

How to Prepare Your Business for Sale

- **Reasons to Sell Today**
- **Putting the Best Face on the Company**
- **Know Your Importance to Buyer**
- **Structuring the Sale**
- **Four Ways to Get Paid**
- **How Much Is the Business Worth?**
- **How to Adjust Financial Statements**
- **How to Increase the Selling Price**

The Purpose of This Report

Selling your business can be a time-consuming, emotionally-draining experience. But you owe it to yourself, your family, and your heirs to invest the energy and time to do it right.

Be sure you understand exactly the total price, as well as the many tax, risk, and business implications. You don't want the final deal haunting you in future years because you missed out on some unrecognized opportunity or fell into some of the hidden pitfalls.

You want to walk away from the sale of your business knowing that you received the best possible price, incurred the minimum tax liability, assumed no liabilities going forward, and received sufficient money for you and your spouse to retire comfortably. You want a full, final, and unquestionable closing.

This Report will help you accomplish those objectives.

If you have any questions, please e-mail us at the address below.

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For Buyers Also

This Report also is a valuable reference tool for buyers who want to know as much as possible about what the *other side* in the negotiations might want and need so a fair deal can be closed quickly and efficiently. The analysis that follows is written for sellers of businesses; buyers can simply reverse the ideas and approach.

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The final price tag is just part of the story; how and when you get paid is the other part.

Introduction: Sale of a Business

Facts: The maximum tax rate on a long-term capital gain is 15%, compared to a top personal tax rate of 35%. That represents a potential federal tax savings of 20 percentage points — \$20,000 per \$100,000 capital gain — and that 20 points doesn't include state, city, and local tax savings.

Best advice: If you're planning to sell your business, start **now**, do the preparatory work with your advisors, and try hard to sell it for **all** cash at closing.

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Establishing the price tag for a business is just part of a broad range of tasks that an owner must complete to assure that he or she receives as much as possible from the sale of a business.

Once a seller has pinned a dollar value on the business, i.e., the answer to the **how much** question, he or she should determine:

- When will I receive the money: all cash at closing, an installment payout, part contingency sale, or a combination?
- What form will it be: cash, stock, installment note, or a combination?
- What assets can be sold separately, e.g., a real estate affiliate owned by me and my family which leases the property to the company?
- How do I make sure I get all the money due me?
- What are my continuing obligations *after* the company is sold: employment, consulting contract, noncompete agreement, etc.?
- How much money will I receive *after* payment of all taxes? How can the transaction be structured to lower these taxes?

And this timing question: Should I sell today or wait until the company reaches a new plateau of sale and profits?

Why Sell the Business

There are a number of excellent reasons for selling a business.

Reduced personal risk — Selling a business lessens an owner's financial risk by diversifying his or her personal investment holdings while providing increased liquidity: cash today versus an investment in a closely-held, non-publicly traded stock certificate.

Higher return on ownership — Look at your current stock ownership from a return on investment point of view. Net proceeds of \$1,000,000 from the sale of the business should generate income for you and your family of \$60,000 a year at an annual return of 6%. Also look at that 6% annual return from a continued *compensation* point of view, which income is not subject to payroll taxes since it's taxed solely as investment income.

Increased retirement money — Selling the business gives you and your spouse *extra* cash to meet your retirement needs. That's critical for many business owners who have little retirement money set aside since, over the years, they invested all available personal capital in the business.

Business continuity — The buyer assures continuity of the business you have worked so hard to build. Selling out also simplifies an estate and assures that your heirs won't be forced to sell the business at a distressed price to provide money for living expenses or to pay estate taxes.

Continued involvement — An owner doesn't have to walk away from the business after its sale. Many buyers want the owner involved in the business, at least during the transition period, usually six months to one year. That continued involvement means a salary or consulting contract and payment of select benefits, e.g., health and life insurance. That added value should be factored into the total "money package" you receive for selling the business.

Need for expansion capital — Many smaller and mid-sized businesses do not have adequate capital to finance growth. Merging with a larger company can

provide the necessary working capital to increase sales, expand production, or move into new product or marketing areas.

Operating advantages — It is usually more efficient for two companies, especially companies with similar products or markets, to operate under one roof. For example, a product developed by a smaller company might be marketed more effectively through a larger and more established sales force, better use can be made of technology, and overhead expenses can be spread over more products. Try to *quantify* these synergies and projected cost savings. Doing so helps you determine the value of your business to the buyer and can substantially increase the selling price.

When to Sell It

Too many business owners refuse to sell out when their business is at its peak and doing well. *Reasons:* There is not a great need for cash and there is less concern about the future. But that's precisely when a company can be sold for its full value — and possibly more. The best time to sell is when you don't have to sell — that's when you have the most negotiating strength.

You also don't want to be in the position of *having to sell* the business because of inadequate working capital, sales and marketing problems, lack of research and development, or any other reason. Selling your business requires good timing, advance planning, and use of professional advisers who know how to present your company to buyers, prepare an Offering Document, and negotiate the best deal for you and your family.

Putting the Best Face on Your Company

Considerable expertise in many different areas is required to close the sale or merger of a business. It's up to you to make certain that your business is presented to the right number of buyers, at the right time, and in the right light.

Don't do it alone: One of your first steps is to consider employing a professional who works full time at the job of helping business owners sell their companies. This professional will help you: (a) present your company, (b) value the business and recommend the asking price, (c) structure the transaction, (d) formulate negotiating strategies, (e) advise on business decisions made while your company is on the

market, and (f) assist you in closing the transaction.

Company document: Next, you and your consultant should prepare written information about your company's operations — history, products, financial profile, customers, niche, production, marketing, sales force, management, and the prospects for future growth. This document should emphasize the strengths of the business while placing the weak points in proper perspective.

An essential part of this overview should be a reconstruction of earnings, a must for closely held businesses since most owners tend to lower taxable income to defer taxes. A reconstruction should add back to pretax earnings such items as excess salaries and fringe benefits paid to the company's owners, nonrecurring expenses, inventory reserves, excess market value of assets over the accountant's reported net book value, goodwill, and other items not reflected accurately or adequately in the balance sheet and income statements.

The total process starts with reviewing the fundamentals of the company and its projections, including the following:

- Analysis of the company's current and historical financial statements, form of business, and taxation.
- The company's special niche or position in the industry, whether for products or services, geographic areas covered, production efficiencies, distribution know-how, reputation, etc.
- Reported and adjusted book values and the fair market and replacement values of the company's assets.
- Financial position, e.g., debt-to-equity ratio, working capital position, operating ratios, annual growth rate, etc.
- Projected sales, profits, and cash flow.
- Company's customer base and each customer's percentage of total sales.
- Whether the company has any goodwill or other intangible values, such as licenses, patents, trademarks, and favorable lease agreements.
- Market price and price-earning's multiples of stocks of other companies engaged in the same or in a similar line of business.
- The present and future condition of the industry and its growth rate.
- Review of the company's charter, bylaws, and other legal documents, such

as employment contracts, lease agreements, and retirement plans.

- Depth, age, and experience of the company's management. Is the owner indispensable?
- Adequacy and capacity of the company's facilities. Are they sufficient to accommodate projected growth? If not, has the need to raise capital for expansion been factored in?

Once this task has been completed, a price tag must be placed on the company by you and the firm who represents you in selling the business.

Know Your Importance to the Buyer

Some potential buyers may be interested in a company for reasons that have nothing to do with the company's balance sheet and profits. Any of these reasons could significantly increase the selling price. *Here's an example:*

One business was acquired by a large company listed on the New York Stock Exchange. The seller had revenues of \$4.3 million, a loss in its most recent year of \$128,000, and an accumulated deficit (negative) net worth of approximately \$1.2 million. **However, the owners still received \$1,800,000 in cash as the purchase price.** *Reasons:* The combination of the two companies resulted in very significant economies of scale, cost savings and, most important, excellent growth opportunities for the buyer. The buyer could immediately increase the seller's revenues by at least \$1.8 million simply by selling the seller's products to its own customer base. In addition, the buyer saved \$400,000 in research and development since the seller had already completed the R&D. There also were synergistic and other cost savings of about \$200,000 a year which made the seller's business profitable despite its deficit of \$1.2 million.

That's why it is imperative for sellers to identify all advantages to the buyer resulting from the acquisition. Always determine why the buyer is interested in acquiring your company and everything he or she stands to gain from owning your company. It is *not* just the company's reported book value, sales, profits, and cash flow. *Specifically, ask yourself:*

- Does our product line fill a gap in the buyer's product line?
- Do we have a trained sales force in place who also can sell the buyer's products and services?
- Does our company offer additional marketing coverage geographically that would cost the buyer a great deal of time and money to establish?
- Is the buyer getting a process, patent, or other assets which are not reflected in our financial statements?
- If the buyer can increase our company's revenues substantially, what will be its projected sales and incremental profits?
- Are there significant tax advantages to the buyer? *Example:* How much can our company's assets be written up by the buyer to generate higher depreciation deductions and greater cash flow?
- How much would it cost the buyer to get to where our company is today, considering the market and replacement value of our assets?

Keep in mind that companies acquire other companies principally for three reasons. First, for *horizontal integration*, that is, to expand geographically or to sell a broader range of products to the same marketplace. Second, for *vertical integration*, that is, to acquire new processes or facilities in the same market, such as a publishing company which buys a printing company to print its magazines. Third, for *unrelated expansion*, where a company, frequently a large public company, enters totally new markets, either to increase its overall growth rate or to diversify and thus diminish its overall market and industry risk.

You must ask as many questions as the buyer. You then will determine why he or she is interested in buying your company. With that knowledge, you will be able to better assess the value of your company to the buyer and negotiate the best deal for you and other company owners.

Structuring the Sale

The best price in selling a business is not always the highest stated dollar price. You also must consider the effect of immediate and deferred taxes, the form and timing of the payments, any future benefits or restrictions on your activity, and any risks assumed in getting your money. *Ask yourself these questions:*

- How much will I net (after taxes) from the sale of the business?
- Will I receive cash, notes, stock, or a combination thereof?
- On an installment payout, what is the term and interest rate on the note and is the note secured by the assets of my company or the shares of stock I'm selling?
- Is the buyer purchasing the company's assets and assuming all or most liabilities?
- What are my continuing obligations to the buyer, e.g., salaried employee, consulting, noncompete agreement? How much money will I receive for these conditions of sale?
- Do I have a bonus or contingent payout as part of the selling price? If so, what are the criteria for payment?

Taxation — The proceeds from the sale of a business can be taxable, partially taxable, tax-free, or tax-deferred. You want to reduce or defer taxes by structuring the transaction to your advantage, and walk away from the deal with as much cash as you can on an *after-tax basis*. Your advisers will help you with this tax analysis. Be sure to use them.

Form of payment — A seller can receive whole or partial payment in the form of cash, notes, other debt instruments (sometimes convertible into the stock of the buyer), stock of the acquiring entity, or some combination of these payments. Of course, all cash at closing is usually best for the seller. Although tax liabilities usually accrue immediately, the seller receives cash to spend or invest as he or she sees fit. He has tremendous liquidity; is free to diversify his investment portfolio; and has no contingent liability or installment payments to worry about.

Payment with the buyer's debt obligation, i.e., a deferred or installment payout,

may spread the tax liability over the period the cash is received. However, if a larger corporation is involved, be sure that the installment note is a direct obligation of the parent company or at least guaranteed by the parent. You don't want a division of a larger company (of which your company is a part) declaring bankruptcy, recapitalizing, selling, or ceasing operations.

Be careful of stock deals: When a seller receives the buyer's stock as payment, he often overlooks the fact that he is making an investment decision of considerable risk. The questions to answer are:

"If I had the cash, would I invest that much money in the buyer's stock?"
"How do I secure any money due me? How do I sell the shares?"

It's a lot different than investing in your own company which you own, manage, and control. With stock or notes from the buyer, you will have substantial monies invested in a company over which you have no significant control. That's why many business owners *escrow* their stock ownership in the company and/or secure any installment note by the assets being sold — with legal release of the escrow and liens *only* after all installment payments have been made by the buyer.

Timing of payment — There's the critical question of timing. As indicated, in most cases, you should try to collect all of your money at closing, *not* over five or 10 years. But the buyer may not be able to come up with the full amount in cash or tax considerations may make a deferred payout desirable. If you go this route, you should consider a higher price for your company; there's more risk. And you should make certain that the buyer has the financial capacity and creditworthiness to meet its obligation to you.

Another option: To bridge the "money gap" between you and the buyer, consider a contingent payout based on future sales and earnings of your company or the combined companies. If this is your choice, specify in the purchase agreement the following: (a) who is responsible for managing the business during the earn-out period, (b) what system of accounting will define sales or earnings, and (c) how much corporate overhead and financing cost will be charged to the new or combined business.

Restrictive agreements — Most buyers will want to protect against a seller starting another company in the same field, winning back his old customers, and

cutting into the buyer's profits by becoming a direct competitor. That's why it's customary for a buyer to ask a seller to sign a covenant not to compete for a 5- to-10 year period. That's okay; but be aware that the value of the noncompete agreement is taxable income to the seller at personal income tax rates up to 35%, not at the 15% capital gain rate.

For the buyer, the value of the noncompete must be written off over 15 years. That's why many buyers prefer a low noncompete value and a higher amount for an employment or consulting agreement, both of which are fully tax deductible when paid to the seller.

Goodwill — For the seller, the sale of goodwill is preferable to a noncompete or consulting agreement (both are taxed at rates up to 35%). In contrast, goodwill produces a capital gain which is taxed at a maximum rate of 15%. The buyer should not object to a higher goodwill amount, since the value of goodwill is written off over 15 years, the same as a covenant not to compete.

Payout period — The buyer often will try to schedule payments due you on a covenant not to compete or other intangible assets according to the length of the write-off period, i.e., 15 years. If you must do an installment payout, limit it to three to five years, obtain collateral, and be sure the installment note doesn't represent more than 25% of the total purchase price.

Compensation — You are entitled to *extra* monies if you are going to be a consultant or employee of the company. These payments should *not* be part of the purchase price for the company itself. It's usually best to negotiate an employment or consulting contract as a *separate* agreement and to integrate its terms within the noncompete agreement to negate the noncompete if the buyer defaults on the payments due you.

Consulting agreement — You may be asked to allocate more of the purchase price to a consulting agreement since the payments to you are tax deductible by the buyer as they are paid and are *not* subject to the 15-year amortization writeoff.

For the seller, all consulting and employment payments are taxed at personal income tax rates (up to 35%), and the annual and total amounts paid must be in a range the IRS considers reasonable. For example, you can't be making \$80,000 a year now and set up a five-year consulting/employment agreement worth \$1 million.

Be aware of this if the buyer wants to set a higher consulting contract in exchange for a *lower* purchase price; the IRS may do its own purchase/sale allocation of the total funds paid by the buyer and received by the seller.

Legal Matters

There are other matters that must be negotiated and settled. *Consider the following questions:*

- Who will prepare the legal documents related to the business' sale? As a general rule, it's best if your lawyer does it.
- What happens if the buyer defaults on the payments due me? What actions can I take? Is there an arbitration clause in the contract? Do I want this clause?
- Whose state's laws will settle legal disputes: the buyer's or my company's? Try to specify your state of residence. If not, you may have to hire a law firm in the buyer's state to initiate and defend a lawsuit.
- Has the buyer given me collateral for any installment note? If no, should I secure the note with the stock/ownership I'm selling?
- Who is responsible for future/unknown liabilities, such as product liability lawsuits dating back to the time I owned the company?
- What are the continuing obligations of the buyer in terms of my employment, consulting contract, fringe benefits, and so forth?
- Have I informed my lawyer and accountant of the information I have provided to the buyer so they can protect me and the company on the *representations* we have made?

While these questions may seem insignificant in relation to the total purchase price, they can loom large during the final stages of negotiation...and in the future after the deal is closed.

Review of Four Ways to Get Paid

Method #1: All-Cash Sale

Advantages: You make a clean break with the company and can invest the net proceeds.

Disadvantages: The tax payable on the proceeds could be substantial and it is due in the year of the sale.

Method #2: Installment Sale

Advantages: Your tax will be spread out and the buyer will have to pay you interest on the installment note.

Disadvantage: There's the risk that the buyer will not be able to make the payments to you in future years.

Method #3: Stock-for-Stock or Combination Sale

Advantages: In most situations, you pay no tax on the stock until you sell it and you share in the growth of both the buyer's company and your own former company.

Disadvantages: You also share in the losses and downturn of the combined company. And, you may be restricted from selling the stock of the acquiring company unless you receive "registered stock", i.e., stock that is publicly traded and can be sold in the open market.

Method #4: Sale of Assets

Advantage: You may be able to get a higher price for the business because of the tax advantages to the buyer of *writing up* select assets to fair market value, particularly equipment and real estate which can be depreciated.

Disadvantages: It may be complicated to take this route. Distribution of gains to stockholders could result in **double taxation**, once at the corporate level and then again when the stockholders receive the distribution. In addition, you still will be liable for liabilities not assumed by the buyer.

* * *

Selling your business can be one of the most difficult — and rewarding — experiences in your life. It takes a great deal of planning and attention to detail to make certain no areas are overlooked that will expose you to greater risk than

necessary or leave you without the money you deserve.

To help you value and adjust your company's financial statements, we have included the Exhibits below. □

References:

Exhibit 1: How Much Is the Business Worth, next page.

Exhibit 2: How to Adjust Financial Statements for the Highest Value and Selling Price, page 19.

Exhibit 3: 14 Ways to Increase a Company's Value and Its Selling Price, page 22.

How Much Is the Business Worth?

You can document and support your asking price by using the following valuation methods. You will want to use as many methods as possible; the more methods you use, the more accurate your average and final, weighted value of the business.

→ *Reported net book value:* This value is prepared by your accountant; it's simply the company's reported assets less all liabilities. To determine *tangible net book value*, simply subtract intangible assets, e.g., goodwill and capitalized financing costs, from reported net book value.

→ *Adjusted net book value:* This method increases the company's net book value to the extent that certain assets (principally real estate, equipment, and inventory) exceed the cost basis of the assets as shown on the company's balance sheet. This approach usually increases the value of the assets and thus the company's net book value.

→ *Replacement value:* This method writes up all assets to their replacement value and then subtracts the liabilities. It can substantially increase a company's value and is principally used when selling a business to company executives or to another company which wants to get into your line of business.

→ *Price-earning's (p/e) multiple:* Here, you simply apply a multiple, say 12, to the company's net income after taxes. If the net income is \$200,000, the value of the company is \$2.4 million. The faster the growth rate, the higher the p/e multiple. This is how most publicly held companies are valued.

→ *Earnings before interest and taxes:* Referred to as EBIT, this method is similar to the p/e method described above. You determine the company's EBIT and apply a multiple to it, usually 4 to 8, principally depending on the company's growth rate, its profit margin on each dollar of sales, and other factors. *Note:* Some appraisers and analysts add depreciation and amortization expenses to the formula

for what is referred to as EBIT-DA.

→ *Dividend value:* This method assumes the company pays out a certain percentage of its net income, say 50%. You average the last three years' net income, say, \$200,000. Then divide the \$100,000 dividend payout (50% times \$200,000) by a desired annual return, e.g., 8%, which results in a value of \$1,250,000 (\$100,000 dividend payout divided by 0.08).

→ *Projected value of earnings:* This method applies a present value rate of about 15% to a company's projected net income. Basically, it is *today's* value of projected net income, usually over the next three to five years. The value can be recalculated to include depreciation and amortization expenses for a total *projected cash flow* value. This valuation method usually results in the highest value for a business whose earnings are expected to increase substantially in the near future. It is also appropriate for young companies with high growth rates.

→ *Multiple of Sales Value:* This valuation method, principally used to value service businesses, applies a multiple of 0.75 to 1.50 to last year's sales, this year's projected sales, or an average of the last three years. *Example:* Your company's sales last year were \$850,000. Based on the higher multiple of 1.50, the value of the business is \$1,275,000. (*Note:* For the factors which affect the multiplier, see *Earnings Before Interest and Taxes*, on the prior page.)

→ *Liquidation value:* This value assumes liquidation of a company's assets and payment of all liabilities. It is used to determine the *absolute* minimum value of a business. *Example:* To determine the liquidation value of a business, you might apply a 25% liquidation value to inventory, 70% to accounts receivable, etc. You then subtract all liabilities to determine the final liquidation value. *Note:* For this valuation method, you may wish to consult with a recognized Asset-Based Lender in your area.

Adjustments and Weighted Value

Valuation adjustments: Many times, an average of the last few years' earnings are used or they are weighted, e.g., a 50% weight to the company's current earnings, 30% to last year's earnings, and 20% to the prior year's. You can do the same,

particularly if the company's earnings are increasing every year. That will help maximize the value of the business. Don't forget to Adjust the Company's Financial Statements, which is explained in Exhibit 2, on the next page.

Weighted value: The final step is to list the results from each valuation method and apply a "weight" (percentage allocation) to each value. An example is shown below, using three of the nine valuation methods explained on the prior pages. To get a conservative reading of the company's value, we applied a greater weight to the adjusted net book value method, which is also less volatile than the other two methods because it doesn't involve earnings, which are more uncertain.

Weighted Value of the Business

<u>Valuation Method</u>	<u>Value</u>	<u>Percent Weight</u>	<u>Weighted Value</u>
Adjusted Net Book Value	\$1,000,000	40	\$ 400,000
Price-Earning's Multiple	\$1,200,000	30	360,000
Projected Earnings	\$1,500,000	<u>30</u>	<u>450,000</u>
Weighted Value		<u>100</u>	<u>\$1,210,000</u>
Average Value without Weights			<u>\$1,233,333</u>

As computed, the weighted value of this business is \$1,210,000. However, *before* accepting that \$1,210,000 weighted value, it should be compared to the *average* value of \$1,233,333 (total values of \$3,700,000 divided by three) and the *median* value of \$1,250,000. Here are the comparisons. The final weighted value of \$1,210,000 represents:

- 98% of the *average* value of \$1,233,333.
- 97% of the *median* value of \$1,250,000.

As a general rule, when the weighted value is within 80% to 120% of the average and median values, you have a reasonable, defensible value. □

How to Adjust Financial Statements For the Highest Value and Selling Price

The goal: To adjust the company's profits upward so you can apply the price-earning's (p/e) and earnings before interest and taxes (EBIT) multiples to the higher profits for a higher value and selling price.

The process: Adjusting the company's financial statements is especially critical for closely held businesses because owners of these businesses typically keep *reported* profits as low as possible to minimize taxes. The techniques owners use to lower their company's taxable income include increasing salaries, declaring bonuses, setting aside more retirement money, starting and investing in affiliated businesses, and writing off bad inventory.

Fact: On average, a company's *adjusted* profits will be 80% above its *reported* profits. Its *adjusted* stockholder's equity (net worth or net book value) is usually 40% to 60% above *reported* equity. So don't penalize yourself today or limit the value of your business just because you made salary, tax, and cash flow decisions which lowered your profits in the past and reduced your stockholder's equity account. In most cases, the impact of those decisions can be explained and illustrated to potential buyers by showing them the adjustments you make to reflect the company's true profitability and stockholder's equity position. And that should be done *before* starting the valuation or selling-out process.

Income Statement Adjustments

Adjustments to a company's earnings should add back to earnings: (a) excess compensation paid to the company's owners/officers and family members above reasonable amounts, (b) extraordinary tax writeoffs of bad debts, unusable inventory and equipment, etc., (c) unreasonably high fringe benefits, and (d) any nonrecurring expenses incurred in one year which benefit the company over future years, e.g., preparation of sales brochures, research and development costs,

establishing a new sales office, etc.

Example of add-backs: If the company's *reported* pretax income is \$90,000 (\$60,000 after taxes) and these adjustments total \$70,000, its *adjusted* pretax income is \$160,000. To this figure, apply a corporate tax rate (say, 35% overall) to obtain the company's *adjusted* net income of \$104,000 (65% times \$160,000). Thus, the company's *reported* aftertax income was *adjusted* from \$60,000 to \$104,000. Now, to determine the value of the business, let's apply a simple 10 price-earning's multiple (p/e) to both numbers:

Reported Net Income: $\$60,000 \times 10 \text{ p/e} = \$600,000$

Adjusted Net Income: $\$104,000 \times 10 \text{ p/e} = \$1,040,000$

Added Company Value = \$440,000

The added value of \$440,000 represents a 73% increase in value above the value based on the company's *unadjusted* financial statements. That shows you the importance of adjusting the financial statements *before* starting the valuation process and setting a price tag on the business.

Balance Sheet Adjustments

Do the same to the assets on the balance sheet, e.g., inventory, real property, leasehold improvements, equipment, and investments in affiliated companies. The reported net book values of those assets also are usually *understated* and must be adjusted upward or downward to fair market or replacement value. The extra values are then added to the company's net worth or stockholder's equity account.

Example: Let's assume that on the company's latest balance sheet, your accountant reports that the net plant and equipment value (after accumulated depreciation) is \$220,000. However, you do some research on current pricing and you find that the current fair market value (FMV) of the plant and equipment (if sold as is) is \$300,000. Thus, you have an *increased value* of \$80,000, which would be added to the company's stockholder's equity account, which correspondingly increases the overall value of the business.

What about the replacement value? This computation is also important since it values the plant and equipment as if they had to be totally replaced today. With rising costs over the years, as well as your depreciation of the assets each year, the replacement value should be substantially higher than the FMV since that value

assumes the assets are sold today in their current used condition. Thus, using an assumed replacement value of \$400,000 in our example above, the company's increased value is \$180,000 (\$400,000 replacement value *less* the accountant's reported net book value of \$220,000). That \$180,000 represents an 82% increase above the accountant's reported value of \$220,000.

Who's interested in replacement values? Potential buyers of the company who want to get into its line of business *or* company-employed executives who want to buy the business from you. *Your selling position is:* It would cost them \$400,000 to replace the equipment and get to where your company is today. Furthermore, the equipment is in place, de-bugged, and fully operational. Those are very strong arguments to use in valuing these assets above the accountant's reported net book value.

Final comments. *First*, if your company is a sole proprietorship, partnership, S corporation, or limited liability company, you must adjust the income statements as if it was a regular (C) corporation with applicable corporate, not personal, tax rates.

Second, if the company owns an affiliate, that affiliate must be valued separately. *Reason:* The value on the balance sheet is the company's net cost, which could be substantially lower than the affiliate's fair market value. Again, that *excess* value is added to the stockholder's equity account and increases the selling price. □

Adjust the company's profits upward so you can apply a multiple to higher profits.

14 Ways to Increase a Company's Value And Its Selling Price

There are many factors which affect the level of the price-earning's multiple applied to a company's profits and thus the resulting value placed on the company.

#1. *Growth rate:* The growth rate of company sales and profits in comparison with our national growth rate and, in particular, the growth rate of the industry the company is in. The higher the growth rate of the company and the industry in which it sells, the higher the multiple.

#2. *Operating profits:* A company's operating profit as a percent of sales and its comparison with industry standards. For example, if the company earns 12% on each dollar of sales and the industry average is 8%, the difference of 4 percentage points supports a much higher multiple.

#3. *Fundamentals:* Good profits and return ratios, excellent management, solid balance sheet, adequate facilities for growth, etc.

#4. *Niche:* The company's special position in the industry, whether for products or services, geographic area covered, production efficiencies, distribution know-how, reputation, trade name, etc.

#5. *Multiple sales opportunities:* Products or services have multiple markets and end-users, providing an opportunity for growth within current markets and from future penetration into new markets.

#6. *Proprietary products:* Proprietary nature of the products and services, e.g., compare a company which is solely a distributor of products versus a manufacturer which has proprietary products. The more proprietary the products and services, the higher the p/e multiple to be applied to your company's profits.

#7. *Customer list:* Breadth of the company's customer base, i.e., good distribution versus a heavy reliance on a handful of major customers. Also consider the *average* number of years these customers have been buying from the company, e.g., two years versus five years.

#8. *Product mix and gross profit:* The greater the number of products the company sells, and the greater the gross profit (percentage return) on those

products, e.g., 40% versus 20%, the better. The higher the return on sales, the greater the number of dollars that flow to profits and thus the greater the multiple that can be applied to those profits.

#9. *Replacement value of assets:* View your company from the eyes of a prospective buyer. How much money would it cost the buyer to replace the business' current assets and operations and how long would it take to get to where you are today? Knowing this replacement cost data is critical to negotiating a good deal and getting a higher multiple (price) for the business.

#10. *Interim results:* If they reflect a good increase in sales and profits, e.g., your six months' results show a 30% increase in sales and profits, you can *annualize* the results and apply the multiple to the higher profits.

#11. *Income projections:* The higher and more certain the projections, the higher the multiple you can apply to the company's profits.

#12. *Growth capacity:* The company's current working capital, facilities, and employee levels are adequate to meet its sales and profit projections for the next few years.

#13. *Same line of business:* When a buyer is rounding out a product line you already have or expanding to a geographic area you already cover. In these cases, you should first adjust the company's profits upward (costs lowered) to allow for the buyer's reduced costs of buying the company, e.g., duplicate accounting and legal fees, select administrative and sales expense, and lease/rental expenses if the buyer intends to consolidate your operations into his or her company's. In essence, you want to know the buyer's profit *after* acquiring your business.

#14. *Intangible assets:* Review all intangible assets; many may have already been written off and have a *zero value* on the company's balance sheet. These intangible assets can include: long-term customer and supplier contracts, high-traffic location, favorable leases, trained employees and a solid long-term management team, growth in the company's backlog, special manufacturing processes, licenses, trademarks, patents, copyrights, franchise, and/or an exclusive territory or product rights.

By carefully analyzing your company, you should find more assets which were previously written off or for which the cash was already expended. Again, these assets can add greatly to the value of the business and its selling price. □

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