Value Highlights™

Electronic Newsletter for Company Principals and Trusted Business Advisors

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The 7 Deadly Sins of Selling a Business

Many business owners are individuals who have started or acquired a business. Most of these business owners have considered or will consider at some point an exit strategy in order to retire, achieve liquidity to pursue other business ventures, etc. Exit planning may be part of the business owner's overall strategy of acquiring, growing the business, increasing its value, and then exiting the business through a merger or acquisition. Throughout the process of buying, owning, and selling a business, the owner will generally rely on the experience and advice provided by professionals such as legal counsel, accountants, financial advisors, and management advisors.

However, when contemplating an exit strategy many business owners attempt to guide themselves through the process without adequate, professional business brokerage or business appraisal services. This approach is filled with many pitfalls and may serve to actually destroy value in the process of exiting the business. The following seven deadly sins of selling a business have been identified in order to give business owners insight into the top reasons the process of selling their business may fail. The seven deadly sins also highlight the benefits of having a professional business broker and business appraiser involved throughout the process of selling a business.

1. The First Deadly Sin—Unreasonable Expectations of Price and Value

Most business owners believe they know what their company is worth. As they may have worked to build the business, often from the ground up, they feel that their intuitive value conclusions accurately reflect the fair market value of the firm. In many cases, they are biased in their views towards the firm, and therefore, have an inflated sense of value associated with the business. Their value may differ substantially from the value that could be realized in an arms length transaction between a willing buyer and a willing seller. Without a formal valuation of the company, the owners of a business often have nothing other than a gut feeling to support the value that they attach to the business.

Many are reluctant to hire an independent valuation professional to conduct an initial valuation of the company if they do not perceive the need for one. However, the valuation helps to set reasonable expectations for the business owner who has a

preconceived notion of value in their minds. The valuation sets a fair market value that may be realized in a transaction between a willing buyer and seller.

In addition, an independent valuation from an appraiser not affiliated with the business broker or any of the business's other advisors provides an objective opinion of value that is useful in negotiating a transaction price. An independent valuation gives the acquirer of the business a level of confidence that the value conclusion is not biased by the owners or their advisors. This is extremely useful when negotiating transactions from a goodwill, time, and tactical standpoint. Furthermore, a history of periodic or annual valuations (typical for larger businesses) may provide the owners and business broker with a foundation for negotiating even more favorable deal terms.

It is not uncommon for the business owner pursuing a sale of the business to require additional financial analysis services from a business appraiser during the sale process. This financial analysis may involve updates to the original valuation based on changing circumstances after the initial report, analysis relative to potential synergies and the impact on value to a strategic buyer, industry analysis and/or research, financial modeling, fairness opinions as to offers and the structure of an offer, or financial analysis for use in supporting a counter offer to a prospective buyer. This additional analysis is beneficial to the business broker and business owners in supporting their negotiating position. In addition, the independent nature of the analysis and valuation from the business appraiser, who has a familiarity with the company, is helpful in raising the confidence of the prospective buyer, who may be reluctant to accept the claims from just the business broker and the owners.

Consequently, the financial analysis services offered by a business appraiser are useful in negotiations in situations where an initial valuation was not performed. In addition, the prospective buyer and sellers may agree to utilize the services of the independent business appraiser to be the final arbiter of valuation disputes arising during negotiations. This allows both sides to remain amicable when negotiations become tense. Should the buyer acquire a majority interest with the owners retaining a minority interest until a future buyout, on-going analysis and valuations by the independent appraiser are crucial in ensuring a positive goodwill between the parties moving forward.

2. The Second Deadly Sin—Lack of Confidentiality

The key to successfully marketing and selling a business is confidentiality. Business owners do not want customers, suppliers, and the competition to know that their business is available for acquisition. Unlike real estate brokers who hang a "For Sale" sign in front of the property, professional transaction advisors or business brokers maintain a high degree of confidentiality. Whilst the professional business broker may advertise the type of business available on websites or in trade journals, no information regarding the company is distributed until the prospective buyer has executed a confidentiality agreement and passed a pre-screening process which may include financial qualifications. This process is designed to ensure that confidential information

regarding the company's financial performance, operations, and/or proprietary technologies is not distributed promiscuously to prospective buyers who do not have the financial ability to pursue such a transaction, to the general public, or to competitors and their associates.

In some cases, business owners will seek the services of a real estate broker to sell their business. This is usually a very unwise approach for the business owner as real estate brokers are typically unskilled at selling a business. Not only do real estate brokers generally lack experience in successfully selling a business, they also do not have knowledge of the unique process and various aspects of selling a business. A real estate "sales" mindset will likely produce suboptimal results for the owners of the business. Placing a "for sale" sign outside a business may have mixed results in attracting a buyer but can greatly damage a business's relationship with customers, vendors, suppliers, etc.

3. The Third Deadly Sin—Emotions

The process of selling a business is, in many cases, a life changing event for the owners. Many consider the business their "baby." As such, there is a great deal of emotion involved in the process of selling a business.

It is not unusual for the owners to become very emotionally charged in attempting to decide how best to achieve an exit strategy and again once an offer is received. Given that the decision to sell the business has already been very emotional for the owners, adding an offer that the owners may feel is insulting only compounds the emotional aspect of the deal-making process. Therefore, a seasoned transaction advisor or business broker will help the business owner understand the price and terms relative to the negotiating strategy of the acquirer. It is unlikely that the terms and conditions set forth in the initial offer represent the absolute best offer of the acquirer.

Given that the transaction advisor is emotionally removed from the process, he can provide objective advice to the business owner and prevent emotions from running high on both sides. Owners handling negotiations themselves are subject to emotional biases during the process that could damage the professional goodwill with the prospective buyer. The transaction advisor or business broker removes this risk and conveys offers and counteroffers to the parties. Removing this emotional aspect helps facilitate the process and may lead to maximizing the transaction price for the sellers.

4. The Fourth Deadly Sin—Inexperienced Professionals

Most small business owners are skilled at running their business but do not have the background that is conducive to successfully negotiating a transaction involving their business. Lacking negotiating skills may result in leaving money on the table in the transaction. As this is not an optimal outcome for the business owner, it is wise to have an experienced, professional business broker/transaction advisor to negotiate for them to maximize the transaction terms.

Retaining professional transaction advisors can help business owners achieve maximum return on the transaction as compared to the "for sale by owner approach." Negotiating transaction value and terms is no easy task, particularly when the emotions of the owners may be involved directly in the negotiating process. Professional business brokers' experience is useful when negotiating and structuring a deal in creative ways that satisfy both the interests of the sellers and the desires of the buyers.

Furthermore, professional transaction advisors working in conjunction with the seller's business appraiser are able to explain the various exit strategy options that may be available, the financial ramifications of such options, and outline the likely benefits of each option. Owner financing is an often used and attractive way to structure an acquisition of a business. This may eliminate the need for bank financing and allow the seller the opportunity to defer taxes and earn interest on the seller finance note that results in total deal proceeds in excess of the initial transaction price. An employee stock ownership plan (ESOP) is another exit strategy suitable for some businesses that allows the seller to transfer ownership, often times in a tax effective manner, to the employees of the company (via a trust). A seasoned transaction advisor will likely identify potential strategic acquirers for a business (if appropriate)—acquirers whose synergies may make an acquisition operationally and financially attractive. A transaction advisor may also identify financial buyers such a private equity groups (typically for larger transactions) who may already have a platform in the seller's industry. This allows for a sale to sophisticated buyers who generally have ready access to capital for acquisitions.

In addition, a professional transaction advisor will be able to advise the seller on options such as an earnout, whereby the seller is paid compensation over time based on specific performance measures of the company, royalties, or consulting agreements that allow for residual income to the owners after the sale of the business. These opportunities and strategies would likely be overlooked by a business owner pursuing a "for sale by owner" strategy, their legal counsel, and their accountants and by real estate brokers attempting to sell a business. Professional transaction advisors/business brokers will help the business owner expand their exit strategy opportunities and provide options that may otherwise go unnoticed by other advisors. These expanded options may enable the seller to optimize the transaction price of the business.

5. The Fifth Deadly Sin—Insufficient Financial Information

Lack of financial information from both the seller and the buyer of a business has the ability to quickly kill a deal. Nothing is more embarassing for the transaction advisor than to get to close the closing table only to find out that the buyer does not have the money to successfully close the deal. Professional transaction advisors typically have extensive experience pre-screening prospective buyers, which may include income verification, disclosures relating to assets, liabilities, and capital available to put into the deal, and/or letters of credit from a lending institution, etc. The pre-screening for financial qualification is important for closing the deal as well as for avoiding wide

dissemination of confidential information pertaining to the business to parties who do not have the financial capacity to consummate a transaction or to buyers who are "window shopping."

Just as important the financial information from the buyer is the financial information on the business supplied by the sellers. Higher levels of financial statements for the business give buyers a greater comfort level in the accuracy of the financial information presented. Obviously, a buyer would have a difficult time accepting claims regarding financial performance of a business if the business owners do not have financial statements and only offer shoeboxes of receipts and other data. Internal statements, though an improvement, are still only information from the seller and may be, in the buyers' eyes, unreliable. Compiled or reviewed statements prepared by the company's accountant (hopefully a CPA) are of higher quality and likely give the buyer more confidence in the accuracy of financial reporting. Audited statements, the highest level of financials provided by a business, would likely give the buyer the greatest degree of confidence relative to the accuracy of the financial position and performance being reported. There is, of course, a cost associated with the more detailed financial statement preparation, a financial burden many businesses, particularly small businesses, may forego. The buyer would then match these statements against the company's tax returns to futher bolster confidence in the financial reporting. Undoubtedly, a buyer would adjust the value of the offer based on the level of financial information provided.

In addition, many businesses, particularly small businesses, expense items that are associated with the current owner of the business but not a future owner of the business. For example, the business owner may be paying family members who are not actively involved in the business consulting agreements, expensing personal automobiles, health insurance, trips, meals and entertainment, paying an above market level of rent for the facilities that are owned by their family, etc. In the event a formal valuation is conducted, the business appraiser, in valuing the business, removes these distortions to income based on research and estimates of reasonable adjustments that could be made for a willing buyer and seller. This gives the buyer and seller an objective opinion of value based on reasonable assumptions and expections provided by an independent third party, once again highlighting the benefit of having an independent valuation performed as part fo the process of selling a business.

6. The Sixth Deadly Sin—Failure to Cooperate

Once the owners of a business have made the commitment to pursue a sale or merger of their company, a great deal of time must be spent on those parts of the process that lead to the closing—free flow of information, coordinating site visits with prospective buyers, due diligence, etc. Whilst the transaction advisor will work with other advisors so that the business owners do not spend time on marketing the business and negotiating to the detriment of running the business, the process does require the owners to cooperate as needed to ensure a timely flow of information. Owners who drag their heels or do not fully cooperate in getting the required

documentation put together for either the business appraiser or the transaction advisor jeopardize the successful consummation of a potential transaction.

From an appraisal perspective, the business appraiser needs the cooperation of the owners in order to review projections, future strategies, and to identify potential non-recurring expenses and/or revenues in the past and the future or other adjustments to be made to the financials. Without the cooperation of the business owner, the business appraiser may find it difficult to complete the assignment or may make assumptions that are not necessarily beneficial to the owners (i.e. not removing excessive compensation or owners' discretionary expenses from the income statement). Consequently, the lack of cooperation by the owners may prompt the business appraiser to increase the risk profile of the firm, thus having a negative impact upon the value of the business.

Cooperation of the owners is crucial once there is a suitor for the business. Transaction advisors are well aware that time will kill the deal. The longer the buyer waits for information or to conduct a site visit or to meet with owners/management, the more likely the deal is to collapse with the buyer pulling out. Uncooperative owners of the business being acquired destroy goodwill between them and the potential suitor. If the buyer begins to feel that the lack of cooperation by the seller is motivated by the desire to hide something or prevent the buyer from discovering something, the deal is likely to fall apart. Therefore, it is crucial that the seller assist the transaction advisor throughout the process to ensure a free flow of information with respect to financials, legal documents, lease agreements, etc.

The same level of cooperation would be expected of the buyer as well. Delaying by the buyer destroys the goodwill with the seller who may conclude that the buyer is not serious about pursuing a transaction. As a result, the seller may refuse to talk to the buyer or may end any further negotiations. Again, time will kill the deal.

It is the transaction advisors' challenge to ensure that all parties are cooperating to their fullest extent so that the process of arriving at the desired outcome for both parties is successful. In the absence of cooperation from all parties to the transaction, the deal is likely doomed. Once off track, the transaction advisor will be hard pressed to get the deal back on track for a successful closing.

7. The Seventh Deadly Sin—Failure to Disclose Problems at the Outset

After prospective buyers have been pre-screened and have expressed sufficient interest in pursuing an acquisition of the company, preliminary due diligence begins. Preliminary due diligence is a basic analysis of the company, its financial position, etc. to whatever extent permitted by time and the willingness of the owners to divulge information at this stage. Typically, the transaction advisor is able to answer many general questions that may arise. For those questions needing more detailed or technical answers, the transaction advisor conveys the questions to the owners and delivers their responses to the prospective buyer.

It is at this point that any of the company's "warts" that have not already been identified are disclose. It is in the best interests of both the seller and the buyer to fully disclose any problems that either party may have so as not to have any surprises that may kill the deal. For example, if the buyer is awaiting the sale of real estate to purchase the business, the time factor or uncertainty thereof may be a deal breaker. Likewise, if the business has contingent liabilities or competitive or technological issues have changed the likely future performance of the company, this should be discussed at the outset so as not to lead the buyer on. This destroys goodwill between the buyer, the seller, and the transaction advisor and will likely kill the deal.

After all, the information can only be suppressed for so long. Once an agreement has been reached on price and terms, due diligence begins. At this point, the acquirer has had limited access to the target company's financial information, operations, legal documents, management, etc., which may have allowed for some information to be shielded. The due diligence phase is where the acquirer delves deeply into the financial information of the company and other aspects to ensure that the information presented thus far correctly and fairly represents the actual financial, competitive, and operational position of the company. It is during the due diligence that any of the warts not already disclosed will be discovered. Rather than waste both buyer and seller's time and money only to find some "surprise," it is in everyone's best interest to be upfront at the outset to identify any potential pitfalls to successfully closing the deal.

Conclusion

The process of selling a business is often more complex than business owners realize. From the decision to sell the company to closing the transaction, the path is often fraught with potential pitfalls that may derail the deal or create unnecessary and unwanted disruptions, which only serve to place additional stress on the company's owners. From the previous discussion, business owners should be able to recognize the need for a professional business broker and business appraiser in order to successfully achieve the desired results of the sale of the business.