

EXIT STRATEGY

Strategies for valuing a company, building its market value and preparing for a future sale

Is The Offer to Purchase My Company Acceptable?

Once a business owner receives an offer or multiple offers for his or her company, the business intermediary works with the client to evaluate the offers. Each is evaluated to determine acceptability and true strength, based upon multiple criteria. While price is always an important factor, there are many other important variables that influence the decision.

When representing a business for sale, we work with the owner to establish both acceptable and unacceptable criteria to provide a basis for qualifying prospective buyers. Not only must the overall offer be evaluated, the relative weights on the various elements of the offers must be addressed. The importance of these elements will differ depending upon the age, goals and preferences of the seller. A few key considerations are: financial resources required; timeframe objectives; most appropriate companies/industries relative to synergy or strategic fit; and transition requirements, to name a few. The following are common criteria used to evaluate the strength of offers to purchase privately held companies:

1- Price

Is the consideration offered fair and does it meet the realistic expectations of the seller? There may be different expectations of sales price for different types of prospective buyers. For instance, an individual or owner/operator may potentially pay the least, with private equity groups often willing to pay more and strategic buyers likely to pay the most, due to the existing synergies. Typically, an offer for the stock of the company will be lower than for its assets. However, there might be reasons for the seller to take a lower price in the context of a stock sale (see After-tax proceeds, below). If the sale is structured as an asset sale, the question arises whether

any assets are being retained. A lower sale price may result in a higher net yield if the seller will retain the net bal-

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ance between the accounts receivable and accounts payable on the date of the closing.

2- Terms and Structure

What are the financial terms of the deal? How much seller financing is required, at what interest rate and over what time

period? What is the level of security on the promissory note? Is any of the consideration structured as an earnout, contingent upon the company meeting specified post closing targets? How likely is it that the earnout targets will be achieved? Is the acquirer requiring a highly restrictive non-compete agreement?

3- After-tax Proceeds

Does this offer (purchase price and transaction structure) provide the seller with the required after-tax proceeds? Many deals fall apart at or near closing due to a lack of advanced analysis of the tax implications. For example, if the company is a "C" Corporation, a stock sale would typically be preferable to an asset

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SBA Loans Simplified and On The Rise

Among small business owners and acquirers, SBA (U.S. Small Business Administration) loans are generally associated with a mountain of complicated paperwork and substantial waiting periods for loan completion. This tedious process once led to an increase in the desire for all-cash agreements and unconventional financing methods. Thankfully, this is no longer the case.

Though the SBA itself does not make direct loans, it has a number of loan programs to assist small business owners. The 7(a) loan guaranty program is its primary lending program; and eligibility is dependent upon meeting the small business size standards as established by the SBA. Other variables which may impact ability to obtain assistance are business type, cash flow, owner's equity and use of loan proceeds. In depth information can be found on the Small Business Administration's website at -

<http://www.sba.gov>.

With a large network of participating lenders in place, SBA financing has become a very common alternative for small businesses that do not meet some of the strict standards for conventional business loans required by lenders. In today's lending environment, the guar-

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anty can range from 50% to 85%, based upon the loan program used and the principal amount of the loan. This protection allows lenders to make loans they would not otherwise consider. The guaranty also provides lenders with increased flexibility to approve

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longer term loans, loans which do not have sufficient collateral coverage and loans which evidence ability to repay from projected earnings versus actual earnings.

Over the past 7 to 8 years, the SBA has worked hard to streamline its process. A significant amount of paperwork has been eliminated for both business owners and lenders. Today, applications can be submitted via electronic format and many lenders have "Preferred Lender" or "SBAExpress Lender" status that affords wider latitude on the approval and servicing of SBA guaranteed loans. It is not uncommon for SBA loans to be approved in a few business days. According to government furnished statistics, in 2005 over 90% of SBA loan applications in NJ (almost 3,500 loans valued at over \$600 million in the aggregate) were approved within 5 business days of the application... a considerable turn-around from waiting

periods that existed a few years ago.

These improvements are nationwide and not limited to the state of New Jersey. Due to the popularity of the 7(a) program, and the hard work of the SBA to simplify the process, it is now a self-sustaining program with \$15 billion in 7(a) loan approvals last year.

As the SBA now has a large number of participating lenders, applicants should avoid assuming that all lenders establish the same lending criteria. Interest rates can be either fixed or variable and are negotiated between the borrower and the lender. Fixed rates may not exceed Prime plus 2.25% for terms less than 7 years or Prime plus 2.75% for terms of 7 years or more.

According to SBA loan policy, the lender is required to make an effort to take collateral to secure the loan, if available. If unavailable, collateral is not a

requirement to obtain the loan. In certain instances, dependent on the amount of the loan, severely encumbered collateral will not specifically be utilized. At this time, consideration is

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being given to increasing the loan cap of the 7(a) program from \$2 million to \$3 million.

As a result of the increasing popularity of SBA financing and loan availability, a greater number of small and mid-sized privately held business transactions are successfully closing. An added benefit is that the decreased reliance on seller financing enables sellers to achieve less risky transaction structures. ▸

Announcing Sun Business Valuations, LLC

Sun Mergers & Acquisitions has formally established a subsidiary, **Sun Business Valuations, LLC**, to focus solely on providing business valuations and appraisals for privately held companies. Sun's Managing Partner, Stephen Goldberg states: "We have always been a best kept secret in providing valuation services and are excited about branding the division to increase awareness of our long-established service. The sale of businesses provides a transactional perspective that uniquely positions us to provide accurate, quality business valuation services."

Sun Business Valuations is a full service business valuation firm providing Attorneys, CPAs, Investment Advisors, Consultants and Business Owners with professional business valuation services. Sun has performed business appraisals for privately held companies in a wide array of industries such as: business services, manufacturing, distribution, retail, construction and financial services. Sun's business valuations are prepared for a wide variety of purposes including: business sales or mergers, partner buy-outs, estate planning, buy/sell agreements,

divorce settlements, financing and gifting. Sun Business Valuations, LLC is a member of the American Society of Appraisers (ASA) and is a long time member of the Institute of Business Appraisers (IBA). Sun's valuations have been reviewed and accepted by many highly respected accounting firms; stand up to legal scruti-

ny; and, when appropriate, conform to IRS Revenue Ruling 59-60. In addition to providing business valuations, Sun offers related litigation support and expert witness services. Please visit us at www.sunbusinessvaluations.com or contact Stephen Goldberg at 201-727-1300 for further information. ▸

Business Enhancement Diagnostic Test

The value of a business is largely driven by a company's pre-tax EBITDA (Earnings before interest, taxes, depreciation and amortization), also known as adjusted earnings. However, there are many intangibles that also play a large part in determining business value. If a business owner recognizes and enhances these intangible factors in advance, he or she can maximize the value of the company. Although every business is unique, buyers tend to evaluate potential acquisitions in a similar manner. Drawing upon our experience in the marketplace, Sun

Mergers & Acquisitions has developed a diagnostic questionnaire to enable business owners to identify potential areas to improve in advance of selling their company. This analysis focuses on management, human relations, sales and marketing, operations and finance. There are 22 diagnostic questions and related action items that will help a business owner to recognize deficiencies and take pro-active steps to enhance value. If you would like to receive the Business Enhancement Diagnostic, please email sg@sunmerger.com. ▸

Common Questions Relating to the Business Sale Process

As a professional business intermediary, we interact daily with business owners and understand many of their concerns. In each issue, we address common questions of business owners relating to the business sale process.

1 *What is a contingency in a business transaction?*

In the sale of a business, a contingency is a condition that is listed in the contract, Term-Sheet or Letter of Intent that must be resolved, satisfied or rectified by either a buyer or seller in order for the transaction to move forward. If the contingencies are not satisfied then the sale will typically not proceed. Business offers contain numerous contingencies, mostly placed in the offer by the acquirer to identify issues and concerns necessary to close the transaction.

Common contingencies include transactions that are dependent upon buyers obtaining financing; verification of the seller's books and records; obtaining lease assignments/extensions; finalizing employment/consulting contracts with the Seller or other key employees; receiving environment clearance from the DEP; gaining access to speak to certain key customers; and, contract assignments.

A contingency may be utilized when confidential or proprietary issues may influence whether a buyer will buy the business, but the seller is not willing to address specifics until an offer containing price and terms is agreed upon. One example would be securing an ongoing employment agreement with a key employee. This is a reasonable request on the part of the buyer, however the seller will want assurance that all other transactional matters have been agreed to before risking notification of a pending sale to a key employee.

General advice on contingencies:

- ✦ There should be a time period in which the contingency must be satisfied to avoid the transaction being unduly delayed.
- ✦ Contingencies should be reasonable, with a strong probability of being satisfied to avoid wasting time, effort and expense.
- ✦ Contingencies should be limited to important or critical issues; those that impact whether a buyer will actually consummate the purchase the business. Minor items should be discussed and resolved between the parties prior to contract drafting.

2 *What is considered a normalized salary and how is it relevant in determining business value?*

When recasting financial statements of privately held businesses it is typical to normalize the owner's compensation, which is a discretionary amount and is often arbitrary. For example, an owner may choose a compensation package of \$25,000 or \$525,000. This discretionary amount must be replaced with a normalized (fair replacement) salary that is indicative of the cost to employ someone to handle the particular job function being performed in the business. Some owners work 70 hours per week and wear a number of "different hats" that may include highly specialized functions. These business owners may require a normalized salary of \$150,000 to \$200,000 or more to replace their role with outside talent. Other business owners may be absentee or passive and not justify any replacement salary. Typically, the normalized salary increases with the size of the firm, since it is expected that the CEO of a \$20 million company would receive a substantially higher compensation package compared to the CEO of a \$2 million firm. A higher normalized or replacement salary will reduce value since the higher normalized salary reduces the companies recast earnings; and earnings tend to be the primary value driver for privately held companies.

3 *How long will a Buyer expect the Seller to remain with the Company following a sale?*

This is difficult to answer without knowing the qualifications and background of the acquirer. The more familiar the buyer is with the industry or the required skills sets, the less dependent he or she is on the former owner. There are two key areas that must be considered in a transition period. The first involves the time required for a new owner to absorb the majority of the operational aspects of the business. The second involves the time and effort required to transition key relationships with customers, vendors and employees. Most transition periods range from six months to one year. It is common for the former owner to start the transition period on a full-time basis and phase into a part-time role. Buyers generally expect one to two months of the Seller's transitional obligation to be included as part of the purchase price. Remuneration typically starts after this period.

Sun Mergers & Acquisitions is a professional business intermediary firm specializing in the confidential sale and merger of privately held businesses.

Sun Business Valuations, LLC provides valuations and appraisals of privately held companies for business owners and their advisors for a variety of purposes.

Stephen Goldberg, the Managing Partner of Sun M&A, is a Certified Business Intermediary, engaged in sales and merger transactions since 1985. He is a frequent speaker and writer on the sale of privately-held companies.

“Exit Strategy” is distributed quarterly, compliments of Sun M&A, to advise business owners and their advisors on topics involving valuing privately held companies, building market value and preparing for an eventual exit strategy.



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sale to avoid costly double taxation and structure capital gains tax treatment instead of ordinary income tax.

4- Transition Period and Requirements

Some buyers may require a lengthy post closing commitment from the seller. Some sellers may not find this objectionable, while others prefer a relatively short transition period, allowing for retirement or the pursuit of other business endeavors. Conversely, certain sellers may desire more ongoing involvement post-closing than a buyer is willing to commit to.

5- Ongoing Compensation or Retained Equity

Some sellers find it appealing to have an opportunity to generate significant ongoing compensation by working with the buyer to expand the business post-closing. Another consideration may be the opportunity to retain equity in the company (recapitalization), thereby participating in the firm's expansion and potentially generating a second payday. This is particularly common with transactions involving private equity groups who focus on incentivizing the owner, through equity retention, to help build the business.

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6- Buyer Profile

Who is the best type of buyer for this business? Will this buyer bring the necessary resources, contacts and/or expertise to the business to allow it to grow and prosper? If the legacy provided by the business is of importance to the seller, is it likely that this buyer will continue the business as envisioned by the seller? Will this buyer retain the existing employees and/or treat them in an acceptable manner?

7- Chemistry and Trust

Some transactions are jeopardized due to lack of chemistry or trust. If the seller perceives that the buyers are not trustworthy, the probability of closing the deal becomes remote; especially when there is a seller note, an earnout or a lengthy transition involved.

8- Experience

As a general rule, the more experience an acquirer has as a result of being involved in prior transactions, the higher the probability of concluding a transaction. There will generally be less trepidation, less likelihood of buyer remorse and a better understanding of the M&A process.

9- Likelihood of Closing

One of the key assessments required in the evaluation of an offer is the probability of the buyer actually finalizing the transaction. While this is a subjective judgment on the part of the seller's team, there are certain objective facts that can be assessed. For instance: how much equity is the buyer investing into the transaction and how reliant is he or she on third party financing; how strong are the financing sources and the likelihood that the financing will come through without a set-back; how much of an earnest money deposit is the buyer willing to commit; how much analysis went into the buyer's decision and how committed are they to buying the company; what is the quality and experience of the acquirer's advisory team; how reasonable do you anticipate the due diligence requirements to be; and, how responsive are the buyer and the buyer's advisors to the seller's team?

Evaluating an offer is often a daunting task and evaluating and choosing between multiple offers is even more challenging. First the overall offer must be evaluated and then the various elements of the offers must be addressed and given proper weight. The importance of these elements will differ depending upon the age, goals and preferences of the seller.

A key value of the Merger and Acquisition Advisor is the knowledge and experience directed in the evaluation of an offer. Thoroughly understanding a seller's mindset and preferences and determining the “ideal” transaction structure early on in the process will establish key benchmarks that need to be achieved. This enables the seller's team to respond on a timely basis, thereby maintaining momentum that is so crucial to a successful negotiation. Proper attention in this area will allow the transaction advisor to appropriately screen prospective acquirers, making the process more efficient for all parties and, in turn, lead to a greater likelihood of successfully closing a desirable transaction. ▶