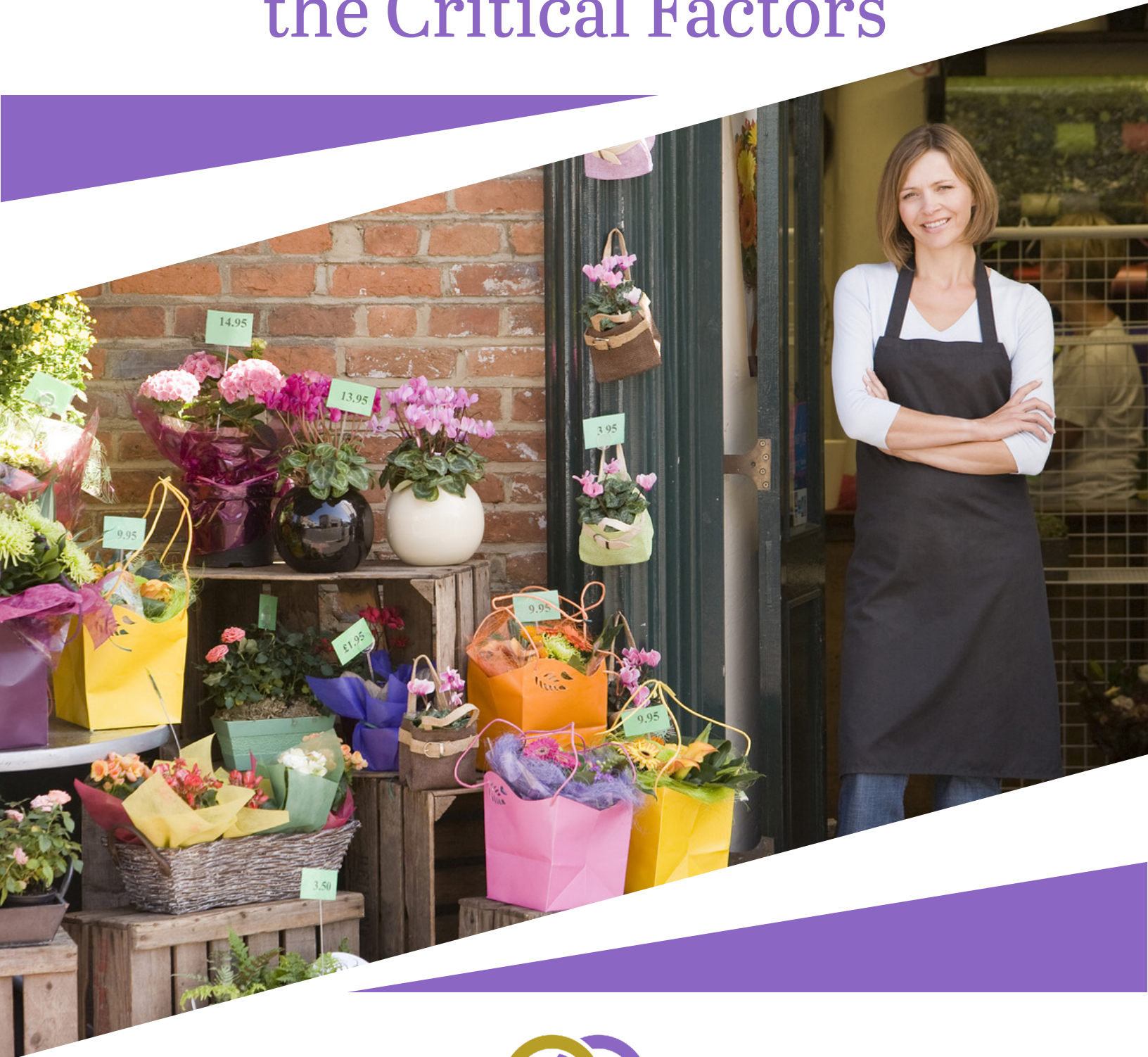


# Selling a Main-Street Business, the Critical Factors



**Golden Circle Advisors**  
SELL SMART, BUY SMART

# TABLE OF CONTENTS

Introduction.....	3
How We Got Here .....	4
Where to Start .....	5
What's the Business Worth? .....	6
When to Sell .....	9
Traits of a Sellable Business.....	10
Increase the Value of your Business.....	13
Managing Inventory in the Sale Process.....	14
Real Estate .....	15
Working Capital.....	16
Future Capital Expenditures .....	17
Seller Financing .....	18
How Long Does it Take to Sell? .....	20
Selling a Partial Interest.....	21
Understanding Buyers .....	22
The Transaction Team .....	24
Non-Disclosure Agreements .....	26
The Offering Memorandum .....	27
Marketing the Business for Sale .....	28
Showing the Business.....	29
Evaluating Offers .....	30
Due Diligence.....	31
The Non-Compete .....	33
Closing the Deal.....	34
Common Deal Killers .....	36
Common Myths About Selling a Business .....	37
Conclusions .....	39
The Short Version (a Summary).....	40



# INTRODUCTION

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Selling a Main-Street Business, by our definition...a Company with less than \$1,000,000 in annual owner benefit, is one of the most misunderstood and poorly managed processes in small business today. This is unfortunate too, because a lot of high-energy, risk-taking entrepreneurs have spent years bare-knuckle brawling with lenders, suppliers, employees, competitors and governments to provide for families, create wealth and provide jobs and service to their communities and one might think exiting for other opportunities or the golden years would be rewarding.

To have the advantage, or at least an opportunity to get to the closing table, you must see the business through the eyes of a buyer and lender, so you're prepared for the incoming fire that will inevitably come your way. Buyers and sellers are at cross-purposes when it comes to terms and conditions of a sale, so knowing how to proceed once the swords are crossed is critical. What is positive for the seller is usually negative for the buyer and vice-versa. When a buyer tells a seller, the business is not worth as much as he/she thought, it's often viewed as a personal attack, and the response can create a barrier to (what still could be) a successful transaction.

Primarily, it's a numbers problem. Today, the business for sale market is flooded with sellers wanting to fund their next stage of life (be it retirement or something else). Retirement is obviously the biggest factor as 70% of all businesses are owned by people over 55.<sup>1</sup> This "age-wave" is further evidenced by the fact that about 8,000 Baby Boomers are turning 65 years old every day until the year 2029, an astounding number. Like stats? Here are a few more:

27.3 million businesses in the United States.

26.7 million of those employ less than 20 people.

19.1 million owners at or near retirement age and only... 15,233 SBA Loans were made in 2017.<sup>2</sup>

Selling your business could be a lot harder than you think. Where are the Buyers and the required capital to buy these businesses going to come from? Even if you do find a buyer, getting the price you want is going to be difficult.



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<sup>1</sup> Source: U.S. Census Bureau

<sup>2</sup> Source: SBA.gov

## HOW WE GOT HERE

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The baby boom, an unstoppable force.

In 1945, soldiers returning from World War II started pumping out babies, lots of them. So many in fact that the U.S. sustained 40 years of economic growth from all the new consumers. This generation was not like the one before, either; their parents read books about how life revolved around kids, not the parents, like the one by Dr. Benjamin Spock, an author whose book was outsold only by the Bible in the 20th century. So, as these boomers grew up, they were taught they could be anything they wanted in life and what they did for a living and the material possessions they acquired were a big part of their identity. They were also taught that upward mobility was noble, if not a birth-right, and since there were not enough corporate jobs to provide this lifestyle, they turned to entrepreneurship. The result was a small business boom never seen before or since. From 1976 to 1986 (as baby boomers were turning 30), businesses were started at a rate of 500,000 per year, the most ever.

It was a simple formula really. Just start with a generation 50% larger than the one before, put 30% more of them (women) into the workforce, have them extend their average work week by 25% or so and you get a U.S. economy that tripled in size from 1975 to 2005. Nice, right? It all works great until all those boomers realize they must all sell their businesses to retire comfortably, and generally speaking, all at the same time. Oh, and guess who the available buyers are - Generation Xers no less, a group that's 1) smaller, 2) more focused on personal happiness than hard work thus 3), not so sure they want to buy what's being sold. Gen Y and beyond are not buyers now since they accumulated so much debt in the great recession. Realistically, they're probably out of the picture for the next decade or so, which will be too late for most boomers. Even if you're not a boomer, the tsunami of available businesses will affect your efforts to sell.

The point of all this is simple: selling your business will be harder than just 10 years ago due to supply (high) and demand (lower). It doesn't mean it won't sell though, and this guide is intended to help entrepreneurs make critical decisions.

***“From 1976 to 1986 (as baby boomers were turning 30), businesses were started at a rate of 500,000 per year, the most ever.”***

## WHERE TO START

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1. Establish a defensible value.
2. Create a compelling story.
3. Show it to the right buyers.
4. Demonstrate transparency and close the deal.

Expecting a speech about being emotionally prepared to sell your baby? Sorry, that's not our style. Suffice it to say you will need to be ready both financially and emotionally for the day when you no longer own the business. You'll also need to be ready for the stress of the sale process itself and the sense of loss that comes with letting go and the uncertainty of what lies ahead. It's a roller-coaster; one day you're thinking of a huge payday and then one email later, it feels like you're stuck with the business forever. There's an old saying in business brokerage; every deal dies at least twice before it can close. We trust you will handle this well.

The purpose here is to give you the critical information you need to close a financially rewarding deal in a reasonable amount of time and the first thing you need to know is what the business is worth. How do you find out?





# WHAT'S THE BUSINESS WORTH?

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An appraisal is not about what it's worth in the current owner's hands; it's about the company's transferable value.

Truthfully, it doesn't matter what your accountant, attorney, friend or lover thinks the business is worth, only the market (willing buyer, willing seller) can provide the correct answer. There is of course a way to at least start with a defensible estimate of value, which is otherwise known as an appraisal. Business owners want to know when the best time is to sell. The answer is sometimes simple: pick a number and when you hit it, get out. There are many advantages to getting it professionally valued, but you don't have to have an appraisal to sell. Generally, if the asking price is over \$250,000, an appraisal of some type is warranted. Less than that, buyers and sellers often come up with something themselves.

Here are the advantages of an appraisal:

1. Is the value high enough? Let's face it, we all believe in sweat equity, but it doesn't exist in a sale. An appraisal provides an informed opinion about the business value, so a seller can decide if the asking price will be enough to move on from the business.
2. It provides confidence that the decision to sell is sound with family and partners.
3. You can see the business from a neutral, 3rd party perspective, which is how a buyer and lender will see it.
4. It puts less strain on a transaction. There are obviously many deal points between the buyer, seller and lender in a transaction. Since price is normally the biggest, a valuation can reduce tension and allow more focus on the terms and conditions of a deal.
5. It shows preparation and forethought. As noted, buyers have literally millions of choices when buying a business, and most of those businesses are not properly packaged for sale. A business valuation shows a buyer you are a serious seller and not simply "testing the market".
6. It saves time and money. Wouldn't you rather know now? There is cost and time required to get an appraisal, but the advantages far outweigh not getting this done.

So, the question becomes, how do you get an appraisal and just how painful is the process? Probably not as bad as you think... here are a few tips:

**Manage your expectations.**

**Be transparent.**

**Put emotions aside.**

**Look for experience.**

First, make sure your records are in order. You simply can't sell (or even appraise) with poor records. Make sure your business tax returns are not extended, that any professionally prepared records (such as tax returns) are reconciled with your in-house system and your accounting system is up to date. Good financial records reduce the chances for a buyer to work the price down during due diligence.

Use someone who is independent: Is the professional you're considering really independent? If they've performed work for you in the past, such as tax preparation or investment advice, then obviously not. Look for a true "third-party" to perform the work. A true business appraisal firm has the necessary tools and resources to provide an objective look at the market. Look at their website; is business appraisal a big part of their practice or are they offering accounting services and tax prep? Always go with someone who

transacts small business sales. If they're not active in selling main street businesses, then they probably learned everything from a book and lack practical experience.

Use an appraiser who works with main-street businesses. If they're talking M&A and EBITDA, then they're probably not the best horse on the track. Another clue is their source of transaction data...if the appraiser talks comps from Wall Street and discounts from there, keep looking. The only fact that may be unambiguous when comparing big and small businesses is that the distinctions are based on many factors, not just size alone.<sup>3</sup> Main-street appraisers deal in SDE (Seller's Discretionary Earnings) and derive risk analysis from the actual company, not a size adjusted or discounted Wall Street firm.

Certification: A huge issue...what certifications does the valuator have? It takes much more than a CPA. At a minimum, they should hold a recognized, but practical certification, be a qualified source<sup>4</sup> and have experience in advising business buyers, sellers and lenders. A good point of reference is the Small Business Administration which lists several certifications as a qualified source, including...

- (1) Accredited Senior Appraiser (ASA) accredited through the American Society of Appraisers;
- (2) Business Certified Appraiser (BCA) accredited through the International Society of Business Appraisers.
- (3) Certified Valuation Analyst (CVA) accredited through the National Association of Certified Valuation Analysts;
- (4) Accredited Valuation Analyst (AVA) accredited through the National Association of Certified Valuation Analysts.

#### *Types of reports:*

- (1) Calculation Report: - intended to provide an indication of value based upon the performance of limited procedures agreed upon by the analyst and client. It is not a formal appraisal, but rather an accurate, efficient and cost-effective method to determine the fair market value of a business. A calculation report normally costs between \$300 and \$2,000 and takes 1-3 weeks to complete. This is a good choice for contemplation of sale. It's inexpensive and provides enough information to sell the business.
- (2) Appraisal Report: - a formal presentation of the value of the business based upon the Uniform Standards of Professional Appraisal Practice (USPAP) containing a summary of the material factors that lead to a conclusion of value. An appraisal report normally costs between \$2,000 and \$10,000 and takes 4-6 weeks to complete. This is a good choice if submitting to a lender or the IRS.
- (3) Rules of Thumb: - a principle with broad application that is not intended to be accurate or reliable. We've all heard this one, right? Just take your revenue or earnings and multiply it by something and you have a value. While not credible with buyers and lenders, they may have a use if properly calculated, and here's how you do that: first, you need to determine the Seller's Discretionary Earnings (SDE).

Simply stated, SDE is:

Net profit (before tax) plus

Non-cash expense (such as depreciation and amortization) plus

Interest plus

Owner perks (such as salary, benefits and travel) plus/minus

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<sup>3</sup> Valuing Small Businesses and Professional Practices, Third Edition, Shannon Pratt, Robert Reilly, Robert Schweihs, 1998.

<sup>4</sup>

Extraordinary expense (rent adjustments and expenses that are one time or non-recurring), which equals;

### Seller's Discretionary Earnings

Critical Factor – if you remember nothing else from this document, remember SDE. It will be the reason the business does or does not sell!

Once you know the SDE, simply multiply it by something between 1 and 3.5 and voila, you have a value. End of story, right? Unfortunately, no... go to market using a simple multiple and buyers, their lenders and advisors will tear you apart. Does that multiple include inventory? What does it include? Where did you get it? Why that one? How many other businesses like yours were studied to obtain the multiple? Can we see those comps? Get the picture? It's what happens when you value a business with math a 10-year old can do in their head.

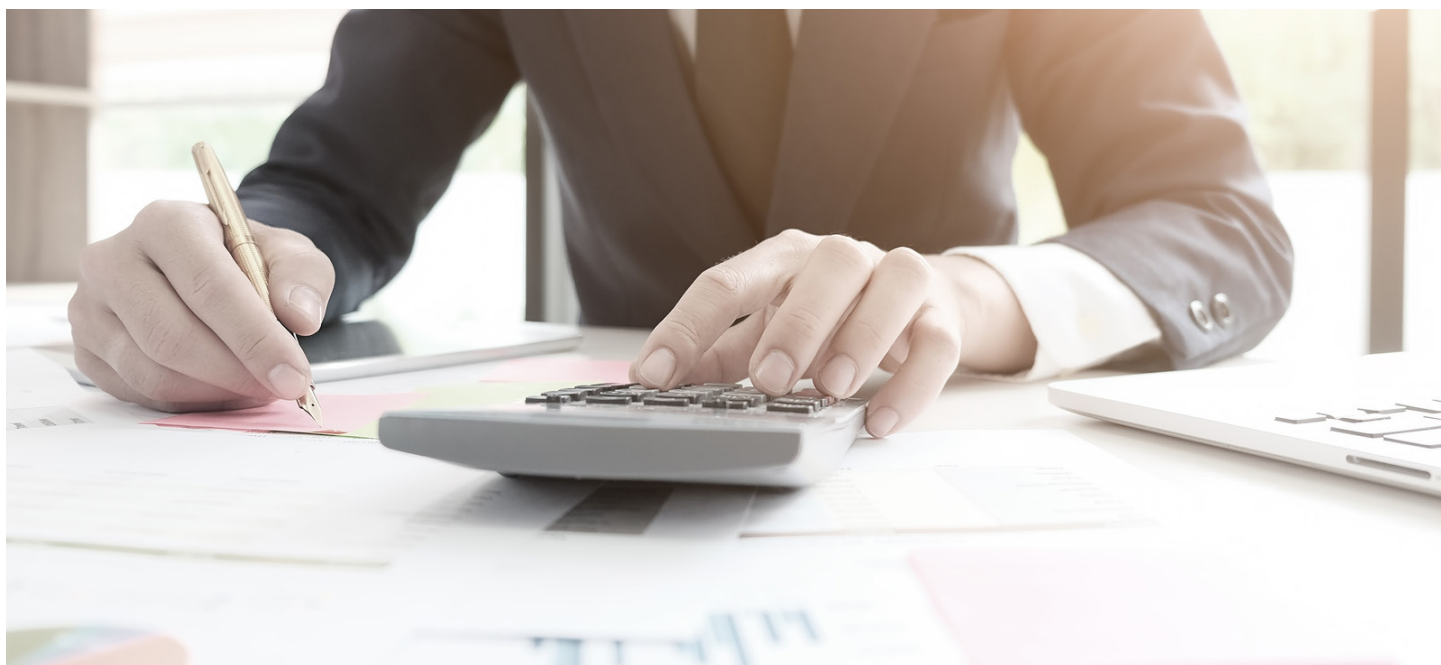
At a minimum, you need to test your multiple for reasonableness, which is also quite simple. Here's a quick formula:

#### ***SDE***

- *Annual debt service*
- *Debt service cushion*
- *Capital expenditures*
- *A new owner salary*
- = *what's left for the buyer.*

If, after paying the note, buying new equipment when needed, and taking a livable wage, a reasonable return on investment remains; a legitimate chance to sell comes into light. Bottom line, rules of thumb are at best “shorthand” business values.

Important note – if your business is real estate intensive, such as hotels, gas stations, car washes, RV parks, golf courses, etc., then a real estate appraisal with a credible income approach to value included is probably better than a business valuation. Just make sure your appraiser has credentials in the income approach to value.





## WHEN TO SELL

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The best time to sell your business is 1) when you're ready and 2) when the recent history and near future are positive within your business, your industry and your region. Ideally, you should have 3-5 years of steady, manageable growth in both revenues and SDE. There should also be a strong likelihood that this trend will continue. The old saying "trends are a friend" is true for one party or the other in a deal. When a seller says, "the business is likely to grow, just look at my history", it's very credible. If you have just one down year in your recent history, you'll spend forever trying to explain that one period to buyers and lenders and it's exponentially harder to sell. Don't ride the wave too long, as sales could start to drop, new competitors could emerge, or your products, services and employees could become dated. It's also important not to let up during the sale process. We've seen buyers/lenders walk away from a deal simply because of a few bad months. Most buyers look at what you've done as something to build on and question how likely it is to continue. A 3 - 5 year positive trend can give a buyer reason to consider the future of your business as positive. It's all about how the business has performed recently. What it did 5 or 10 years ago, in a completely different economy, has little bearing today.

*"If you have just one down year in your recent history, you'll spend forever trying to explain that one period to buyers and lenders and it's exponentially harder to sell."*

# TRAITS OF A SELLABLE BUSINESS

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Go ahead, say it...we're stating the obvious here, but please bear with us; we need to stress this stuff; it's almost like a checklist of requirements to sell. You don't need every one but the more you have...well, you know.

1. **Stable and predictable earnings:** Think of revenue and SDE as the first introduction to a buyer. By far, revenue and earnings are the number one attraction. Over the last few years, have there been patterns of growth or decline? If in decline, are there good reasons for the decline? The value of a business is directly related to risk, and the lower the risk of losing the earnings in a transfer of ownership, the higher the price will be. Buyers are willing to proceed with a transaction when their perception is that the earnings are predictable and will not only continue, but also increase in the future. A highly critical factor!
2. **Records:** Are your books and records up to date? Are your internal records updated after preparing the tax return? Do you file your taxes on time? Do you use modern software to keep track of sales, expenses and inventory? Answer no to any of these and it will be difficult to sell. In the purchase of a business, a buyer and lender will perform a high level of financial due diligence. If either of them is not comfortable with the review, there will be no deal. Accurate and current financials are critical in determining how the company fares in its industry, amongst competitors and most importantly, verify what you are claiming. Hint: everything should be electronic. The days of file boxes are long gone. Buyers know that anything that is printed can also be emailed. Demonstrate transparency with electronic records. Also, be prepared to produce interim financial statements. Sometimes called stub or year over year statements, buyers and lenders will want to see how the current year is progressing, and comparing the same periods will ease their fears. An example is producing a statement that shows January through June of the current year with a comparison to the same period in the previous year. This especially helps if you have a seasonal business. Finally, a note about cash vs accrual statements...if you are on a cash basis system of accounting, make sure to keep access to accrual as well. We commonly see cash-basis tax returns, which are a legitimate tool, but you will also need accrual statements to go along with them. As long as your dates are entered correctly, most financial software (such as QuickBooks) can easily produce both. Records are a highly critical factor.
3. **Management Depth:** A strong management team reduces risk, thus increases value. Can the company operate without the owner for more than a week or two? Is there good management to fill in while you're gone? What is the average age of management? Are key managers bound by a non-compete agreement? What levels of experience and education do they possess? Having a good management team is critical to the transferable value. If a company's success is reliant on capable, well-trained employees – and not the owner – it means the business will not be negatively impacted under new ownership. Keep in mind, most business buyers are buying a job (which, btw, is not a bad thing) so they can control their own destiny and take pride in ownership. If you're working key to key, buyers will likely want help in replacing you, which adds costs and decreases value. Simply put, the more the business depends on the owner, the lower the price will be. The best thing you can do is work yourself out of a job. If you are the rainmaker, you can still sell but you should expect to stay with the business for a longer transition period and likely have part of the sale price come later as a contingency payment for customer/client retention. Another important issue is family members. It's common to have family members working in a small business, but how are those positions filled when the business sells? If you have a spouse or child working in the business with you and both want to leave upon sale, have a transition plan in place that ensures continuity. If 2 or more rainmakers plan to leave small business, the buyer pool can dry up. Depth within the staff is a highly critical factor.
4. **Customer Diversity:** A broad customer base in which no single customer accounts for more than 5% (up to 10% in some industries) of total revenue helps to insulate a company from financial hardship if a good customer does not stay after a sale. This is easier said than done for some businesses. If the nature of your business sometimes requires large customers, try to have that customer managed by

someone other than the owner. Relationships are key in small business and giving a buyer the best opportunity to keep good customers is critical to selling. Customer concentrations are another reason getting part of your price on a contingency basis is likely. Concentrations of revenue are a huge issue when selling!

5. **Barrier to Entry:** Buyers want your earnings, not your assets. Anyone can buy furniture, fixtures, equipment, vehicles and inventory, and if that's all it takes to compete with you, someone probably will. The harder it is to get started in your business, the more likely it will sell. A low barrier to entry usually equals a lower price and more difficulty in selling. However, there are steps you can take to help your cause no matter what the industry. For example, create customized software or apps that lower costs and increase customer awareness and satisfaction, develop a process, training and employee manual, maintain drawings or menus for continuity purposes, improve and manage your digital presence, become an industry expert and publish articles and offer training, develop your brand(s), copyrights, trademarks, etc., etc. Any advantage you have over your competition strengthens your position while lowering perceived risk.
6. **Growth Potential:** When a Seller can describe realistic growth opportunities, a deal is much more likely. Future growth is the most basic covenant for acquisition, and without it, there is no reason to buy. Before going to market, try to identify new products or services that could be delivered to existing customers, study your trade area...would expansion increase margins? Will demand for your product or service increase as technology and population grows? What about adding capacity - can more equipment or staff increase profits? Change is hard when you're running a small business, but identifying new opportunities for a buyer with a new passion will definitely check a box for the buyer and lender. Use caution though...project too much growth and the question becomes "why didn't you do it if it's that simple?" You should also use caution in justifying your price with growth potential. If "potential" is what your price is based on, buyers quickly notice you want to be paid for work and value they create in the future. Sorry, but opportunity for growth is a target for the buyer; whoever shoots it down gets the credit.
7. **Facility and Equipment:** Are your facilities and equipment well maintained and modern? Old technology, or a disorganized facility or office creates the impression that other aspects of the business, such as financial statements, customer records and employee files may be similarly disorganized and unreliable. Ensure your facility and equipment are organized and in good repair before showing the business, as buyers look for opportunities that do not require immediate repair or expansion. A question you will likely face is "what capacity are you at now with regard to facility and equipment?" In other words, how much growth can your facility and equipment accommodate? Generally, if you're operating at 80% of capacity or higher, expect some pushback. It's also a good idea to get rid of any obsolete equipment or inventory. If something is ready for salvage, move it out and de-clutter. You might also be surprised how far a little fresh paint will go in projecting a clean, positive image. Don't forget the sign too! Finally, a quick note about excluding equipment from the sale. Generally, if it's used in the business, it should go with the sale. We sometimes find business owners want to exclude a vehicle or piece of equipment. For example, if the business provides the owner with a vehicle and it's only used to drive back and forth to work, ok, keep it. However, if the owner uses it for deliveries or to call on clients, it should go with the sale. Buyers and lenders view exclusions as a deduct to the price.
8. **Loyal Employees:** Outside of ownership and management, is there staff that is reliable and capable? Are they considered knowledgeable for your industry? Again, what levels of experience and education do they possess? What is the average length of employment? Do you have low or minimum wage employees? If so, buyers view that as the root cause of employee turnover. A responsible business buyer will be looking for opportunities where the current staff, especially management, will remain in place. Here's a sensitive matter...have you told the employees you're selling? We get it, a lot of business owners don't want their business world to know the business is for sale. Suppliers, competitors, lenders and who knows who else seem to find this shocking (unless it were their business, right?). Well, truth is, all businesses change hands at some point. So it has to be addressed. Points to consider... a buyer will want to talk to key employees before closing



to assess retention... yet some employees think a new broom sweeps clean and they will lose their jobs, so they might as well look elsewhere now. Wow, this one's a bit tough. We find that telling key staff ahead of time is generally the best practice for several reasons. One, it avoids the shock and disappointment you will get if you wait until closing. Dedicated staff with tenure will not appreciate being out of the loop after years of service. Two, if someone decides to leave because of a sale, you know at the beginning rather than finding out right before closing or in front of the buyer. Three, the truth is easy to remember. There will be showings and information requests and making stuff up about your bank or insurance company needing something is a bit weird and rarely fools anyone. A good balance is telling trustworthy key staff but holding off on a company-wide announcement. If important to you, a confidential sale is possible but will add difficulty to the process.

9. **Operating Systems and Procedures:** Remember fax machines, file cabinets and Windows XP? Let's hope they're a distant memory because they're obsolete and rarely used anymore. If you still own any of those, you might want to upgrade your tech a bit, say 20 years or so. Buyers want cost effective business systems in place. Old technology and paper offices are expensive to maintain, and the margin for error is high. Today's business apps are inexpensive and effective, especially when compared to manual systems. Your systems and procedure should provide for:

- a. Business performance reports for management that track revenue and expense by product or service.
- b. Inventory and fixed asset control.
- c. A modern, easily found website.
- d. Customer and vendor tracking and communications.
- e. Employee benefit and wage tracking.
- f. New customer identification, solicitation and acquisition.

Proper systems and procedures also help with due diligence and transparency. When buyers and lenders request information, and you can provide it quickly and in a convenient format, your business appears organized and well-managed.

10. **Goodwill:** Name recognition, customer awareness, location, history, ongoing operations, reputation, and many other factors are all part of goodwill and are already reflected in your earnings. They also greatly influence value. As mentioned, buyers do not want your assets; they want your earnings and the ability to grow the business. Even if the company does not have many hard assets, its relationships are still key and can have significant value. The fact that customers have been with the business a long time does matter. Brand recognition, service or product reliability and high customer satisfaction are distinguishing factors that add value and mitigate perceived risk. Does your business have goodwill? There's a simple way to check using an old appraisal method (developed by the U.S. Treasury in the 1920's to compensate distilleries during prohibition). It's called Excess Earnings and the general theory is earnings over and above a reasonable return on your asset value represents goodwill. For example, if your furniture, fixtures and equipment have an in-place value (not replacement cost) of say, \$1,000,000, and a reasonable return on that investment is 10%, well, that equals \$100,000. If your total adjusted earnings are \$300,000, then you have \$200,000 to capitalize for goodwill (\$300,000 - \$100,000 = \$200,000). Simple and fun, right? Caution though, the IRS says the method should not be used if there is better evidence from which the value of intangibles can be determined. In other words, they don't like the method anymore. BTW, if a reasonable return on your assets meets or exceeds your actual earnings, you could be a liquidation candidate and should conduct further studies.

Again, you don't have to nail each one of the traits, but the more your business can hit, the more likely a sale. If taken as a whole, you can see buyers want earnings, a livable wage and satisfaction from operating a clean, modern business.

# INCREASE THE VALUE OF YOUR BUSINESS

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Want to set your business apart from the masses? Use your experience to create what the vast majority of businesses do not have; a business plan to protect and create value. Here are a few suggestions to include in your plan:

Protect what you have. We see a lot of businesses with over 50% of their value in intangibles such as customer relationships, methods and software, intellectual property, etc. It takes more than just insurance to protect your business. Consider the following:

1. Employee non-disclosure agreements.
2. Employee non-compete agreements.
3. Employee intellectual assignment agreements
4. Monitoring and reacting to forces that affect your brand.
5. Buy-sell agreements supported by life insurance for all owners.
6. Business interruption insurance.

Customer base. It's not just quality products and services at a fair price - everyone claims that. A good customer action plan can create a solid barrier to entry:

1. Identify add-on possibilities for your existing customers.
2. Create a system to measure customer satisfaction and retention.
3. Identify, then target more customers by knowing the cultural landscape.
4. Create a modern, efficient customer database that recognizes trends and opportunities.
5. Participate in community reinvestment activities.
6. Why, or why don't customers buy from you?
7. Why do customers buy from your competitors and what are you doing to combat it?

Operational Value Drivers. Don't wait until you're ready to exit the business to document and measure the following:

1. Maintain a 3-year pro-forma at all times.
2. Discontinue poor performing products and services. Keep a product and service history.
3. Establish recurring revenue streams.
4. Compare your performance to your industry.
5. What trends are emerging in your industry? Are you following or setting those trends?
6. Increase returns and more fully utilize your physical assets.

Have a Succession Plan. We rarely see this, but when we do, Buyers and Lenders are impressed:

1. Have an emergency plan in case of an unforeseen change in key personnel.
2. Periodically implement training of the next generation of managers and key employees.
3. Document best practices and ideas for improvements from the next generation of company leaders.
4. Have a plan that ensures company-wide understanding of the owners' vision, desires and knowledge.

# MANAGING INVENTORY IN THE SALE PROCESS

Is inventory included in the sale price? Well, of course it is. The Seller has no use for it after the sale and the buyer needs it to run the business. Additionally, the Seller must continue to operate profitably while trying to sell and if inventory is required to do that, then a reasonable level must be maintained. Businesses that are priced “plus inventory” are very hard to sell. Think about it, would it be reasonable to price it plus employees or plus customers or plus equipment? No, a business uses all its assets, tangible and intangible, to generate benefit to its owner(s), and everything but cash and debt should be included.

But wait, how do you account for inventory variance in a sale price? If a buyer comes in when inventory happens to be high, the Seller is at a disadvantage, right? Yes, so it's best to include only a normalized level of inventory in the price. What this means is taking out the highs and lows and including enough inventory to maintain prudent operations. Then, your purchase and sale agreement will include language such as....

*If the actual value of the inventory to be transferred is less than \$(the included amount) at closing, the Purchase Price shall be adjusted downward on a dollar-for-dollar basis for the amount under \$(the included amount). In the event the value of the inventory exceeds \$(the included amount) at closing, the Purchase Price shall be adjusted upward accordingly.*

It's simple, reasonable and equitable. The inventory has to go with the business.

A quick note about old or slow moving inventory; buyers will likely want to see your inventory aging report, and if something is old or not moving, will expect a significant discount for that type of product. It's not uncommon to see offers where old inventory is discounted from 50 to 90%. The best practice is to clean out old product (sell it, return it, whatever) before going to market. You'll have the cash for it and appear well managed with an organized facility.





## REAL ESTATE

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Does including the real estate in the sale increase demand for the business? Not necessarily. Flexibility does, however. We find it's about 50-50 - some business owners also own the real estate, others lease. Unless home-based, the transfer of rights to the facility where the business is located in an equitable manner is critical to the sale process.

Those who own the real estate typically control earnings with the rent they charge themselves. Want to show more income, lower the rent... want less income, raise the rent. Those who have an arms-length lease are commonly locked in to a rental rate for a specified time and often with an accelerator (a periodic, automatic increase in rent). Lenders almost always insist on a long-term lease that, at a minimum, matches the length of the loan. Add that landlords are reluctant to change when something is working well, and you can see how planning the facility transfer is a critical factor.

If you lease your facility, simply read your lease to determine if it's transferable. Most leases contain language to address this issue. Ideally, you want a landlord who will agree to terminate your lease and give the buyer a new one. This relieves you of all obligations under your current lease and encumbers the buyer directly. This works well unless the landlord substantially raises the rent to the buyer, which can reduce the value of the business. If you have to transfer an existing lease, use caution and get legal advice if you are unsure what obligations, if any, you will still have upon transfer. Also, there should be enough time left on the lease to give the buyer a few years of ownership before having to move or renew. Five-year options/increments are great as long as the rent does not increase dramatically when exercising the option. Right of first refusal and options to buy can also help close deals. If by chance you are currently operating on a month-to-month lease, you will need a letter, or better yet a proposed lease, from your landlord indicating what terms are readily available for a buyer. Month-to-month leases all but eliminate commercial financing for a business being sold.

If you, or an entity you control, own the current facility, you will need to decide if you want to lease or sell the property with the business. In either event, a lease rate needs to be established. Buyers view real estate purchases as they would any other investment; they want a return on their money and the rent payments they receive from the business represent that return.

The lease rate directly affects the value of the business. If you charge the buyer of the business substantially more rent than it has historically paid, the value of the business obviously goes down. A best practice is to establish a market-based rent before appraisal and selling efforts begin so an accurate SDE can be determined.

The advantage to including the real estate in the deal is financing. Lenders love real estate and view it as good collateral. It also extends payment terms. A real estate loan can be 20-25 years whereas a business only loan is usually 5-10 years. Lenders will often blend the terms if both business and real estate are included in a deal to determine the length of a loan.

Finally, it's always a good idea to run a quick sanity check on the real estate value. The term used by real estate appraisers is Highest and Best Use (Google the term) and it basically means the property is being used in a manner that results in its highest value. You don't need a \$3,500 real estate appraisal to know if the current use is realistic and passes the smell test. For example, if your family bought the property 60 years ago and handed down a restaurant to several generations, and that property is now worth \$3M and the restaurant (which has never paid rent) makes \$75,000 a year, you have a real estate transaction, not a business sale. If rent was just 1% a month (\$30,000), who would buy it. Just saying....

# WORKING CAPITAL

Working Capital is money available to a business for its day-to-day operations. All businesses need it and for most it consists of cash, inventory and/or accounts receivable. Working Capital is a highly critical factor.

One of the first questions a buyer and lender will ask is what are the working capital requirements, and it's important to have a credible answer. The obvious reason it's so critical: the buyer has to come up with it in addition to the purchase price. In most cases, lenders will not loan unless adequate working capital is present. Everything you exclude from the sale increases the cost to a buyer.

An old rule of thumb exists to calculate working capital. Simply take current assets minus current liabilities and you have a figure. The problem with this method in Main Street Business is cash and other assets are often commingled with the principals' personal finances, making it unreliable. Additionally, since most small business sales take the form of an asset sale, cash and A/R are excluded, which means not only does the buyer have to replace cash, the product/service has to be sold and proceeds collected, which often takes 30, 60 even 90 days. If the business has a strong seasonal aspect to it, the problem is greatly magnified. A better rule of thumb is to add A/R + inventory and subtract A/P, taking cash out of the equation.

Some businesses have lines of credit while others use personal credit such as credit cards and home equity loans. Whatever the source of working capital, the higher the requirement to operate your business, the higher the purchase price is to the buyer.

Many think working capital is the buyer's problem and to some extent it is, as they must have a sufficient level. However, it's critical that you know the effect your working capital requirements will have on the buyer because it directly affects the likelihood of a sale and the multiple of earnings the buyer ultimately pays.

A best practice is to look at your recent history and calculate an average working capital requirement. Then, add that figure (minus the inventory that's being included) to the purchase price and check your multiple again. Does the transaction still make sense for both buyer and seller?

***“It’s critical that you know the effect your working capital requirements will have on the buyer because it directly affects the likelihood of a sale and the multiple of earnings the buyer ultimately pays.”***

## FUTURE CAPITAL EXPENDITURES

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Often called “CapEx”, future capital expenditures have a direct effect on the value of your business. The less equipment a business needs to invest in, the more cash flow is available, which equals a higher value. Again, buyers want your earnings, not your assets, and generally prefer a business without a lot of tangible assets to maintain. If your business is asset intensive, it can still sell of course, but asset maintenance is critical.

A good practice is to keep your facility, furniture, fixtures, equipment and vehicles well maintained and invest in new equipment wisely. Building a marble shrine with your statue out front does not increase the value of your business unless it dramatically increases earnings. New yellow iron and vehicles are the same, they do not increase value unless earnings go up. Think maintenance records and prudence!





# SELLER FINANCING

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We get it; you don't want to carry any debt - nobody does, but you need to be aware that it's part of most deals. In fact, during the recession, commercial financing dried up and almost every deal was seller financed. Thankfully, times are better now, and SBA lenders are active again, albeit with heavy government regulation. Looking for a good read? Try the SBA SOP, which can be found here: <https://www.sba.gov/document/sop-50-10-5-lender-development-company-loan-programs>. As an added bonus, it's updated almost every year.

To be serious, and a little contrary to popular belief, the SBA is...well...amazing. Advantages include:

- 7A loans to \$5M.

- 10 years to repay vs 5-7 with a traditional commercial loan.

- 20-25 years repayment if the real estate is included.

- Lower down payment.

- The loan can be paid off early without penalty if real estate is not included.

- The loan does not have to be fully collateralized, goodwill can be financed. Try getting that with a traditional loan. Does your business have goodwill?

- It costs taxpayers nothing! The SBA does not actually make loans, it insures them and pays for itself with fees collected from the borrower.

- It creates/maintains millions of jobs.

True, it's a government program and as such, can't be all good:

- Process can be slow, requiring lots of paperwork. Remember though, the SBA doesn't loan money, banks do so buyers can shop for "preferred lenders".

- Requires personal guarantees from anyone owning more than 20% of the business.

- Seller can't maintain ownership after the sale; consider consulting agreements instead to help with transition.

So, why is seller financing so common? Consider what it says and the effect it has on the deal:

- The seller has confidence in the business.

- The seller has incentive to assist the buyer in transition.

- Lowers the buyers perceived risk.

- Decreases time to closing.

- Could decrease initial tax liability (because of installments).

- Offers a mechanism to deal with customer concentrations.

- Helps to address future contracts or contingency payments.

- Shows the Seller is motivated to sell.

Obviously, the biggest reason for seller financing is the lender's mitigation of risk. Let's face it, Main Street Business is very risky, and buyers and lenders want a way to lessen the risk. Lenders, attorneys,

accountants and authors all talk about it, and it's one of the first things a new buyer will learn when searching for a business; is the seller sharing the risk?

As mentioned, times are better now with commercial financing compared to just a few years ago. During the recession, a typical deal structure included the buyer putting a third down and the seller financing the balance for 10 years. Now, a typical deal includes about 20% down, 60% commercial loan and 20% seller financing. Obviously, the seller portion will be subordinate to the commercial lender and likely on standby, but it's much better than carrying 2/3 of the price.

Those who offer seller financing often take a security interest in the business assets, insist on a personal guarantee from the buyer and require quarterly financial statements during the term of the loan.

The more you're willing to finance, the more likely (and timely) a sale - it's that simple. In fact, we still see sellers finance one half, sometimes up to two thirds, of a deal. Why do that when you can get 80% of your money at closing? A lot of sellers do not want to subordinate to a commercial lender, that's why. If there is little debt to clear at closing, the business has been well-managed, and the buyer is a hands-on owner, it's a great way to get full value.

In summary, seller financing is the way deals get done! Yes, there are cash deals (cash to seller, that is) happening, especially when a lot of real estate is involved, but it's rare. It's critical you consider carrying a portion of the deal. Without it, the pool of willing buyers and lenders is significantly reduced.



*“The biggest reason for seller financing is the lender’s mitigation of risk.”*

# HOW LONG DOES IT TAKE TO SELL?

On average, about 9-16 months if properly priced and packaged. If you can't defend your price and terms, then it will take a long time. There's also an industry variance. For example, at the time of this writing, automotive businesses are in demand and tend to sell quicker, whereas construction and fitness related businesses are very slow. The industry that's hot now will likely be different next year as the economy changes fast on Main Street. Remember the old saying "liquor stores are recession proof"? What was that guy drinking?

Recently, Business Valuation Resources had an article on their website analyzing the selling price and days for private deals. It noted in 2004 the average days on market was about 160 climbing to almost 250 days by 2014. It's probably no coincidence that the age wave (baby boomers starting to retire) started in 2011. It also found that the more days on the market, the lower the final selling price compared to the original asking price. Business Brokers call this "rotting" and it's common for overpriced and poorly packaged businesses. Buyers always seem to ask how long a business has been on the market.

Ultimately, the terms of the offering will decide how long it takes. What experience has taught us (it's just common sense):

Smaller the cash at closing, the faster it sells.

Larger the cash at closing, the longer it takes.

More seller financing equals a quicker sale.

The closer the down payment is to the SDE, the quicker the sale.

Over a 20% return after livable wage equals a quicker sale.

Needing a license or certification equals a longer time to sell.

All cash at closing equals a long time (if at all) to sell.

Another way to position your business ahead of others is to get it pre-approved for an SBA Loan with a preferred Lender. With this approach, you have experts looking at your business (usually for free) and you know what terms are likely to be available. Caution though, using the bank you've been with for many years can generate a false sense of security as you've put them on the spot asking if they'll finance. What are they going to say, no? Of course not.





# SELLING A PARTIAL INTEREST

Value lies in control. Control refers to the ability to appoint management, set management compensation, determine strategy and policies, acquire or sell assets, acquire other companies, liquidate or recapitalize the company, buy or sell treasury stock, declare and pay dividends, and amend articles of incorporation and bylaws. Without control, value is greatly diminished. Minority interests in a business are typically worth less, often a lot less, than the proportionate share of the business value.<sup>5</sup> There is also the challenge of marketability; it's very hard to sell (or re-sell) a minority interest.

Can it be done? Yes. Is it likely? No. If it were to happen, it would likely be at the higher end of the scale with earnings approaching the \$1M mark. Otherwise, with a detailed operating agreement, buy-sell agreement, an above-average ROI opportunity and Jupiter and Mars lining up just right, you might find a buyer. Realistically though, partial sales rarely happen. Again, it's all about control.



<sup>5</sup> Guide to Business Valuation, Shannon Pratt, 1999. Ninth Edition, Volume 2.

# UNDERSTANDING BUYERS

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The buyer looks at the total investment in the business, not just what the buyer pays to the seller.<sup>6</sup> In addition to the purchase price, a buyer must have working capital, pay loan fees, legal and accounting fees, appraisal costs, establish trade accounts, pay utility deposits and many other costs, all before receiving the first dollar from the business being bought. The cost is astounding!

Though passionate and energetic by nature, Main Street buyers mostly work on two basic principles; substitution and leverage. “Substitution” is an appraisal term, which states, “a buyer will not pay more for your business than an equally desirable substitute”. In other words, it usually doesn’t matter what industry you’re in, where you’re located or how hard you’ve worked, it always boils down to; does it make financial sense.

Leverage, on the other hand, is how buyers make transactions. We all remember learning about leverage, from fulcrums and pivots in high school: “a lever allows you to use less force to lift or move objects”. Likewise, buyers use the principle of leverage to accelerate their financial goals. Or, said another way... using their liquid funds as a down payment and letting the business make the payments.

So, with dozens of factors to consider when buying a business, a successful sale will likely come down to how four basic questions are answered:

....are the Seller’s Discretionary Earnings sufficient to pay...

- 1) the projected debt service and debt service cushion,
- 2) a new, fair replacement salary,
- 3) new capital expenditures and/or deferred maintenance and
- 4) does the remainder of the earnings provide a reasonable return on investment?

If you can answer yes to these basic questions, the likelihood of selling increases dramatically.

It’s also useful to know the different types of buyers. Obviously, they all have their own investment criteria, but for the most part, can be categorized into 3 primary groups.

Individual Buyer

Financial Buyer

Strategic/Synergistic Buyer

**The Individual Buyer:** This type of buyer is solely a small business or “Main-Street” buyer (because of lack of resources). This buyer usually seeks a business with a value range of \$100,000 to \$1,000,000. Additionally, this type of buyer is usually buying or replacing a job and wants to: a) control their own destiny, b) not work for someone else, and c) leverage their talents, skills and abilities to make more money. Because the buyer will be working in the business, pride of ownership and other psychological and emotional factors are usually involved in the buying decision. Most importantly, this type of buyer is a down payment driven buyer.

**The Financial Buyer:** This type of buyer is usually an individual as well, but of substantial means, i.e. this buyer is not just buying a job. (S)he is influenced not only by the return on investment and salary the business offers, but also its scalability and potential to accumulate wealth by taking it to the next level which is likely the private equity market. This buyer often buys Main-Street Businesses but also larger

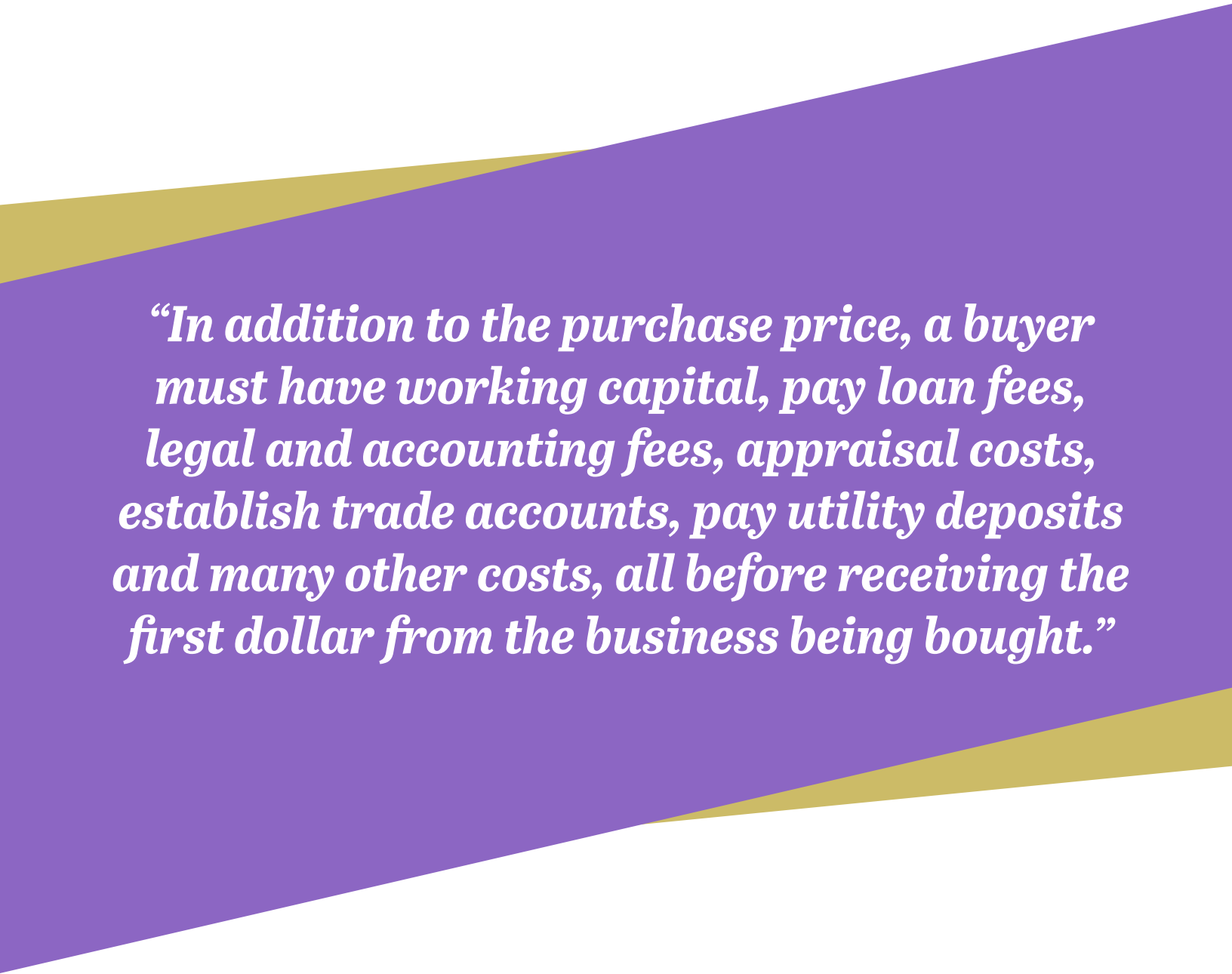
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<sup>6</sup> Valuing Small Businesses and Professional Practices, Third Edition, Shannon Pratt, Robert Reilly, Robert Schweihs, 1998.

businesses on occasion. This type of buyer is also a down payment driven buyer.

**The Strategic or Synergistic Buyer:** This buyer is usually a company or private equity group buying a business that fits in its portfolio of similar businesses. They may also buy if the target acquisition can increase market share, provide new technology, add distribution channels, or eliminate competition. Typically, their definition of value is investment value which is usually higher than fair market value. However, in order for you to value your business using this definition of value, the specific buyer would have to be known because a target's investment value is likely different for each potential buyer. This is because of the synergies that are created through the acquisition. Therefore, unless the specific buyer is known at the time of the appraisal, the individual buyer and financial buyer will be the most likely candidates. For the Strategic Buyer, the target business will usually have, at a minimum, more than \$750,000 in SDE. This type of buyer is a return on investment driven buyer.

In summary, the most likely buyer of a Main Street Business is the individual buyer for the reasons stated above. They typically search for a business with an asking price of 4 to 5 times their down payment ability knowing they will leverage the cash they have on hand.



*“In addition to the purchase price, a buyer must have working capital, pay loan fees, legal and accounting fees, appraisal costs, establish trade accounts, pay utility deposits and many other costs, all before receiving the first dollar from the business being bought.”*



# THE TRANSACTION TEAM

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They better be good - this is important. In most cases, it's best to use outside advisors. The accountants and attorneys used by most main-street businesses have very little, if any, transaction experience. Why would they? It's a different occupation. Transaction professionals are a must, and it's best to engage them in the beginning. Here's what you will need:

Business Broker – sometimes called business intermediaries. Obviously, you want experience and there are two primary credentials; Certified Business Intermediary (CBI) and Merger & Acquisition Master Intermediary (M&AMI). The difference between the two is mostly the size of market they serve. A CBI works with Main-Street businesses and M&AMI's work in the middle market. You can check them out here:

CBI - <https://www.ibba.org/>

M&AMI - <https://www.masource.org/>

The advantage to using a Broker is primarily to gain access to his/her buyers and transaction experience. A good Broker will be able to help you price the business, know where and how to market it, screen buyers for you, prep you for showings, depersonalize the negotiations, have gigabytes of contracts to use and have the lending, legal and accounting contacts to help you close a deal. Selling a business is complicated and there's a lot that goes into the process. Using a Broker can save literally 100's of hours that would otherwise be taken from the business.

A few things to expect in an agreement with a Broker:

Clearly defined fee arrangement.

Term – most Brokers want at least a 12-month agreement.

Exclusivity – the process can take some time and Brokers want to ensure their time and expense does not go to waste.

Seller's responsibility – defines what you are expected to do during the agreement. Basically, cooperate and provide records.

Tail – a list of potential buyers the Broker communicated with about your business which, if they come back and buy after the agreement is terminated, the Broker will get paid.

The disadvantage of course, is cost, usually about 10%. While each Broker sets their own rates, a common compensation arrangement in the industry is 10% on the first \$1M, 8% for \$2-3M, 6% for \$3-4M and 4% for the amount over \$4M. Some Brokers also ask for an up-front retainer, usually around 2% of the expected sale price, to show your sincerity and motivation to sell. However, the commission (AKA success fee) should always be the most significant part of any compensation package. Many Brokers will credit their retainers against any commission that is earned, and if not, you should ask that they do. Another disadvantage is industry specialization. Use caution with Brokers who specialize as they tend to market towards the industry. Many buyers, if not most, are looking for a career change and marketing to someone who is already in the business is bottom fishing.

What about real estate agents? Would you use a Proctologist for your Dental work? They're both licensed...right? Here's the thing with real estate agents; they just don't have the education, experience or infrastructure to sell a business. Why would they? They're also in a different profession. They're good at staging homes and know where all the schools are, but businesses have many moving parts, such as inventory, non-competes, allocation, employees, customers, AR, etc., whereas with real estate, it's just one simple asset to sell, and the title company does the majority of the work. Real estate agents take business listings primarily because real estate offices often pay agents based on the number of listings

they are able to accumulate. The more listings the agent may have, the more commission they will get if something should sell. Look at it this way, would you put a sign in your yard to sell your business only for its asset value using a soccer mom working part-time? That's the modus operandi of a real estate agent.

Transaction CPA – Funny how we use CPA and accountant (or bookkeeper) interchangeably in small business, but there is actually a difference. A CPA is licensed by the state, and the designation requires a rigorous qualification process - not so for an accountant. That's not to say, however, that an accountant can't gain through experience the skills to advise clients on selling a business. The critical factor is experience in allocation of purchase price. As mentioned, most small business sales take the form of an asset transaction which means the purchase price could be allocated to many different classes, having an effect on your after-tax proceeds. If your current firm regularly practices in this area, fine, run with them. If not, you'll want to find someone that does.

Transaction Attorney – In business law, there are basically two types of attorneys; litigation and transaction. Obviously, you will want to go with a transaction professional when selling your business. It's also a good idea to mention that your sale will likely be an asset sale, not a stock sale. In Main Street, most attorneys will know this, but if your business bids a lot of work or has contractual work in progress, like construction companies for example, it could take the form of a stock sale and be more complicated. There are also "neutral" closing services run by attorneys who will prepare the documents and help the deal close. Similar to a transaction broker, they typically work by handling earnest money, documents, due diligence and closings and can genuinely help the deal along while the buyer and seller make the decisions.





# NON-DISCLOSURE AGREEMENTS

Always get a Non-Disclosure Agreement (NDA) when disclosing sensitive info about your business. It's the first document of any transaction, and buyers are accustomed to signing them. It's designed to enforce confidentiality and limit what can be disclosed to 3rd parties. Primarily, you want any info you share to only be used for evaluating the potential purchase of the business, not to compete with it. It's usually ok to disclose your revenue and SDE so buyers know if the business is the right size, but certainly do not disclose your processes or customers without an NDA in place. A good rule of thumb is not to disclose anything, other than revenue and earnings, that's not on your website. It's a good idea to have an attorney prepare this for you, keeping in mind if it's too restrictive, buyers will simply move on to the next business. Mutual NDA's are also common whereby you agree to protect the buyer's info as well. If you're using a Business Broker, they will likely have an NDA.





# THE OFFERING MEMORANDUM

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For Main Street transactions, its normally called a Confidential Business Review (CBR) which, after the buyer signs the NDA, acquaints the buyer with the business. Sometimes, they're called a teaser, offering memo or confidential information memorandum, but regardless of the name, it should be detailed enough to answer most questions about the business including detailed discussion of the following topics:

History of the business.

Owners involvement.

Customers.

Products and services.

Employees.

Competition.

Marketing programs.

Facilities.

Financial recasting and records.

SDE discussion.

Since you only get one chance to make a first impression, the document should be impressive. A few tips include:

It should be typed and emailed as a PDF. Use a professional font, and try to avoid scanned or faxed documents. Check the file size too; everyone hates getting a huge file to download.

Do not capitalize words i.e. GLASS COMPANY WITH AMAZING POTENTIAL.

Avoid the fluff, such as "once in a lifetime opportunity", etc. Buyers want cold, hard facts, and superlatives are not credible.

State the good, bad and ugly, being brutally honest. Buyers and their lenders will perform substantial due diligence, and if they discover dishonesty or an omission, your credibility will not recover. Every business has challenges, and you're not diminishing value by pointing out areas that could be improved.

Keep it concise. Buyers look at many opportunities, and they need the facts clearly stated. They will refer back to this document until closing.

Finally, it's important to update the document on a regular basis, at least quarterly. Buyers get frustrated receiving a document that has old financial information which reflects poorly on the business moving forward.

Tip – at or near the bottom of your NDA but prior to the signature line, ask the buyer to disclose the amount of cash available for a down payment and his/her net worth. Now you know if the buyer is worth courting.

# MARKETING THE BUSINESS FOR SALE

Think Internet...obviously. Print is obsolete, expensive and hasn't produced a buyer in over 10 years. Social media is right there with print...ineffective! I know, young people will argue social media is totally lit but remember "dude", that demographic is not buying. You have to appear where the buyers look which is not on Facebook or some real estate MLS, but legitimate business for sale websites. There are dozens of sites to choose from, and the major players seem to be:

**Bizbuysell.com** for Main Street Businesses.

**Axial.net** for Middle Market.

You'll have just a few seconds to get a click, so your ad headline needs to get attention. A title that includes "in a Beautiful Mountain Town" means you have to shovel snow if you buy this business so it's better to state what they're looking for. Better descriptions include; highly profitable, with good cash flow, seller will carry, automated, absentee, experienced staff, only \$\$ down, easy to run, great location....you get the picture. It's a good idea to go to a few sites and look at the ads you will compete with. Buyers primarily search by revenue size, earnings and zip code but interestingly, rarely by type of business.

If you get that click, you'll have a few more seconds to make your case so use the time wisely to describe the business. Remember, buyers are scrolling through literally hundreds of ads, so it needs to point out the ability to make a good living (while they shovel the snow). As space permits, a few quick cut and paste headlines from your offering memo saves time and points out your key value drivers. A word of caution; we see some sellers withhold critical figures such as revenue or earnings, instead asking the reader to call for more information. Experience tells us this rarely works; the buyers simply scroll to the next listing.

As you get calls and emails, it's important to respond promptly (same day at least, within hours is best). Get your NDA signed and answer questions as best you can. The overall message you want to communicate is transparency. When a buyer feels comfortable that you are forthcoming with information, it reflects on the business in a positive manner.

***"It's a good idea to go to a few sites and look at the ads you will compete with. Buyers primarily search by revenue size, earnings and zip code but interestingly, rarely by type of business."***

## SHOWING THE BUSINESS

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This is a good sign. A potential buyer has signed an NDA, reviewed your financials and CBR and now wants to meet.

Showing a business is nothing like showing a home. The buyer and seller know each other's financial position and will meet face to face to talk about how the business operates. It's important that you are prepared.

It's best to show during business hours so the buyer can see the operation. If it's a confidential sale, then there's nothing wrong with showing after hours or on a weekend. At some point however, the buyer will want to see the operations and meet the staff, but it doesn't have to be at the first meeting.

Be organized and clean...unfiled/unscanned documents, obsolete or overstock inventory, equipment in disrepair and clutter in general reflects poorly on management. It's much better to start the meeting talking about an award or plaque on your wall than with an apology about being too busy lately to tidy up.

Don't feel like you need an agenda for the showing. The buyer is there to learn, and it can be overwhelming throwing too much out at once. It's good to start with an offer of a quick tour which sometimes answers a lot of the buyers' questions.

The buyer will likely come with a list of questions, and transparency should be the word of the day. Help the buyer learn. Some of the more common questions we hear at showings include:

1. How/why did you start or buy the business?
2. How long have you been trying to sell?
3. Why are you selling?
4. What will you do after the sale? Will you stay in the area?
5. How was the price determined?
6. How much will you carry?
7. Experience and age of the staff? Will they stay?
8. My background is XYZ, can I learn your business?
9. How can I grow the business?
10. How many hours do you work per week?
11. Are you able to leave the business, is there someone who can step in while you're gone?
12. Etc., etc., etc.

Be honest, but not modest. If there's something about the business that could be improved, it doesn't hurt to talk about it, they will likely discover it anyway. You should not feel pressured to have a perfect small business, there's no such thing.

You should also ask questions of the buyer. It would be nice to know the buyers professional background, why s(he) wants to buy a business, how long is the search, what else has been/is being considered, will you be hands-on or bring in a manager, have you worked with a lender, have you formed an entity, etc., etc. Knowing your buyer will help you negotiate.

Remember two important things; 1) transparency and 2) this is Main Street. You're not on Wall Street, and this is not a corporate take-over; rather, it's a small business transaction where Buyer and Seller work together to get deals done. All this tough talk from Attorneys and Brokers about hard negotiations and fist-slammings ultimatums only leads to wasted time. Effort, ethics and reasonable compromise gets you to the closing table.



## EVALUATING OFFERS

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Nice, someone wants to buy your business! But wait, it's not what you asked for. What to do...

Consider this, the conversation just went from if, to how, the deal will close, so look carefully at the terms and formulate a good response. There's no set rule about splitting the difference or how many counter-proposals go back and forth. It's simply about getting to a deal that Buyer and Seller are comfortable with (which is also known as market value).

Assuming you went to market at a defensible price, most offers are usually at or above 75% of the asking price. Consider the offer in its entirety before responding. How is it allocated, how much inventory is included, is there a provision for aged inventory, how much transition assistance is being requested, who is paying the tax on the sale of tangible assets, how much are they asking you to carry, is the Seller note on standby, when do they want to close, what are the contingencies, what kind of due diligence do they want to do, is there a lockup included...and on and on it goes.

The key is to respond with something you can live with. You never know if the buyer offered their best price or they're just testing the water. Use the defensible price you established in the beginning to tactfully get the price as close to ask as you can. Consider how many offers you've had, how many calls you're getting and what alternatives the buyer may have in his/her price range and area. Remember the showing and the questions you asked? Use that information to your advantage.

"Low-ball" offers happen all the time and are easy to handle. If you get one at some crazy price or with a whacky stock trade, just use common sense. Many times, a simple response like...put it in a formal contract and I'll consider it or...no, but I'll pay half the closing cost as a measure of good faith or... no, let's talk again after you've looked at a few more businesses... can reveal a buyer's true motivation. A lot of buyers simply test the water first, don't be offended.

Offers can come in many ways; they could be verbal, could be a non-binding letter of intent or even a formal asset purchase agreement. The most common in Main Street is a Letter of Intent (LOI). The LOI is usually non-binding (except for confidentiality) and identifies the critical elements of a deal like price, terms and structure. Though not detailed, the LOI can work well because it allows the parties to negotiate without incurring substantial legal costs. Once the primary deal components are agreed upon, the purchase and sale agreement, usually called an "Asset Purchase Agreement", can be drafted.

It's critical to understand that negotiations never really end, as unexpected details can arise as any time, including at the closing table and beyond. Being prepared at all times for some give and take will help your cause.



# DUE DILIGENCE

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Due Diligence is a review, investigation and confirmation process designed to corroborate the representations of a business owner about the true status of the business with the intent to uncover material variance.

Sounds hard-core, right? Well...it is. The buyer is always the most nervous party in a transaction and by far, has the most risk. There is a legitimate need for access to accurate, timely records to help manage the risk and provide some level of assurance that the seller's representations are materially true and correct.

About half of all deals fall apart during the due diligence process, and it's usually because the buyer (or an advisor) finds the earnings were overstated. When this happens, most buyers walk away mad with the encouragement of their lender, but some will ask you to cut your price to account for the discovery. Avoiding this pitfall can be simple.

We suggest conducting an internal due-diligence examination as you prepare the business for sale. This is helpful in several ways...1) it will allow you to see the business from a buyer and lender perspective, 2) will refresh your memory and identify problems and 3) confirm to a buyer and lender that the business is well managed. Here's what to do.

Create folders on your computer or in a file-sharing service with the more commonly requested items in a due-diligence exam. As you create the files, you can check for problems while at the same time getting prepared to wow the buyer with efficiency. Here are a few common files to prepare:

## 1. Financial Documents:

- a. Monthly financial statements for the most recent 2 years. QuickBooks can export this in one document to Excel with the push of a button.
- b. General ledger for each of the last 2 years including journal entries.
- c. Bank statements (for all bank accounts) for the most recent full year and year-to-date for current year.
- d. Description of anything labeled as "other" on financial documents.
- e. Last 3 federal income tax returns. (Note; never extend a tax return during the sale process.)
- f. Sales tax returns for the past full year and year-to-date.
- g. Payroll tax returns for the past full year and year-to-date.
- h. W-2's for all owners for the past 2 years.
- i. Documentation of any perk that was added back to income. (Cancelled checks, invoices, etc.)
- j. Schedule of gift certificates issued/redeemed/outstanding. (Hint: check the expiration dates on any outstanding gift certificates) You might be surprised how big of an issue gift certificates and other customer loyalty programs can be at closing.
- k. Customer Rewards/Loyalty programs: Ensure this program is clearly defined; buyers will expect a credit at closing for any unredeemed rewards.
- l. Schedule of customer deposits held.
- m. Payroll summary by employee that includes compensation (wages, bonus, expense acct).

## 2. Assets:

- a. Equipment list with serial numbers for major items.
- b. Copies of all equipment leases and service contracts.
- c. List of all computer programs currently used (including current version) and any licensing requirement and cost.
- d. Copies of all equipment warranties if applicable.
- e. Most recent depreciation schedule (check for accuracy).
- f. Copies of all vehicle titles.

### 3. Misc.:

- a. Copies of all licenses and permits or government approvals necessary to operate the business (local, state, federal).
- b. Articles of incorporation or organization.
- c. Ensure corporation/entity is in good standing with the state.
- d. Copies of any franchise agreements (if applicable).
- e. Current insurance policies (business, health, workers comp, auto, professional liability, etc.).
- f. Workers compensation claim history for the past three years.
- g. Facility lease (if applicable) with landlord contact info.
- h. Name, phone # and account numbers of all utility companies.
- i. List of all suppliers/vendors with name, address, email address of contact and telephone number.
- j. Copies of current marketing materials, print ads, publicity, solicitation letters, etc.
- k. 2 year history of warranty claims (if applicable) and a copy of your warranty policy.

It's almost impossible to predict what a buyer/lender might ask for in due diligence, and the items mentioned above are simply some of the more common requests we see. Your transaction might include more or less. Remember, transparency is the single most important service you can provide to buyers and lenders to help your transaction close.





## THE NON-COMPETE

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All cars come with a key and a heater and all businesses include a non-compete. It's a fact of life. Unfortunately, a non-compete does not add value to your business either, rather it's required to close a deal. If a buyer or lender senses you will somehow compete with the business after the sale, there will be no deal.

It gets worse...depending on how the non-compete is worded, you could pay tax on it. Typically, the non-compete will be for a specified period (like the number of years on the loan) and a mileage radius. It will cover all customers, employees, suppliers, referral sources, lessee's and others that have relationships with the business.

One important tip: before you sign the non-compete, make sure it becomes void if the buyer defaults on a payment with you or the bank. It's rare, but never hurts to be prepared. It's also a good idea to check with both an attorney and tax pro to know what you're getting into.

*“A non-compete does not add value to your business either, rather it's required to close a deal.”*

# CLOSING THE DEAL

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Expect the unexpected and don't let up; sprint across the finish line. Banks, attorneys and accountants will drive you nuts with silly info requests, a lot of which seems to be repetitive, but everything needs to be documented, so you have to work through it.

Each deal will have its own set of documents, and the more common docs include:

1. **Asset Purchase Agreement:** this is the primary, binding document that contains the terms and conditions of the deal. It's sometimes called a PSA (Purchase and Sale Agreement) or simply Purchase Agreement. In most cases, this is signed after the LOI and the parties work toward closing per this agreement. In some cases, however, this document is not signed until closing. We see risk in signing at closing because either party could walk away or demand a change to close the transaction, so we recommend signing the formal agreement sooner rather than later. Both scenarios can work though
2. **Bill of Sale:** a somewhat simple document, usually 1-2 pages conveying everything to the Buyer. It's a good idea to list any exclusions as well (like cash for example).
3. **Promissory Note(s):** if you're carrying part of the deal, you'll want your attorney to review this prior to closing. It will likely include a personal guarantee from the Buyer. You, as Seller (Note Holder) should keep the original in a very safe place.
4. **Security Agreement:** describes any collateral for the Promissory Note.
5. **Settlement Statement:** lists the credits and debits per the agreement the parties reached. It's a good idea to get this a day or two prior to closing if possible so you can study it in detail. It's just as the title indicates, "settlement" of the deal.

Depending on your primary agreement, there could be other important documents as well. Again, we prefer a comprehensive Asset Purchase Agreement that encompasses the following, but there are those who prefer to have separate docs for each topic. Both scenarios can work, but the more documents drafted, the more cost for each party it seems:

Non-Compete Agreement.

Due Diligence Acknowledgment.

Inventory Acknowledgment.

Transition and Training Agreement.

Assignment of Name.

Corporate Resolutions.

Creditor Affidavit.

Lien Searches.

Reaffirmation of Reps and Warranties.

Escrow Agreements.

Purchase Agreement Amendments.

Post-Closing Agreement.

Etc., etc., etc.

It's not uncommon to have post-closing adjustments with a deal. For example, buyers usually insist some of your funds remain in an Escrow Account until you have fulfilled any training/transition assistance that was agreed to. There might also be more inventory to account for as well as utility payments, vendor credits, warranty claims and other issues that are not possible to fully settle at Closing. Post-closing adjustments are a legitimate tool in Main Street Closings.

The actual Closing itself can happen in different ways. In this electronic age, the formal meeting-style Closing to sign docs and shake hands can still happen, but it's becoming a bit rare. Instead, the documents and funds are commonly sent electronically while the parties work on day-to-day business and transitioning matters. If real estate is involved, a title company is still used but they rarely want to close a business transaction, so your Attorney and/or Broker will handle that portion coordinating with the lenders and others.





# COMMON DEAL KILLERS

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In the Main Street arena, deals go south...a lot. Here are some of the more common reasons we see (outside of the obvious overpriced business):

1. Poor financial records; they have to instill confidence.
2. Lack of transparency; be open and honest.
3. Lack of Seller financing.
4. Your business requires too much working capital.
5. Excluding assets that are used in the business.
6. Business is too dependent on the owner, a customer, an employee or supplier.
7. Landlords; make sure your lease is transferable to a Buyer.
8. Employees won't stay after the sale.
9. Non-compete issues.
10. Revenue starts to decline during the sale process.
11. No recurring revenue.
12. You are in a commoditized business, nothing differentiates you.
13. Professional advisors; most people think attorneys kill deals and while it does happen on occasion, it's usually the accountant. Make sure you have a good deal team that specializes in Main Street transactions.
14. Lenders; the Buyer will need to have experience in the field being bought which is rare. Most Buyers are looking to change careers, not expand in their current one.



# COMMON MYTHS ABOUT SELLING A BUSINESS

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We get calls almost daily asking questions about selling a business. Here's a light-hearted look at some of the more interesting conversations we've had over the years.

1. "Rich people will overpay with buckets of cash because of where I live." There seems to be some notion that rich, out of state buyers with tons of cash will overpay for a business. Let's look at the facts: It is very hard to become rich in the first place and those who do probably have some degree of intelligence to get there. Don't you find it reasonable to assume most rich buyers are pretty smart and don't get stupid just to buy an overpriced business in a swanky neighborhood. There are way too many reasonably priced/value choices for buyers.
2. "Businesses that do not cash flow are still worth a multiple/percentage of gross." Before my fellow appraisers start screaming at me, let me explain. The point here is simple. If the investment doesn't cash flow (i.e. pass the reality test), then you cannot use a multiple/percentage of gross income solely to value the company. I have seen some very respected valuation experts weight this approach most heavily because their subject business is worth next to nothing through an income approach and a multiple of earnings in the market approach. Who is going to buy a business and not get a decent return? Don't say Strategic Buyers. (Hint: there's no test later but the answer is "No one")
3. "Strategic buyers pay more because they will have synergies." I don't think so! Here's the thought process. If that were true, then if there were only one strategic buyer in the market place, and everyone else was a financial buyer, the strategic buyer would still overpay. NOPE! They only pay more when they fear losing the deal to another buyer (there is competition). Otherwise, most competitors and strategic buyers will smell the blood in the water and eat your lunch if you're not properly represented. Plus, if they were smart and successful enough to be acquiring companies, they probably are not dumb enough to over pay. And don't listen to stories about strategic buyers who overpaid with stock or wacky earn-outs! If I could print my own money, I would overpay too.
4. "There is conventional financing for businesses beyond SBA guaranteed loans." Please don't email me and say I'm wrong, my aggressive banker friends. You are lying and your pants are on fire! It will always boil down to someone collateralizing the loan with assets. No one does non-SBA air balls. If I am wrong and you do write non-SBA cash flow only loans with no outside collateral, call me; we both are about to be rich.
5. "This business is 100% absentee." Please, must I defend this statement? There are some businesses you can leave for longer periods of time, perhaps even years, but a ship with no captain eventually runs aground.
6. "My business has tons of potential that is worth a lot of money now." Seriously? There's a buyer out there who will pay a seller for the growth the buyer works to create? If that were true, then rose seeds would cost more than the roses. No, buyers look at the HISTORY of a business as something to build on and will usually pay for that success if they're reasonably sure it will continue. What they create in the future is theirs.
7. "My backers will give me the money when I find the right business." Or we have unlimited funds to buy a business or we can find the money for the right business. I call them pretenders. Probably why the saying "buyers are liars" has come to be. Real buyers and serious companies in the acquisition mode have no problem providing proof of financial ability to buy.
8. "Assets alone can make a business more valuable." The opposite is true. For the most part, excess assets are a handicap in business sales. Examples are under performing jewelry businesses and excavation companies. Who wants to pay \$2M for a business that earns \$200K and has \$1.5M in

Inventory or equipment? The answer is NO ONE. We often advise businesses with underperforming earnings compared to assets, or businesses with excess assets to liquidate or get their balance sheets in shape in order to sell.

9. “Widget companies are selling for 5X revenue”. One of my favorites! Also slang for “I have no clue what my company is worth and don’t know how to find out”. I tend to cut business owners a little slack with this one simply because this is what they’ve heard from so-called “experts” for a long time. Truth is, once a value is determined, it can of course be boiled down to a multiple or percentage of something. BUT, starting with a rule of thumb (a principle with broad application that is not intended to be accurate or reliable) is asking for trouble. Get an appraisal to see if you can exit for that price. If not, keep it and grow it!
10. “I’ll sell when I’m ready”. Certainly, an owner wants to be sure he or she is mentally, emotionally and financially prepared to sell. But, personal readiness is just one factor. Economic factors can have a significant impact on the sale of a business. Sale prices can be affected by industry consolidation, interest rates, unemployment, technology, regulation, competition and most importantly, earnings trends. Talk with a professional and aim to sell when your personal goals and market conditions align.





# CONCLUSIONS

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All Main Street Businesses change hands at some point. It could be from parents to kids, owners to employees, taken over by a creditor or the most common transaction: sold to a complete stranger. Whichever transaction works best for you will require planning.... advance planning. You simply can't wake up on your 65th birthday and decide to sell, there are too many outside forces (the economy, your recent trends, etc.) to consider. Realistically, the process should start 1-2 years in advance.

As stated earlier, you must take a close look at your business from a buyer's perspective, which is quite simple to do. When you go to work tomorrow, look at your facility as you drive up; are you impressed? Go in and tell your assistant to print a YTD financial statement and last year's federal tax return; did you get it within about 5 minutes? How does it look? Are sales trending up? Are you able to read it without being interrupted? Get the picture?

Selling a Main Street Business is hard to do because they're risky investments. This is evidenced by lenders who want a guarantee from the government just to loan money on them or at least have tangible collateral like real estate to back it up. They will also want the earnings to be at least 125% of what it will take to pay the debt and draw a livable wage. They're not being difficult, they're managing risk.

Though risky, there are a lot of people who want to control their own destiny and build a better life through entrepreneurship, which gives you a good chance you can sell if you are reasonable, transparent and patient.

The purpose of this document is to provide you with the "most-likely" scenarios you will face when selling a small business. We understand that anything can happen in the marketplace, and if you should run across something not covered here, we invite you to call and ask questions. We'll do our best to help.

Finally, we welcome your feedback. If you have a story to share, a suggestion to give, or a complaint to lodge, please contact me at [curtis@teamgca.com](mailto:curtis@teamgca.com). Your comments and contact info will not be shared with others.



# THE SHORT VERSION (A SUMMARY)

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Didn't want to read 40+ pages, huh? I understand, it was hard for me just to proof it. If you jumped to here, we hope this helps.

## **Selling a Main Street Business, the Critical Factors:**

1. 27,000,000 businesses in the U.S., 70% of which are owned by people over 55 years of age. 8,000 people a day (baby boomers) will turn 65 until the year 2029.
2. Supply is very high, and demand is low, so selling your business will be hard if you don't prepare. This doc will help.
3. Establish a value. It's critical that you can defend your price:
  - a. An appraisal is best, but not required.
  - b. Do it yourself if you prefer. To start, determine the Seller's Discretionary Earnings (SDE) which is:
    - Profit before tax
    - + non-cash expense like depreciation and amortization
    - + interest
    - + owner perks such salary, benefits and travel
    - +/- extraordinary expense and rent adjustments
    - = Seller's discretionary Earnings.
  - c. Pick a multiple of SDE5, usually between 1 and 3.5 and then test it (use a weighting of the most recent 3 years):
    - SDE
    - minus annual debt service on the business after about 20% down
    - minus a debt service cushion (about 25% of annual debt service)
    - minus annual capital expenditures
    - minus a livable wage for the new owner
    - = return on investment for the buyer.
  - d. If the ROI is above 20%, you're in good shape.
4. Check your timing, it's best to sell when you can check a majority of the following boxes:
  - a. You're ready, both emotionally and financially, and committed to sell.
  - b. The last 3-5 years are trending up.
  - c. Your financial records are in excellent shape and kept electronically.
  - d. You have a good staff and the business does not rely on you.
  - e. You have no customers accounting for more than 5-10% of revenue.

- f. It's hard to start a business in your industry.
  - g. The future is bright with substantial growth potential.
  - h. Your facility and equipment are in good shape.
  - i. Your staff is well trained and relatively young.
  - j. You have modern systems and procedures.
  - k. You have strong brand recognition.
5. Update your business plan to protect and create value (Buyer's and lenders are impressed with this).
  6. Make sure use of the current facility is available for a Buyer.
  7. Know your working capital requirements. A high requirement makes it harder to sell. A good rule of thumb to calculate working capital is  $AR + Inventory - AP = \text{working capital}$ . Now add it to your sale price, is the price still reasonable?
  8. Show confidence in the business by offering to finance part of the deal.
  9. Plan on it taking about 9-16 months to sell (if your business is properly packaged).
  10. Retain an experienced team to help you sell (Broker, Attorney & Transaction CPA).
  11. Protect your confidential information but prepare a thorough offering package.
  12. Market the business on sites such as bizbuysell.com and axial.net. Check other ads to know who you're competing with.
  13. Make sure your business is presentable throughout the sale process, showings can happen on short notice. Ask the Buyer questions.
  14. Carefully study all offers and promptly respond.
  15. Demonstrate transparency during the Buyer's due diligence period.
  16. Be prepared to sign a non-compete agreement.
  17. Use transaction professionals to close your deal.
  18. Do not, under any circumstance, let up while you're trying to sell.
  19. Be prepared to negotiate all the way through Closing.
  20. Help the buyer transition into the business.

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