. If the businessperson in the previous example were to have moved his or her residence and domicile to Florida prior to the sale, he or she could probably save enough taxes, by virtue of the shift of residence and domicile, to purchase a significant-sized house or condominium in Florida. This assumes, of course, you sell stock of your company, rather than the assets located in New York.

You do not necessarily have to change your place of employment in order to change your residence and domicile. You should change your voter registration address, your driver's license, and your bank accounts to Florida. You can still have your business in New York. You should take care to examine the state laws at the time you make your decision because some states, such as New York, California, and Ohio, are carefully auditing this method of avoiding state income tax. Check with your tax attorney before you attempt this maneuver. In addition, if you do not follow correct procedures, you might be considered a resident of more than one state and therefore subject to tax from each state. For a web site that covers state income taxes, see www.taxadmin.org/fta/rate/ind_inc.html.

This procedure is not for everyone. It does not make sense to change your residence and domicile to Florida or Nevada unless you would actually enjoy living in Florida or Nevada. The change should fit your lifestyle and not be driven solely by tax motivations.

Chapter Six

Marketing Your Business

The effective marketing of your business requires you to put yourself in the place of potential buyers and imagine the characteristics they would find appealing. You must learn to think like a buyer. Many business owners are abysmally ignorant of their competitive position in their own industry. In fact, knowing this is key to effectively marketing your business.

During the years before your target sale date, you must learn as much as possible about the strengths and weaknesses of the competitors in your industry. Potential buyers would expect you to understand your strengths and weaknesses vis-à-vis your competition. Therefore, it is essential that you become more knowledgeable about your competition.

You must also become an expert about your markets and customers. Do you have a special niche in the marketplace? Is your market growing, flat, or declining? If the latter two, what are you doing in order to diversify your markets?

A useful step is to try to prepare a marketing brochure five years prior to your sale target date. See where the weaknesses are in the description of your business.

During the years prior to the sale target date, grow your business with an eye toward eliminating these weaknesses and improving your strengths. The maximization of the ultimate sale price depends upon how successful you are.

SHOULD YOU USE AN INVESTMENT BANKER OR BUSINESS BROKER?

Just as it is possible (though not always practical) to sell your home yourself, it is possible to sell your business yourself. A few business owners do so successfully, particularly those whose businesses have values of less than $1 million. However, business owners who do not have significant experience in selling a business should consider hiring a reputable investment banker or business broker. This is particularly true of businesses having a value of more than $1 million.

A business broker is used for smaller businesses, usually those below $10 million in total value. Some business brokers specialize in selling businesses worth less than $1 million. An investment banker is used for larger businesses, with the minimum size depending upon the size and prestige of the investment banking firm.

The larger New York Stock Exchange firms (Goldman Sachs, Merrill Lynch, etc.) will typically not handle transactions below $50 million to $100 million. Local and regional investment banking firms will usually handle transactions in which the consideration is at least $5 million to $10 million or more. Transactions between $1 million and $10 million are usually handled by either larger business brokers or smaller investment banking firms.

The advantages of using an investment banker or business broker are as follows:

- An investment banker or business broker experienced in your industry has a greater knowledge of potential buyers for your business than you do.
- Even if you know one obvious buyer for your business, an investment banker or business broker may be able to find one or more other prospects, thereby permitting an auction to occur, which tends to maximize the sale price (see Chapter 8).
- The investment banker or business broker can help screen your potential buyers and prevent you from wasting your time on financially unqualified buyers.
- An investment banker or business broker can assist you in maintaining the confidentiality of your decision to sell by soliciting buyers anonymously.
- An experienced investment banker or business broker can de-

vote a significant amount of time and attention to selling your business and has better methods of contacting potential buyers than you do.

- An experienced investment banker or business broker can assist in negotiating the sale, smoothing rough spots, and protecting you from unrealistic demands.

Some business owners foolishly refuse to retain an investment banker or business broker because they know at least one potential buyer for their business and do not want to pay an investment banker or broker a commission on the sale to this buyer. It is far wiser merely either to exclude this one potential buyer from the commission arrangement or to provide for a lower fee and to use the investment banker or business broker to seek out other purchasers.

The disadvantage of using an investment banker or business broker is that you have to pay a fee based upon a percentage of the sale consideration. In the case of business brokers, for businesses worth less than $500,000, the fee can be 10 percent or even more. The high commission percentage is the result of the relatively low valuation for the business and the fact that the business broker has certain fixed costs of marketing the business. For businesses worth less than $500,000, for which you are unable to negotiate a fee lower than 10 percent, you might consider using a business broker only as your last resort.

For larger businesses, the fee is usually based on the so-called Lehman Formula: that is, 5 percent of the first $1 million, 4 percent of the next $1 million, 3 percent of the next $1 million, 2 percent of the next $1 million, and 1 percent on the rest of the sale consideration. These commission percentages are usually negotiable.

In some cases, you may also have to pay a fixed consulting fee, which is due regardless of whether the business is sold. This is particularly true if your investment banker or business broker intends to prepare a brochure to describe your business in order to better market the business to potential buyers.

Finding an Investment Banker or Broker

How do you find a reputable and experienced investment banker or business broker? You should start with recommendations from an experienced M&A attorney.

If other companies in your industry have been sold recently, inquire as to whom they used for the transaction.

WARNING Make your inquiries discreetly and indirectly so that you do not tip off competitors, customers, suppliers, or employees that your business is for sale.

Obtain recommendations from trusted friends and business acquaintances who can keep a secret. Your accountant can also be a good source for referrals.

You should ask all potential investment bankers or business brokers about their experience in selling companies in your industry. Some investment bankers or business brokers represent only buyers. Try to obtain the names of persons whom they have previously represented in selling their businesses and seek to interview these persons. Take care not to identify yourself as a potential seller.

Many persons who call themselves investment bankers or business brokers are either inexperienced or disreputable. Unemployed executives who have an MBA degree may call themselves investment bankers even if they have never sold a business. A number of investment bankers and business brokers are less than reputable.

In some states, such as New York, business brokers must be licensed. However, state licenses are no guarantee of either competency or reputability.

Once you have selected the investment banker or business broker, you must negotiate an agreement with this individual, setting forth the terms of the arrangement, including the transaction fee. You will need the help of your experienced M&A lawyer to negotiate this agreement. There are many pitfalls.

WARNING State laws may require you to pay a commission once a ready, willing, and able buyer is located and signs an agreement, whether or not the transaction closes, unless you have a specific agreement to the contrary. In effect, you may be legally liable to pay a commission for aborted sales. The fee agreement should be in writing and be specific that no fee is due unless and until the sale closes.

Many other issues are involved in negotiating an agreement with an investment banker or business broker. Here are some examples:

- If a purchase price is payable in installments, the fee should be paid in similar installments and should not be paid in full when the sale closes.
- If the deferred payments to you are reduced by indemnification claims of the buyer, the fee payments should likewise be reduced.
- If the purchase price is payable in whole or in part in stock, try to pay the fee in stock in the same proportion.
- Some forms of agreement require you to pay a commission on the amount of your long-term debt assumed by the buyer. The assumption of long-term debt does not necessarily put money into your pocket, so you should resist paying a fee on such debt assumption.

You must control whom your investment banker or business broker approaches as a potential buyer to purchase your business. Advance approval of such approaches helps you control the sale process and preserves the confidentiality of your decision to sell.

WARNING Be extremely careful how you approach direct competitors. Do so very carefully and on a no-name basis. Otherwise, your competitors may use your sale decision as a competitive weapon.

SELLING THE BUSINESS YOURSELF

If you decide to sell the business without an investment banker or broker, you must maintain the confidentiality of your decision to sell in two ways: by not specifically identifying your business in letters to prospective buyers and in advertisements, and by designating your attorney, accountant, or a friend to be the initial contact person with potential buyers.

To discover buyers, you might consider having your attorney, accountant, or friend do the following:

- Consult investment bankers and business brokers who represent potential buyers.
- Advertise in trade journals.
- Advertise in business papers, including the *Wall Street Journal*.
- Send letters to companies that you think would be interested in your business.
- Send letters to companies that have the same SIC code as yours.

Various Internet sites purport to assist owners to sell their businesses, including eBay. Other sites include www.business4U.com, www.businessnation.com, and www.bizbuysell.com. Caution should be exercised in using these web sites to avoid public disclosure, and the reputation of each web site should be carefully checked in advance.

PREPARE A MARKETING BROCHURE

Whether you use an investment banker or business broker to sell your business or sell it yourself, prior to commencing the selling of your business you should have a marketing brochure, which should contain a description of your business, including a package of financial information.

The marketing brochure will be a key selling tool and should be carefully prepared. If you prepared a marketing brochure many years before the target date, be sure to update your existing brochure.

A good marketing brochure will take several months to prepare. Your attorney, accountant, and other advisors will be helpful in its preparation. It is important to highlight the strengths of your business and to present the weaknesses in the best possible light. You must take care to identify off-balance-sheet assets and assets that your balance sheet undervalues. (See Chapter 2.)

If your business has favorable special valuation factors (see Chapter 2), emphasize these in the brochure. You should also discuss customer relationships and market identification. Your competitive strengths should be carefully noted and explained.

The marketing brochure should not be provided to a potential buyer until appropriate confidentiality agreements have been executed. (See Chapter 4.)

A well-prepared, detailed, and thoughtful market brochure will reduce the buyer's due diligence and expedite the sale. More importantly, a good marketing brochure will enhance the valuation of your business to a prospective buyer, particularly to a large corporate buyer.

If a marketing brochure emphasizes the parts of your business that have higher valuation multipliers, it will assist you in negotiating a higher sale price. The marketing brochure also is useful in assisting corporate development personnel of large corporate buyers to justify to their management and board of directors why they should be purchasing your business at the proposed sale price.

> **WARNING** When hiring someone to prepare your marketing brochure, it is not necessarily wise to choose the low bidder. The marketing brochure is the most important document you can use to enhance the sale value of your business. It does not make sense to save $15,000 by using the low bidder only to have the business valued at a $1 million less than its true worth. Carefully check the credentials of the person you choose to prepare the marketing brochure and review the quality of other marketing brochures prepared by that person.

SETTING THE SALE TARGET DATE

Some business owners wait until they are too old or too sick to sell their business. Some let their executors sell their business after their death.

A great deal of energy is required to market your business properly. Your active participation is necessary in the sale process. Who better can market your business than you?

If you wait to sell until you lack the energy to run the business, potential buyers will sense your weakness. Potential buyers also like to purchase a business from an estate that is under pressure to sell.

To maximize the sale price, you must attract financial buyers, if possible, to compete with strategic and other buyers. A financial buyer will generally want you to continue to operate the business until new management can be trained.

All of these considerations dictate that your target sale date should be several years before you really have to sell. Of course, no one knows when their health will fail them. Therefore, unless you have trained management that is able to carry on without you, prudence would dictate a target date that will make it likely that you can actively participate in the marketing of your business.

The best time to sell your business is when your business is doing well, your industry is growing, and the overall economy is healthy. This may not coincide with your preferred exit date. Therefore, you must be flexible about your exit date.

A good time to sell is after a company in your industry has had an initial public offering (IPO), particularly if the Use of Proceeds section of their IPO prospectus contemplates further acquisitions. The IPO company will be under pressure to effect acquisitions to maintain their credibility to the public market.

You may market your business and discover that there are no buyers or only buyers at fire-sale prices. In this situation, you must be prepared to withdraw your business from the market and, if necessary, operate it for a year or two longer before trying to market it again. If you have a flexible exit date, you will have a greater potential for ultimately maximizing the sale price for your business.