

Buying & Selling a Small Business



HELPING SMALL BUSINESSES GROW!

Louisiana Small Business
Development Center



www.lsbdc.org



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THE SIMPLE GUIDE TO BUYING & SELLING A SMALL BUSINESS

Starting a company from scratch can be daunting. Maybe that's why the idea of being able to "turn the key" and walk into a business that's already in full operation is so appealing. The new owner instantly gains a name, employees, vendors, customers and income. But buyer - and seller - beware. The sale of a business requires time, research and careful planning, even if professional advisors help with the process.

Buyers must do their homework

The process has many phases: searching for an appropriate business, analyzing business and financial data, developing a viable offer and then doing all it takes to close on the sale. Then, the real work begins. It takes experience and expertise to make a smooth transition to new ownership, without the business "skipping a beat." Once the sale is finalized, the current owner may not be around to answer questions.

Sellers have work to do too!

Years before they put their business on the market, sellers should perform an evaluation. This allows time to groom the business, making it more attractive to potential buyers. This is also a crucial period that should be used to track and gather several years of business and financial information. Buyers will want to see complete financial data — and sellers should have it ready to present to them.

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Common areas both buyers & sellers need to consider and review

The Many Facets of a Business Sale

- ◆ **REASON** Why is the business for sale? Buyers need to ask, and sellers need to develop a history of the business right from its inception. Provide a detailed explanation.
- ◆ **PRICE** How much is the business worth? What is the value of its assets? (See pages 10 and 11.) Provide a breakdown (See page 13.)
- ◆ **TYPE** What type of business is being sold or bought? Categories include service, retail, manufacturer, importer/exporter and franchise.
- ◆ **INDUSTRY** What's the bigger picture? Is the business big or small compared to others in the industry? What are the industry trends and predictions?
- ◆ **SIZE** Numbers don't lie. What are the annual sales and number of employees?
- ◆ **LOCATION** In some cases, it's the foundation of a business' value (for example, an inn perched right on the ocean). What's the history at its current location? Can the business be relocated or merged with another business? Provide a copy of a proposed or actual lease.
- ◆ **PRODUCTS AND SERVICES** Define them and ask if they've changed over time. How are they priced? Are the materials or supplies available from several sources? Are patents, proprietary processes or trade secrets transferable to new owners? Which products or services, if any, will the new owners add or remove?
- ◆ **OPERATIONS** How are services handled and products produced, from the beginning to end? Is the facility the right size and type for the business? Buyers should review a list of names, addresses and payment terms of suppliers. Manuals and handbooks help potential buyers understand the day-to-day operation of a business.
- ◆ **EMPLOYEES** Is there an organizational chart, with detailed job descriptions and pay rates? Buyers may or may not keep existing employees on. (If employees are unionized, union officials should be consulted before any decisions are made.) New owners usually re-hire existing employees and review present and future responsibilities, as well as wages and benefits. These expenses should be included in the financial statements. The buyer may incur new expenses from hiring and training employees, or from outsourcing jobs to other companies.
- ◆ **MANAGERS** Does the business have a competent management team? Who will remain and who will leave? Should some functions be handled by outside firms? Management salaries and outsourced expenses should be calculated by the buyer and included with financial statements.
- ◆ **MARKETING** How effective is the current owner's marketing plan and how big is their budget? The entire plan — including copies of ads, schedules, and budgets — should be reviewed. Who will handle marketing under the new ownership — employees, outside agencies, or a combination of both? What are the buyer's marketing plans and costs? Consider:
 - ❖ **Market Share and Growth Potential** Is the business growing? Does it have the potential to grow under new ownership?
 - ❖ **Competition** Where can customers get similar services or products? A competitive analysis should be created to list and rank competitors, including their good and bad points as well as their similarities and differences.
 - ❖ **Covenant Not To Compete** Buyers may feel more comfortable if the seller agrees not to compete with the business after it's sold. Sellers often sign a non-compete agreement along with the purchase-and-sale agreement (see page 14). It should include a time frame and a geographical boundary. For example, the seller cannot buy or open a gift shop within a 10-mile radius for two years.
- ◆ **CUSTOMERS** A company's client base is very valuable, so it's crucial for buyers to know the number of customers a business has and if their sales have increased or decreased. Can a new owner retain existing customers and/or gain more? Buyers should evaluate any customer who accounts for 10% or more of total sales, since losing one of these clients would cause a large cash flow dip. Suppliers and customers should be introduced to the new owners.

Points To Ponder

- ◆ **OWNERS** Who started the business? Who are the current owners, how long have they owned it and what percentage does each own? How much does each owner earn in salaries and profits? Who is actively involved in the business?
- ◆ **DEPENDENCY** Is the business dependent on the current owner? If so, the transition to a new owner is crucial. Learning as you go isn't an option — the expertise, experience and qualifications to run the business must be in place.
- ◆ **REPUTATION** What is the business' reputation in the community and its industry? Find out by contacting the Better Business Bureau, chambers of commerce, suppliers, and trade associations. Buyers can also ask employees and customers.
- ◆ **GOODWILL** Goodwill isn't something you can hold in your hand, but more the ability to continually operate a profitable business. The goodwill amount is the difference between the total value of the assets (both tangible and intangible) and the selling price.
- ◆ **BUYER'S FINANCING** Can the new buyer raise enough money to purchase the business? After the sale, is there enough money to run the business and pay back the loan? (See page 8.)
- ◆ **SELLER FINANCING** Is the seller willing to finance some or all of the business' purchase price? (See page 9.)
- ◆ **ENVIRONMENT** If real estate is involved, make sure there are no environmental problems. Lenders will order environmental studies, but a buyer who isn't financing with a lender should do so as well.
- ◆ **LEASES** Are any existing leases vital to a company's performance? A long-term lease provides predictable expenses for a specified time period. Short-term leases are preferred when buyers want to relocate the business. If any equipment leases are assumed by the new owner, the monthly charges, and conditions and covenants must be renegotiated with the lessor. Lessors need to provide letters stating that they approve the transfer of the lease to new owners.
- ◆ **LIABILITIES** Usually all company debts are paid by the seller (at or before the closing) unless there is a mutual written agreement stating what debts the new owner will assume.
- ◆ **TRANSITION** If the owner agrees to stay on after the sale — offering valuable advice, explaining daily operation and integrating the new owner with customers and employees — it should be stated in the purchase and sale agreement (see page 14). The length of time they remain should be specified.

Helping Hands

Many entrepreneurs and business owners lack the time or the expertise it takes to avoid the pitfalls that come with buying and selling a business. Professional advisors and consultants can lend the insight necessary to point out both the positive and negative aspects of a potential business purchase, providing a wealth of valuable advice along the way.

Experience among advisors varies, so find out:

- ❖ How long the advisor has been in business
- ❖ How many and what kind of companies they handle. Ask for references.
- ❖ What methods are used to evaluate and sell businesses and buyers
- ❖ Hourly rates and all other fees charged for services

BUSINESS BROKERS appraise businesses by analyzing financial statements and tax returns. They also screen potential buyers to ensure they have the ability to purchase a business. A licensed real estate agent should handle business transactions that include real estate. (Finding a business broker who's also a real estate agent is a smart idea.) Brokers charge a flat fee or a percentage of the purchase price.

FINANCIAL ADVISORS & BROKERS find financing sources for sellers via loans and investors. Brokers earn a commission based on the loan amount. Brokers who use Small Business Administration loan programs are paid for their time, since the SBA doesn't allow broker's commissions or sales fees.

ACCOUNTANTS analyze past financial statements and construct realistic financial projections.

ATTORNEYS review legal business documents (leases, patents, insurance policies), construct offers and draft purchase-and-sale agreements (P&S). Negotiations are reviewed by the seller's and buyer's attorneys. An attorney also performs the closing.

Financial Statements & Business Plan

Together, the buyer and seller negotiate a purchase price for a business and develop the purchase-and-sales agreement, which transfers ownership (see page 14). But first, many documents must be developed by sellers, then reviewed by buyers. The process begins by reviewing data from the past including financial statements, pertinent business information, and tax returns which are provided by the seller.

FINANCIAL STATEMENTS

As the sale of a business is negotiated, sellers provide historical (going back three years) and interim (not more than 60 days old) Balance Sheets and Income Statements to buyers. Statements should be less than 30-60 days old since lenders want to see if any major financial changes have happened since the end of the previous year. If the loan approval process takes more than 90 days, the seller will need to provide updated financial statements. If the loan is large, the lender may require financial statements prepared

by a certified public accountant (CPA). With smaller loans, financial statements prepared and signed by an officer of the company are usually acceptable. Financial statements and tax returns must show a profit since small profits make it difficult to get a commercial loan because the new owner will have the added expense of a loan payment. A seller who claims that some business income is not shown in tax returns adds no value to the business since buyers and lenders only consider reported income.

BALANCE SHEET

ASSETS	
Current Assets:	
Cash	10,000
Accounts Receivable	75,000
Inventory (ending)	85,000
Total Current Assets	170,000
Non-Current Assets	
Fixed Assets	140,000
Less Accumulated Depreciation	(25,000)
Fixed Assets (net)	115,000
Advances to Owners	5,000
Total Non-Current Assets	120,000
Total Assets (170+121)	290,000
LIABILITIES	
Current Liabilities	
Current Portion of Long-Term Debt	6,000
Note Payable	100,000
Accrued Taxes	3,000
Accounts Payable (A/P)	41,000
Total Current Liabilities	150,000
Long-Term Liabilities/Loan Payable	50,000
Total Liabilities (150+50)	200,000
CAPITAL OR NET WORTH	
Owners Investment	20,000
Retained Earnings	70,000
Total Capital	90,000
TOTAL LIABILITIES & CAPITAL (200+90)	290,000

A Balance Sheet is a snapshot of a particular period of time in a business. It lists the business assets (what is owned), liabilities (what is owed) and capital (business equity or net worth). Buyers should carefully review this statement with the seller, since it outlines the specific assets included in the purchase. To gain accurate, unbiased values, lenders (not sellers or buyers) order appraisals of assets.

The business plan should include an opening (current) and projected statement for one year, month by month.

INCOME STATEMENT

SALES	
Net Sales	900,000
Cost of Goods Sold:	
Beginning Inventory	75,000
Purchases	325,000
Labor	200,000
Total	600,000
Less: Ending Inventory	(85,000)
Cost of Goods Sold (600 less 85)	515,000
Gross Profit (900 less 515)	385,000
EXPENSES	
Operating Expenses:	
- Selling Expenses	100,000
- General & Administrative	100,000
Total Expenses	200,000
Operating Income (385 less 200)	185,000
Interest Expense	25,000
PROFIT	
Net Profit before taxes (185 less 25)	160,000
Less: All Income Taxes	30,000
NET PROFIT (160 LESS 30)	130,000

An Income Statement is like a company's "report card" - it shows income, expenses, and profits. Also shown are interest payments on loans (not the principal payments, which are included in the Cash Flow Statement). The current Income Statement can be compared with the previous year's to determine if the income, expenses and profits are going up or down.

The business plan should show sales and expenses for the next year, month by month. Some lenders want three years of projected income statements. (See below).

Other names for the Income Statement are the Operating Statement, Earnings Statement, or Profit and Loss (P&L) Statement

THE BUSINESS PLAN

Buyers develop a business plan to buy or finance a business, as well as to predict its growth. A business plan includes the:

- History of the business, its owners, and the reasons the business is being sold
- Executive summary that describes the business and its prospective owners
- Business description of the managers, employees, operations, and location
- Marketing plan including a competitive analysis
- Buyer's personal financial statement (See page 12)

- Buyer's loan request (See page 13)
- Seller's historical financial statements (going back three years)
- Tax Returns: The accuracy of financial statements is done by reviewing the business' past three years of tax returns.
- Buyer's projected financial statements which predicts how the business will perform in the future (see above). Buyers should be realistic when forecasting sales and expenses, since projections need to be proven.
- Cash Flow Statement projecting sales and expenses, month by month, for the next 12 months. (See page 8).

Ratio Analysis

Ratios are business "scores" developed by analyzing historical and projected income statements and balance sheets. Lenders compare a company's scores to acceptable loan ranges.

Buyers should compare current ratio answers to prior years'. The ratios of the company being bought can be compared to national industry averages by using its NAICS (North American Industry Classification System) code number, which can be found at www.census.gov/epcd/www/naics.html.

Numbers used in these examples come from the **Balance Sheet and Income Statement** on page 6

1 Asset Management Ratios

ACCOUNTS RECEIVABLE TURNOVER

Number Source: Balance Sheet & Income Statement

FORMULA

$$\frac{\text{Accounts Receivable } (\$75,000 \times 365 \text{ days})}{\text{Net Sales}} = \frac{\$27,375,000}{\$900,000} = 30.4$$

It takes 30 days to collect bills

NOTE: This shows how many days it takes to collect money owed to you. Lower answers are better.

INVENTORY TURNOVER

Number Source: Balance Sheet & Income Statement

FORMULA

$$\frac{\text{Inventory Figure } (\$85,000 \times 365 \text{ days})}{\text{Cost of Goods Sold}} = \frac{\$31,025,000}{\$515,000} = 60.2$$

60 days to turnover or sell the inventory

NOTE: This formula shows how many days it takes you to turnover (or sell) your inventory. Lower answers are better.

2 Debt Management Ratios

LEVERAGE (OR DEBT-TO-WORTH)

Number Source: Balance Sheet

FORMULA

$$\frac{\text{Total Liabilities}}{\text{Total capital}} = \frac{\$200,000}{\$90,000} = 2.22$$

The company is leveraged 2.22 times

NOTE: Determines if a company has enough equity. Lower answers are better. Lenders prefer this ratio to be 3 or lower.

ACCOUNTS PAYABLE TURNOVER

Number Source: Balance Sheet & Income Statement

FORMULA

$$\frac{\text{Accounts Payable } (\$41,000 \times 365 \text{ days})}{\text{Purchases}} = \frac{\$14,965,000}{\$350,000} = 42.75$$

Accounts Payable are paid every 43 days

NOTE: Shows how quickly suppliers are paid. Lower numbers are better.

3 Liquidity Ratios

WORKING CAPITAL

Number Source: Balance Sheet

FORMULA

$$\text{Current Assets} - \text{Current Liabilities} = \text{Working Capital}$$

$$\$170,000 - \$150,000 = \$20,000$$

NOTE: Shows if a company has enough cash to pay bills. This example shows an excess amount after paying all current liabilities. The answer must be positive. More money is needed to meet expenses if the answer is negative.

QUICK OR ACID TEST

Number Source: Balance Sheet

FORMULA

$$\frac{\text{Total Current Assets of } 170,000 \text{ less Inventory of } \$85,000}{\text{Total Current Liabilities } \$150,000} = .56$$

Answer should be 1 or more. This answer, shows the company could not pay its current liabilities without selling inventory.

NOTE: Inventory may become no longer useful. This ratio eliminates inventory from current assets and cash. It's called "quick" because it includes items that can be turned into cash.

CURRENT

Number Source: Balance Sheet

FORMULA

$$\frac{\text{Total Current Assets } \$170,000}{\text{Total Current Liabilities } \$150,000} = 1.13$$

Number of times you can pay current liabilities

NOTE: Tests a company's short-term debt paying ability. This means there is \$1.13 in cash and current assets available to pay every \$1 of current liabilities.

4 Profitability Ratios

PROFIT MARGIN ON SALES

Number Source: Income Statement

FORMULA

$$\frac{\text{Net Profit } \$130,000}{\text{Net Sales } \$900,000} = .1444$$

The profit margin is 14.4%

NOTE: Shows the percentage of net profit for every dollar of sales. If the profit margin is too low: the prices are too low, the cost of goods is too high, or expenses are too high. Compare the profit margin to previous years (if the business is over three years old).

CASH FLOW TO CURRENT MATURITIES (Debt Service)

Number Source: Balance Sheet & Income Statement

FORMULA

$$\frac{\text{Net Profit of } \$130,000 + \text{previous years Depreciation of } \$10,000}{\text{Current Portion of Long-Term Debt to gain historical answer. New owners should use one year's worth of loan payments. } \$6,000} = \$23.3$$

For every dollar of debt, \$23.30 is available to pay it

NOTE: Shows a company's ability to pay term debts after owners' withdrawals. Lenders prefer 2 or better.

Cash Flow Statement

Cash Flow Statements show 12 months of projected income and expenses after the business is purchased by a new owner. Although numbers in the Cash Flow Statement also appear in the Income Statement, it differs because it records when cash is received, when cash is paid, and how much cash is reserved.

Business profits do not guarantee positive cash flow. Lenders carefully review this statement to make sure all debt and expenses are shown (including loan payments, seller

financing, and assumed leases). This statement proves a new business owner has the ability to pay expenses and loan payments... without running out of money.

Cash strains are revealed in this statement. For example, if a buyer plans to increase sales with new products and services, it causes expenses to grow. Low cash balances can be raised by increasing sales, reducing expenses or by an infusion of money.

	Jan	Feb	Mar	April	May	June	July	Aug	Sept	Oct	Nov	Dec	Total
A. Cash On Hand (Beginning of month)	\$20,000	\$30,500	\$51,500	\$58,600	\$65,600	\$71,300	\$76,700	\$86,900	\$102,600	\$122,000	\$144,000	\$92,600	
B. Cash Receipts													
1. Cash Sales	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	
2. Collections from Credit Accounts	\$70,000	\$80,000	\$75,000	\$80,000	\$80,000	\$85,000	\$85,000	\$90,000	\$90,000	\$85,000	\$8,000	\$80,000	
3. Loan or Other Cash injection (specify)													
C. Total Cash Receipts (B1+B2+B3)	\$80,000	\$90,000	\$85,000	\$90,000	\$90,000	\$95,000	\$95,000	\$100,000	\$100,000	\$95,000	\$18,000	\$90,000	
D. Total Cash Available (A+C, before cash paid)	\$100,000	\$120,500	\$136,500	\$148,600	\$155,600	\$166,300	\$171,700	\$186,900	\$202,600	\$217,000	\$162,000	\$182,600	
E. Cash Paid Out:													
1. Purchases (Merchandise)	\$30,000	\$30,000	\$40,000	\$42,000	\$44,000	\$45,000	\$45,000	\$42,500	\$41,000	\$40,000	\$38,000	\$38,000	\$475,500
2. Gross Wages (excludes withdrawals)	\$11,000	\$11,000	\$11,000	\$12,000	\$12,000	\$12,000	\$12,000	\$13,000	\$12,000	\$11,000	\$11,000	\$11,000	\$139,000
3. Payroll Expenses (Taxes, etc.)	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,200	\$1,300	\$1,300	\$1,100	\$1,000	\$1,100	\$1,000	\$13,000
4. Outside Services	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$800	\$800	\$1,000	\$900	\$1,000	\$900	\$800	\$11,200
5. Supplies (Office and operating)	\$800	\$400	\$500	\$400	\$400	\$400	\$500	\$500	\$400	\$400	\$400	\$300	\$5,400
6. Repairs and maintenance	\$600	\$400	\$500	\$400	\$400	\$500	\$500	\$500	\$500	\$400	\$500	\$400	\$5,600
7. Advertising	\$4,000	\$4,000	\$4,000	\$4,000	\$4,000	\$4,000	\$4,000	\$4,000	\$4,000	\$4,000	\$4,000	\$4,000	\$48,000
8. Car, Delivery and Travel	\$3,000	\$3,000	\$3,000	\$3,000	\$3,000	\$3,000	\$3,000	\$3,000	\$3,000	\$3,000	\$3,000	\$3,000	\$36,000
9. Professional Services (Accounting, legal, etc.)	\$1,500	\$200	\$200	\$1,500	\$0	\$0	\$0	\$0	\$0	\$2,000	\$0	\$0	\$5,400
10. Rent	\$1,500	\$1,500	\$1,500	\$1,500	\$1,500	\$1,500	\$1,500	\$1,500	\$1,500	\$2,000	\$1,500	\$1,500	\$18,500
11. Telephone	\$200	\$400	\$300	\$300	\$300	\$300	\$300	\$300	\$300	\$300	\$300	\$300	\$3,600
12. Utilities	\$600	\$600	\$400	\$400	\$400	\$400	\$400	\$400	\$400	\$400	\$400	\$400	\$5,200
13. Insurance	\$0	\$500	\$500	\$500	\$500	\$500	\$500	\$500	\$500	\$500	\$500	\$0	\$5,000
14. Taxes (real estate, etc.)	\$0	\$900	\$0	\$0	\$800	\$0	\$0	\$800	\$0	\$0	\$800	\$0	\$3,300
15. Interest (on loans)	\$800	\$600	\$500	\$500	\$500	\$500	\$500	\$500	\$500	\$500	\$500	\$500	\$6,400
16. Other/Miscellaneous Expenses (specify)	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
17. Subtotal	\$56,000	\$55,500	\$64,400	\$68,500	\$69,800	\$70,100	\$70,300	\$69,800	\$66,100	\$66,500	\$62,900	\$61,200	\$781,100
F. Other Operating Costs:													
1. Loan Principal Payment	\$1,500	\$1,500	\$1,500	\$1,500	\$1,500	\$1,500	\$1,500	\$1,500	\$1,500	\$1,500	\$1,500	\$1,500	\$18,000
2. Capital Purchases (ex., Buy a computer)	\$0	\$0	\$0	\$0	\$0	\$5,000	\$0	\$0	\$0	\$0	\$0	\$0	\$5,000
3. Other Costs	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
4. Reserve and/or Escrow	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$1,000	\$1,000	\$5,000	\$97,000
5. Owner's Withdrawal	\$2,000	\$2,000	\$2,000	\$3,000	\$3,000	\$3,000	\$3,000	\$3,000	\$3,000	\$4,000	\$4,000	\$4,000	\$36,000
G. Total Cash Paid Out (E17 + F1 through F5)	\$69,500	\$69,000	\$77,900	\$83,000	\$84,300	\$89,600	\$84,800	\$84,300	\$80,600	\$73,000	\$69,400	\$71,700	
H. Cash Position (End of month, D minus G)	\$30,500	\$51,500	\$58,600	\$65,600	\$71,300	\$76,700	\$86,900	\$102,600	\$122,000	\$144,000	\$92,600	\$110,900	

This company has positive cash flow

Financing A Business

There are several ways buyers can finance a business that include the seller, lenders, and investors.

SELLER FINANCING HELPS BUYERS especially if a lender or investor offers to finance only a portion of the purchase price. This financing method keeps the seller involved and interested in the business' success while the new owner takes over. The full sale price is not given to the seller at the closing. Instead, the seller takes back a portion of the purchase price in the form of a loan and receives payments from the buyer, over time. Sellers secure the loan by taking a second position or lien on the business assets. The seller might opt to take the entire purchase price in the form of a loan which is secured by the business assets (the loan is usually at a fixed rate that is comparable to commercial loan rates). Sellers that want a short loan repayment period may add "balloons" in 3 to 5 years. This gives new business buyers several years to gain a financial track record before refinancing to pay off the balloon.

Balloons

Loans are re-calculated and re-evaluated at certain time intervals. For example, if a 15-year commercial mortgage includes five-year balloons, the business owner must re-apply for a loan every five years. The lender may add more points, ask for a new appraisal, or request new inspection reports or required balance paid.

COMMERCIAL LOANS are used for financing a business when no real estate is involved. Term-loans are paid over time (for example, five years). The loan is secured with the business assets and/or the new owner's personal assets. The interest rates on commercial loans fluctuate according to the prime lending rate (reported in financial newspapers). Lenders usually charge percentage points above the prime lending rate. If the lender wants an SBA guarantee, the lender approves the commercial loan and then contacts the SBA for the guarantee.

COMMERCIAL MORTGAGES

A commercial mortgage is used to buy a business that includes commercial real estate. The loan is amortized for a period of time (for example, 15 years) and may include balloons. Some Small Business Administration (SBA) loan programs offer 20 to 25 year loans without balloons and smaller down payments. SBA loans help when a lender is not willing to take all of the risk for the entire amount needed. For example: A lender may offer 50% of the loan request amount on a first mortgage, an SBA program has the second mortgage for 40%, and the buyer puts down 10%. Some new owners will end up with two loans – one for the real estate and another for the business.

INVESTORS, VENTURE CAPITALIST (VC), AND ANGELS

Venture capitalists or "VCs" typically invest in businesses that need \$1 million or more, have a large market, strong earning capacity, and a solid management team. Investors usually want 1) a certain return on their investment over a specified period to time, 2) partial equity or ownership, and/or 3) active participation and decision-making in the business. Plus, they usually have a 3-5 year "exit strategy" which means the business will be merged, acquired, or prepared for going public. Their involvement and investment is defined with legal agreements.

Pricing A Business

BUYER AND SELLERS need to analyze business records and financial statements to develop an accurate selling price. However, the final business price can be difficult to calculate since the perceived value varies according to who is reviewing the business.

There are dozens of valuation methods and formulas. Lenders usually require a valuation when a business is being purchased. Many industries have frequently used formulas for calculating the value of a business. For example, a firm

might be worth the market value of its assets plus one year's income. Another valuation method assumes the business is worth the value of its assets, plus a premium for goodwill (the difference between the value of hard assets and the business purchase price). For example, a premium location or a good distribution system. The valuation method used should be reasonable and realistic.

Buyers and sellers must still understand how the value is calculated even if advisors help determine the business value.

A-B-C-D VALUATION METHOD

THIS IS ONE SIMPLE METHOD FOR PLACING A VALUE ON A SMALL BUSINESS.

This method considers the:

◆ assets being bought
FROM THE BALANCE SHEET

◆ stabilized earnings
FROM THE INCOME STATEMENT

◆ loan interest expenses
SEE SECTION A

◆ business quality
SEE SECTION C

◆ turnkey operation value
SEE SECTION D

A CALCULATE THE ASSETS VALUE & INTEREST EXPENSE USING THE BALANCE SHEET

It's important to break down the selling price of the business assets being purchased. Buildings, equipment, furniture and fixtures are depreciated using IRS rules. Land is not depreciated. Depreciation time frames vary according to the asset.

ASSETS

Land	\$100,000	book or fair market value (state which)
Buildings	\$250,000	fair market value (include appraisal)
Inventory	\$25,000	Wholesale value of raw materials, work-in-process, & finished work
FFEM/Furniture, Fixtures, Equipment, Machinery . .	\$110,000	book or fair market value (state which)
Total Value of Tangible Assets	<u>\$485,000</u>	this number is used in Business Value (Part D, pg. 11)
Plus Working Capital	\$15,000	lowest cash level (usually one month's worth of expenses)
Assets Value	<u>\$500,000</u>	(\$485K + \$15K)

INTEREST

Value of Assets	\$500,000	
Commercial Interest Rate	x 7%	Prime rate of 5% plus 2% (this is the cost of money.)
ANNUAL INTEREST EXPENSE	\$35,000	Use this number in Section B below.

B CALCULATE THE ADJUSTED EARNINGS USING THE INCOME STATEMENT

Sales	\$2,000,000	Previous year's annual revenue/sales
EXPENSES		
Operating Expenses or Cost of Goods Sold ..	\$1,200,000	Previous year's annual amount or estimate
Administrative Expenses	\$600,000	Employee wages, benefits, and associated expenses
Owners Salary	\$50,000	Annual amount, shown separately from other salaries
Depreciation (equipment replacement Fund)	\$50,000	Amount from previous year's tax return/financial statement
Total Expenses	\$1,900,000	Subtract expenses from sales
Earnings	\$100,000	
Less Annual Interest Expense	(\$35,000)	Number from Section A above
ADJUSTED EARNINGS	\$65,000	

C CALCULATE THE BUSINESS QUALITY RATING

Assign a number from 1-6 to each business area. Numbers vary according to who is rating the business-- the buyer or the seller. This should be done separately by both parties and then, together, so the items and their effect on the overall business value can be discussed.

		EXPLANATION OF RATINGS	
BUSINESS AREA	RATING	HIGHER NUMBER FOR: - - - - -	LOWER NUMBER FOR: - - - - -
1. Risk	2	Less risk - - - - -	More risk
2. Competition	2	Less competition - - - - -	Many competitors
3. Industry	3	Good growth - - - - -	Industry is fading
4. Company	3	Business is more desirable - - - - -	Less desirable
5. Growth	2	Good sales growth - - - - -	Sales flat or decreasing
6. Owner's reason for selling	1	Good reason like retirement - - - - -	Bad reason like business losing money
7. Age of business	6	Business is 10+ years old - - - - -	Young companies
8. How long with current owner	6	Business is 10+ years old - - - - -	Young companies
9. Profitability within industry	3	Above industry standards - - - - -	Below industry standards
10. Location	3	Premium locations - - - - -	Problem locations
11. Entry barriers	3	Difficult to take over - - - - -	Easy to take over
12. Customers	3	Growing with loyal customers - - - - -	Flat or shrinking number of customers
13. Technology	2	High-tech or dependent on - - - - -	Low tech
TOTAL	39	Business worth more - - - - -	Business worth less
Quality Rating Average ...	3	39 ÷ 13 (or the total divided by the number of items)	

D CALCULATE THE BUSINESS VALUE

Value of Adjusted Earnings

Adjusted Earnings	\$65,000	Number from Part B on page 10
Business Quality Rating	x 3	Quality Rating Average from Part C above
Adjusted Earnings with Quality Rating	\$195,000	

Business Value

Value of Tangible Assets	\$485,000	from Line 6 of Part A on page 10
Adjusted Earnings with Quality Rating	+ \$195,000	Number calculated above
Final Business Value	\$680,000	485K + 195K
Plus Turnkey Operation Value	\$25,000	\$25K- 100K depending on the business size
TOTAL BUSINESS VALUE	\$705,000	

Buyer's Personal Finances

Personal financial health is an indication of business financial behavior. A personal financial statement should be completed by each owner and anyone who is crucial to the operation. Lenders may have their own personal financial statement form and the information they need is similar to the example below.

A buyer's personal assets may be used as collateral to secure a commercial loan or mortgage. If a loan is not repaid, this collateral will be sold. A loan guarantee may include personal real estate (which can be secured with an additional mortgage) or stocks and bonds which are not for retirement purposes. Assets used as collateral are appraised by lenders and their value is discounted (see page 13).

PERSONAL FINANCIAL STATEMENT	
Assets (what is owned)	
- Cash	\$5,000
- Savings Accounts	\$10,000
- Retirement Accounts	\$5,000
- Accounts & Notes Receivable	\$0
- Life Insurance, cash surrender value	\$0
- Stocks & Bonds (market value)	\$50,000
- Real Estate (market value)	\$200,000
- Automobiles (market value)	\$30,000
- Other Property	\$40,000
- Other Assets	\$0
- TOTAL ASSETS	\$385,000
Liabilities (what is owed)	
- Accounts Payable	\$0
- Notes Payable	\$10,000
- Residential Mortgage, balance	\$100,000
- Investment Mortgage, balance	\$0
- Installment Loan Balance, auto	\$10,000
- Installment Loan Balance, other	\$0
- Unpaid taxes	\$0
- Other liabilities	\$0
- TOTAL LIABILITIES	\$120,000
Net Worth = Assets less Liabilities (385-120)	\$265,000
Total Liabilities plus Net Worth (120+265)	\$385,000

Buyers should review their **personal credit report** since it impacts many decisions, from the maximum loan size to the interest rate. A credit report includes a history of loan payments, and a listing of credit cards and mortgages. Three credit reporting agencies (Equifax, TransUnion, and Experian) provide information to lenders so all available information will be reviewed. A FICO credit score comes from the Fair Isaac Company which condenses personal credit information into one number or score. Credit scores typically range from 500 to 800. Low scores may affect a buyer's ability to get a commercial loan amount or desired interest rate.

Loan Request

A buyer's loan request should resemble this one.

REPAYMENT

The loan is repaid with the business' income (which is proven with a Cash Flow Statement-- see page 8).

Lines of Credit (LOCs) last one year and are used for short-term working capital. They must be paid in full once a year. LOCs use and repayment are reported in the Cash Flow Statement (see page 8).

Intermediate-term loans last one to ten years and are used for buying the business, equipment, and long-term working capital.

Long Term loans last 10 years or more and are used to buy commercial real estate, commercial vehicles, and heavy equipment.

LOAN REQUEST	
• Amount Requested from lender (50%)	\$250,000
• Buyer's Investment (10%)	\$50,000
• Other Investors (40% SBA)	\$200,000
Total	\$500,000
Use of funds	
• Inventory	\$30,000
• Working Capital (expenses for 1 month)	\$100,000
• Equipment & Machinery	\$100,000
• Furniture & Fixtures	\$20,000
• Other	\$0
• Real Estate	\$250,000
Total	\$500,000
Repayment TERMS	
- Furniture, Fixtures, Equipment, Machinery:	10 years
- Real Estate:	20 years
Collateral (for securing a loan):	
• Accounts Receivable	\$0
• Inventory	\$30,000
• Equipment & Machinery	\$100,000
• Furniture & Fixtures	\$20,000
• Real Estate	\$250,000
• Real Estate Equity in buyer's home	\$150,000
• Other including personal assets (savings)	\$10,000
Total	\$560,000

LIFE INSURANCE

Lenders often require term life insurance policies equal to the amount of the loan. A new policy can be obtained or if the borrower already has a life insurance policy, with the required amount, it can be assigned to the lender (if the current beneficiary agrees to the change).

COLLATERAL

The loan will be repaid by first selling business assets and then the personal assets pledged as collateral to secure a loan. Any deficit or unpaid balance, after the collateral is sold, is still the responsibility of the borrower. Lenders request appraisals of the assets and then, discount their value. The total discounted collateral amount needs to equal the total loan amount requested (see #1 below).

1-2-3 METHOD FOR LOAN DECISIONS

This is a general way to see if a business qualifies for a commercial loan and calculates the maximum loan amount. Adequate collateral, a history of positive cash flow, and a good credit history are criteria reviewed for a commercial loan.

	EXPLANATION	EXAMPLE: ABC COMPANY	ANSWER																				
1	DISCOUNTED COLLATERAL COVERAGE Also called COLLATERAL COVERAGE	Every \$1 borrowed must be covered by \$1 in collateral. Lenders discount the value of assets (collateral) so the discounted value must equal the loan amount. This covers the lender in case of foreclosure. This is a common discount formula used with collateral: Example:	Maximum loan based on discounted collateral: \$55K																				
		<table border="1"> <thead> <tr> <th></th> <th>Market Value</th> <th>Discount Percentage</th> <th>Discounted Value</th> </tr> </thead> <tbody> <tr> <td>• Inventory</td> <td>\$30,000</td> <td>50%</td> <td>\$15,000</td> </tr> <tr> <td>• Fixed Assets</td> <td>\$50,000</td> <td>50%</td> <td>\$25,000</td> </tr> <tr> <td>• Accounts Receivable</td> <td>\$20,000</td> <td>25%</td> <td>\$15,000</td> </tr> <tr> <td>Total</td> <td>\$100,000</td> <td></td> <td>\$55,000</td> </tr> </tbody> </table>		Market Value	Discount Percentage	Discounted Value	• Inventory	\$30,000	50%	\$15,000	• Fixed Assets	\$50,000	50%	\$25,000	• Accounts Receivable	\$20,000	25%	\$15,000	Total	\$100,000		\$55,000	
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Total	\$100,000		\$55,000																				
2	THE ABILITY TO REPAY DEBT SERVICE COVERAGE	For every \$2 a business has in annual cash flow, the lender will allow \$1 in loan payments. The ABC Company needs to calculate how much they can borrow and afford to re-pay for a seven-year loan: • \$12K net profit + 3K in depreciation = \$15K annual cash flow • \$15K x 50% = \$7.5K the maximum lenders usually allow in annual payments is half of the annual cash flow • \$7.5K/12 months = \$625 maximum monthly payment • \$625/\$17.13* = \$36.48K rounded to \$36.5K *Monthly payment on a \$1000, seven-year loan with an interest rate of 11% is \$17.13	Maximum loan based on the ability to repay: \$36.5K																				
3	EQUITY DEBT-TO-WORTH OR LEVERAGE	A business can borrow \$3 for every \$1 invested. Assume ABC Company wants to refinance a \$75K loan. The business has assets of \$100K, liabilities of \$75K, and Net Worth or Equity of \$25K. Maximum loan based on equity is \$25K in equity x \$3 or \$75K	Maximum loan based on equity: \$75K																				

LOAN DECISION
The lowest of the three answers calculated here is the maximum loan size. The maximum loan size for ABC Company is \$36.5K.

The Transfer

THE OFFER

A prospective buyer may make a written offer before the purchase-and-sales agreement is developed.

The buyer hires an attorney, preferably one who

specializes in commercial law, to develop the offer. The offer serves as the basis for the final purchase-and-sales agreement. Lenders want the offer signed, by the buyer and seller, before they analyze a loan request.

PURCHASE-AND-SALE AGREEMENT (P&S)

A purchase-and-sales agreement (P&S) shows the buyer agrees to purchase a business and the current owner agrees to sell it within a certain time period and is binding once it is signed by both parties.

The P&S includes:

- the total purchase price and a breakdown including the down payment. How much will be financed?
- a time frame. Commercial loans may take 60 to 90 days to close so the P&S needs to last that long
- actions required by the seller (such as repairs, resolving legal/zoning issues and transfer of licenses.)
- actions required by the buyer such as seeking financing
- accurate appraisals of the business' assets being sold with the business if available. Lenders order their own appraisals including:
 - a list of the inventory and its market value
 - a list of furniture, fixtures, equipment and machinery (FFEM)
 - real estate appraisals and clear property titles (with warranties on title or title insurance)
 - the value of accounts receivable (if being sold) and the the age of the invoices
- copies of transferrable leases and/or leases being re-negotiated with the lessor and letters allowing transfers
- passing inspection reports (federal, state and local, environmental)
- client contracts that transfer to the new owner
- documents showing paid taxes or those that will be paid by the seller at the closing
- how the seller will operate the business until the closing day
- non-compete clauses for sellers with a time frame and geographical boundaries
- a cancellation clause if the buyer cannot get financing

CLOSING

After financing is secured, a closing date is scheduled to transfer ownership from the seller to the buyer. Before the closing day, legal and financial documents should be reviewed by the attorneys and accountants. The lender's attorney or officer usually handles the closing.

Before the closing, the buyer or seller need to handle these issues:

- **Closing costs, points, and fees**
- **Appraisals** are ordered by the lender and paid for by the borrower. If an old appraisal exists, it can be included with the loan request so the lender gets an idea of the historical value.
- **Environmental tests** are ordered by the lender and paid for by the borrower. Old test results can be included with the loan request since they can sometimes be updated or used as to compare to the new tests. If no problems are found in new tests, more tests are not needed. If problems are found, a second round of tests is performed which is usually paid by the seller. Any environmental problems are corrected and paid for by the seller.
- **Escrow agreements** are developed if there are outstanding seller obligations or if work is to be done after the closing. Money is held in escrow and then released after these obligations have been satisfied or when the work is completed.
- **Legal fees and documents** are typically paid for by the buyer. They include the settlement sheet, escrow agreements, bill of sale, promissory notes, mortgages, UCC filings, financing statements, warranties, and agreements (security, loan, covenant not to compete, and any contingent liabilities).
- **Inventory** transferring to the new owner must be saleable. A count of the inventory should be done when the purchase-and-sales agreement is signed and again before the closing. Suppliers' warranties and return policies should be reviewed by the buyer.
- **Accounts Receivable** (money owed to the business) is typically kept by the seller. If receivables are sold with the business, the seller provides a list and total amount and their age (since invoices over 90 days old are discounted or even removed from the sale price).
- **Accounts Payable** are typically the seller's responsibility and are paid at or before the closing. Any expenses remaining with the buyer require an adjustment of the selling price.
- **Taxes** due by the seller should be paid before or at the closing (including property, sales and payroll taxes).
- **Current business** loans are usually re-paid by the seller so the new owner gains clear titles to the assets. Negotiations with the lender must occur if any loans are transferred or assumed by the new owner and require an adjustment in the selling price.