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Tips for Buying or Selling a Business

Presented by: Victor W. Vaccaro, CPA/ABV, CFF

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Overview

- Acquisitions are common among larger businesses, but it is often more difficult for smaller companies to use acquisitions as part of their growth strategy or to plan for an external sale as a means of ownership transition.
- Valuation multiples tend to be lower in smaller transactions and plans for continued employment post transaction will be even more critical.
- In this session, we will cover these issues and empower small to medium sized businesses to find a path to an external sale.
- In addition, we will also provide information to help possible acquirers successfully purchase small companies that will complement their business and help their company grow and thrive.

Reduction Two (2) Main Types of Ownership Transition Plans

- **Internal** – Transition of existing ownership to key employees or family members who have or will take an active role in the company
  - Common internal ownership transition strategies include gifts, cross-purchases, redemptions, stock bonuses, deferred compensation and employee stock ownership plans (ESOPs)
- **External** – Transition of existing ownership to individuals or entities outside the company
  - Common external ownership transition strategies include mergers, stock acquisitions, asset acquisitions and liquidations
- Business owners generally seek to accomplish an internal succession plan before looking to outside buyers as an exit strategy; however, due to synergies, value may be greater with an external plan (merger/acquisition)

Internal Ownership Transition Plans

Pros	Cons
• Continuation of the business	• Lack of future owners
• Access to a pool of buyers who are in the company	• Candidates for ownership may be more risk adverse
• Assurance of a reasonable return	• Funding through current operations
• Ongoing control until retirement	• Possible transfer for less than maximum value
• Continuance of salary and benefits	• Greater risk post-transition if management not properly transitioned

Internal Ownership Transition Planning Process

Phase 1

Valuation

- Establishes the current value of the company
- Aids in projecting the value over term of plan
- Estimate of "dollars" to be transitioned

Phase 2

Transition Plan Structure

- Identify the goals of existing owners, family members & key employees
- Develop plan structure that "meshes" these goals
- Addresses key elements of timing, funding, affordability & taxes

Phase 3

Buy/Sell Agreement

- Incorporates key elements of valuation and transition plan structure
- Provides legal substance to transition plan
- Eliminates confusion in the event of death, disability, retirement or separation from service of a current or future owner

External Ownership Transition Plans

- When companies do not have the necessary ingredients for an internal ownership transition plan, business owners must then look to external exit strategies, including the following:

  - Mergers
  - Asset Acquisitions
  - Stock Acquisitions
  - Orderly Liquidations
  - Forced Liquidations

External Ownership Transition Plans

Pros	Cons
• Possible transfer for maximum price	• Difficulty in finding right buyer
• Provides for greater liquidity and less risk for existing owners	• Confidentiality
• Shorter time frame	• Post-merger integration can be difficult due to cultural differences
• Add new talent, skills, markets or service offerings	• Loss of control and identity
	• Staff / client retention

Merger/Acquisition Planning Process

Phase 1	• Pre-Acquisition Review of Existing Business
Phase 2	• Search & Screen Potential Buyers / Targets
Phase 3	• Investigation / Valuation / Due Diligence
Phase 4	• Negotiation & Closing
Phase 5	• Post-Merger Integration

Positioning the Company for Sale

- **Consider goals in selling the business**
  - Obtain maximum in cash for sale
  - Provide for continuity of business
  - Allow for continued employment of owners or key employees
- **Determining what will be sold**
  - Entire entity
  - Divisions, locations or business segments
  - Specific assets
- **Evaluate steps to prepare company for sale**
  - Maximize potential value
  - Allow for a smooth sale and transition process

Searching for a Buyer or a Target Business

- **Finding a buyer for your company**
  - Who are your potential buyers?
  - How can you reach them?
  - Establish a process for “qualifying” potential buyers
  - Confidentially is key throughout the entire process
- **Searching for acquisition targets**
  - Consider your goals in acquiring a business
  - Evaluate businesses that are actively for sale
  - Investigate other companies that might be a strategic fit
- **Consider utilizing a business broker**

Fit Is More Important Than Price!

- Certainly it is important for both the buyer and seller to work out a good financial deal, in fact most of our session today will focus on financially related matters.
- However, it is rare that a slightly higher or lower deal price will be the deciding factor in whether a transaction is successful.
- Instead, whether a transaction truly works for both parties will be based on things like:
  - Culture
  - Client satisfaction
  - Employee retention
- After cultural fit, the structure of the transaction actually has more ability to lead to success or failure than does the deal price.

Get to Know the Business and the People

- The potential buyer and potential seller should make a significant effort to get to know each other.
- It is better to find out that cultures aren't aligned during the discussion process than during due diligence and especially before a deal is completed!
- Senior management with each company should plan time for meetings to make certain that the entities will fit well together.
- Well planned deals may also involve meetings of operational personnel that will be critical to the future of both organizations and possibly instrumental in the integration of the businesses after an acquisition.

Financial Reporting and Results are Critical

- Must get internal financial reporting process in good order
  - Evaluate quality of internal financial statements and make improvements as needed
  - Budgets, forecasts and projected financial may play a key role
  - Consider other financial analysis that will be useful in evaluating potential sale
- Consider type of annual financial statement and reliability of information
  - Audit
  - Review
  - Compilation
- Annual tax returns will also be reviewed by a potential acquirer

Business Valuation

- A proper business valuation is both an **art** and a **science**
- The science of business valuation is represented by systematic approaches, quantitative analysis, fact gathering and research about the subject company, the industry in which it operates and other internal and external factors impacting the company's business and ability to generate future cash flow
- The art of business valuation is represented by those who have the depth of experience and expertise in the science of valuation to achieve the best result by weighing the underlying components of value and taking into account all relevant issues at hand

The Valuation Process

- Purpose, Standard of Value, Premise of Value, Valuation Date, Nature of Subject Interest, Limiting Conditions
- Financial Analysis, Economic Analysis, Industry Analysis, Site Visit
- Benefit Stream
- Risk Analysis – Discount Rate / Capitalization Rate
- Valuation Approaches – Asset, Income, Market
- Asset Approach – Adjusted Net Assets
- Income Approach – Discounted Earnings (Cash Flow) or Capitalization of Earnings (Cash Flow)
- Market Approach – Guideline Public Company Method, Comparable Sales, Rules of Thumb
- Selection of Most Appropriate Approach or Model
- Valuation Discounts / Premiums
- Sanity Checks
- Value

Purpose of a Valuation

- Business valuations are conducted for a variety of strategic, legal, tax and financial reporting purposes, including the following:

  - Internal Ownership Transition
  - Estate, Gift & Income Tax
  - Employee Stock Ownership Plans
  - Financial Reporting
  - Allocation of Purchase Price
  - Buy/Sell Agreements
  - Reorganizations and Bankruptcies
  - Business Planning
  - Mergers & Acquisitions
  - Litigation & Ownership Disputes
  - Dissenters' Rights Cases
  - Shareholder Oppression Cases
  - Goodwill Impairment
  - Family Limited Partnerships
  - Recapitalizations
  - Stock Option Plans

Valuation Reports

- There are generally two (2) types of valuation reports, including the more detailed Valuation Report and the more abbreviated Calculation of Value.
- For many of the purposes of valuation, a formal valuation report must be prepared and would be relied upon to support the transaction.
- For an acquisition, an actual written valuation report is not always needed or utilized as each side would instead have their own analysis that they would use to support their negotiating position.
- However, a seller may have a valuation report prepared so that it can better understand the possible value of its business and in some cases a buyer may commission a valuation report as part of its investigation of the seller.

Standards of Value

- The proper **Standard of Value** for valuing a closely-held business is based on an assumption or set of assumptions regarding the specific characteristics of the buyer and seller (either hypothetical or actual) in a given set of circumstances surrounding a particular transaction (or assumed transaction)

- There are three (3) principal **Standards of Value** for valuing a closely-held businesses:
  - **Fair Market Value (IRS Value)**
  - **Fair Value (Stockholder's Value)**
  - **Investment / Strategic Value (Merger/Acquisition)**

Fair Market Value

- IRS Revenue Ruling 59-60 defines Fair Market Value as:

"the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property."

Fair Market Value

- **Fair Market Value** standard is the most recognized and accepted standards used in all tax situations (estate, gift, income tax, purchase price allocations, etc.)
- Key elements of the **Fair Market Value** standard are that the parties to the transaction are "hypothetical," the transaction is at "arm's-length" and that the buyer and seller are able and willing
- **Fair Market Value** will contain a premium for control and a discount for minority interest
- Because a fair market is based on a hypothetical buyer and a hypothetical seller, this value can be affected by an actual buyer or seller's unique motivations

Fair Value (Stockholder's Value)

- **Fair Value** is the appropriate standard for state actions including dissenting rights cases and shareholder oppression cases; however, its definition and application can vary from state to state

- **Fair Value** is defined by the Uniform Business Corporation Act as "the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action"

- The **Fair Value** standard possesses some characteristics of Fair **Market Value** in that there is commonly a willing buyer but not a willing seller. However, the parties are typically known and the buyer may be more knowledgeable than the seller

- Many valuation experts consider **Fair Value** to be **Fair Market Value** without discounts for minority interest or lack of marketability

Investment Value

- International Glossary of Business Valuation Terms defines **Investment Value** as "the value to a particular investor based on individual investment requirements and expectations"
- Stated differently, **Investment Value** is the value to a particular investor, which reflects the particular and specific attributes of that investor
- In contrast to **Fair Market Value**, the **Investment Value** standard identifies a particular buyer or seller and the attributes that buyer or seller brings to the transaction
- Also commonly referred to as **Synergistic Value** because of synergies between the buyer and seller (geographic location, specific product or service offerings, know-how, customer base, competition, etc.)
- The **Investment Value** standard is typically used in merger/acquisition transactions

Levels of Value

Strategic Value of Closely-Held Business Sold to Outsider

Synergistic Value
(Investment Value or Acquisition Value)

Premium 10% - 40%

"Deal Zone" – sales price to outsider

Internal Transfer Price
- No premium for control
- No discount for minority interest

Fair Value of Closely-Held Business
(Stockholder's Value)

25% - 50% Discount

Value for Income, Estate and Gift Tax
-Premium for Control and Discount for Minority Interest
-Marketability Discount

Fair Market Value
(IRS Value)

Premise of Value

- **Premise of Value** is an assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation

- The three (3) main **Premises of Value** are:

  - **Going Concern Value** - the value of a business enterprise that is expected to operate into the future; the intangible elements of going concern value result from factors such as having a trained workforce, an operational plant and the necessary licenses, systems and procedures in place

  - **Orderly Liquidation Value** - the liquidation value at which the asset or assets are sold over a reasonable period of time to maximize the proceeds received

  - **Forced Liquidation Value** - the immediate liquidation to minimize the timing in which the sale proceeds are received (i.e. auction price)

Elements of Value – Revenue Ruling 59-60

- IRS Revenue Ruling 59-60 introduced eight (8) factors that must be considered in determining the fair market value of a closely-held business
  - The nature of the business and history of the enterprise since its inception
  - The economic outlook in general and the condition and outlook of the specific industry in particular
  - The book value of the stock and financial condition of the business
  - The earning capacity of the business
  - The dividend-paying capacity of the business
  - Whether or not the enterprise has any goodwill or intangible value
  - Sales of the stock and the size of the block of stock to be valued
  - The market price of stocks engaged in the same or similar line of business having their stocks actively traded in a free or open market

Valuation Approaches

- Valuations of closely-held businesses fall into any one of three (3) general approaches
  - **Asset Approach** – Value of the business is based solely on the value of the entity's assets net of liabilities, including both tangible and intangible assets
  - **Income Approach** – Most widely used method of valuing a closely-held business where value is the sum of the present values of the expected future economic benefits attributable to the ownership interest
  - **Market Approach** – Value of a closely-held business is determined by reference to the market values of comparable companies who are either publicly-traded or were recently sold in the private marketplace

Valuation Approaches – Asset Approach

- **Book Value Method** – The value of the business is determined by reference to its historic book value (assets – liabilities) as reflected on its financial statements

- **Adjusted Book Value Method** – The value of the business is determined by reference to the historic book value, adjusted to fair market value to reflect the settlement of its assets and liabilities in cash as of the date of valuation
  - Presents the value of all tangible and intangible assets and liabilities
  - Generally represents "liquidation value"

Valuation Approaches – Asset Approach Adjusted Book Value Method

- Due to the limitations inherent in financial statements prepared under GAAP, adjustments to a company's historic balance sheet is required to determine the fair value of a business under this method

- The valuation adjustments common to companies in determining the value under the Adjusted Book Value Method include:
  - Securities and investments
  - Billed receivables and an allowance for uncollectible accounts receivable
  - Inventory reserves
  - Unbilled work-in-process
  - Depreciation of property, plant and equipment and valuation of assets including real estate
  - Cash surrender value of life insurance
  - Unrecorded liabilities (vacation pay, sick pay, deferred compensation, benefit plans, lawsuits)
  - Deferred income taxes

Valuation Approaches – Asset Approach

Pros	Cons
• Easy to calculate and understand • Establishes "baseline" value or liquidation value of the business	• Ignores future earning capacity of the business • Financial statements prepared under GAAP may not be representative of market value due to historical cost principle

- Although Revenue Ruling 59-60 requires that the Asset Approach be considered in business valuation, it is seldom relied upon in rendering a final conclusion of value for operating companies in which value is more appropriate determined by reference to earnings or cash flow

Valuation Approaches – Asset Approach Impact on Acquisition

- The Asset Approach should have a direct impact on the value of the business and amount received or retained in an acquisition!

- If the selling company has cash or other non-operating assets, those will most often be retained by the seller, or if they are purchased as part of the transaction they would contribute to the value on a dollar for dollar basis.

- The operating assets or working capital may also factor into the valuation on a dollar for dollar basis, and may in fact be part of an adjustment to the transaction price.

Valuation Approaches – Income Approach

- The Income Approach is most reflective of the "forward looking" premise of business valuation

- Under the Income Approach, the value of a closely-held business equals the present value of the expected future economic benefits discounted at the appropriate rate to reflect the risk associated with the entity

- The Income Approach can be represented by a fraction (or series of fractions) where present value equals:

$$\frac{\text{Expected Future Economic Benefit Stream}}{\text{Discount Rate}}$$

Valuation Approaches – Income Approach Methods

- **Discounted Future Earnings (Cash Flow) Method** – a method under the income approach in which a series of future economic benefits is converted to present value using an appropriate Discount Rate

- **Capitalization of Earnings (Cash Flow) Method** – a method under the income approach in which the economic benefits for a single period are converted to present value through division by a Capitalization Rate. For example, a capitalization rate of 20% equals an earnings multiplier of 5 times.

- As illustrated in the foregoing, the key difference between a Discount Rate and a Capitalization Rate is the expected long-term growth rate of the business being valued

Capitalization Rate = Discount Rate – Long-Term Growth Rate

Valuation Approaches – Income Approach Process

Normalization Process

- Restatement of historic financial statements that can be used to determine future economic benefit stream
- Normalization adjustments include adjustments for ownership characteristics (control vs. minority), GAAP departures, extraordinary or nonrecurring items, non-operating items, taxes and synergies

Define Benefit Stream

- Single period benefit streams (capitalization method) and multi-period benefit streams (discounted method) are usually defined as "net income" or "net cash flow"
- Whether earnings or cash flow is used, it is important to determine who will receive benefit stream – equity holders or invested capital holders (debt and equity holders)

Develop Discount Rate

- Build-Up Method
- Capital Asset Pricing Model (CAPM)
- Weighted Average Cost of Capital (WACC)

Calculate Present Value

- Utilizing either the capitalization method or the discounted method, apply the proper discount or capitalization rate to the economic benefit stream to determine present value under the Income Approach

Valuation Approaches – Income Approach
The Economic Benefit Stream

- As illustrated above, the two critical components of the income approach are the economic benefit stream and the discount rate used to convert the economic benefit stream to present value

- The economic benefit stream should match the characteristics of the denominator (e.g. pre-tax or after-tax) and should be appropriate for the ownership interests being valued

- The economic benefit stream used in an acquisition is most often the Earnings Before Income, Taxes, Depreciation, and Amortization (EBITDA)

- In order to predict future earnings, the company's past earnings are most often used as a guide

- Revenue Ruling 59-60 indicates:

  "Prior earnings records usually are the most reliable guides for future expectancy."

Valuation Approaches – Income Approach
The Economic Benefit Stream

➢ Common adjustments to the income stream include the following:

- Discretionary bonuses and salaries
- Pension, profit-sharing and retirement plan contributions
- Depreciation
- Non-recurring expenses relating to marketing, office start-up expenses, insurance claims, etc.
- Rent and other related-party charges
- Non-operating items of income including gains on fixed asset sales, investment gains, etc.

Valuation Approaches – Income Approach
Determining the Economic Benefit Stream

- As indicated above, historic earnings, adjusted for abnormal and non-recurring items are usually the best indicator of future earnings
- Under the income approach, the "look-back period" should be the most recent period and most representative of future performance
- The valuation for most companies utilize a five (5) year look-back period as this generally encompasses a complete business cycle of a company
- Many valuation cases have used ten (10) or more years; however, the historic earnings outside of a five (5) year period will generally have little use in the current valuation of a company
- For companies that have been in business less than five (5) years, a shorter period is used
- If the company was in "start-up" or its current operations are substantially different (due to growth, recessionary impacts, etc.), then a shorter period must be used

Valuation Approaches – Income Approach
Determining the Economic Benefit Stream

- Past earnings should not simply be averaged in order to arrive at future earnings – evaluation of the recent trends and expected future performance of the company needs to be taken into consideration
- Consider the following example of two companies and their historic after-tax adjusted net income for a representative five (5) year period:

Year	Firm A	Firm B
20X1	$5,000	$45,000
20X2	15,000	20,000
20X3	15,000	15,000
20X4	20,000	15,000
20X5	45,000	5,000
Total	$100,000	$100,000
Average	$20,000	$20,000

Based on the above, both companies would have average earnings of $20,000; however, both companies have very different trends.

Valuation Approaches – Income Approach
Determining the Economic Benefit Stream

- A more representative approach would be to weight the earnings in order to give benefit to the discernable trend in earnings demonstrated by each company

- Consider the following weighted average earnings calculation for Firm A:

Year	Earnings	Weight Factor	Weighted Earnings
20X1	$5,000	1	$5,000
20X2	15,000	2	30,000
20X3	15,000	3	45,000
20X4	20,000	4	80,000
20X5	45,000	5	225,000
	Total		385,000
	Divided by: # Years		15
	Weighted Average		$25,667

This weighting reflects the upward trend in earnings for Firm A. In similar fashion, Firm B would have a weighted average earnings of $14,333, each resulting in a different valuation

EBITDA Multipliers and Transaction Size

- Historically acquisitions of larger companies have been at slightly higher multiples than smaller acquisitions.
- This has often been due to additional risks associated with smaller businesses, including dependence on the owners and possibly concentration with a few key customers.
- More recently we are seeing further separation with larger companies being acquired at EBITDA Multipliers in the range of 7 to 8 times, while smaller companies are still seeing multiples in the range of 4 to 5 times EBITDA.
- While risk plays a major factor, the source of funds available to public acquirers and their ability to leverage a transaction with debt financing also make it possible for public companies to pay higher transaction multiples for large acquisitions.

Valuation Methods – Market Approach

- **Public Multiples of Value Method** - Uses guideline publicly traded companies and applies median multiples of items such as earnings, cash flow, EBITDA, revenue, and book value

- **Comparable Transaction Method** - Various services provide details on the acquisition of private companies. From these databases, comparable companies can be selected and median multiples can be determined similar to those with public companies as indicated above

- **Industry Rules of Thumb** - A formula based valuation calculation using multiples of company data such as sales, net income, or EBITDA using multiples commonly applied for actual transactions within specific industries

Valuation Methods – Market Approach

Pros	Cons
• Easy to calculate and understand	• Comparable public companies often are not really comparable to a privately held company that is considerably smaller and often less diversified
• Considers external factors including market multiples at the valuation date	• Rules of thumb often provide a very basic calculation that does not consider all relevant factors
• Utilizes key value indicators that buyers in a particular industry might consider	• They often result in significant value ranges depending on the rule of thumb being employed
• They are easy to use and understand	• They ignore the specific characteristics of a given company which contribute to value
• They can be used to determine "preliminary value"	

Common Rules of Thumb for Acquisitions

- As indicated above, the most common rule of thumb is that values are based on a multiple of five (5) times EBITDA, with higher multiples for large companies and possibly slightly lower multiples for smaller businesses.
- This valuation based on EBITDA may include delivering a reasonable amount of operating assets including working capital, or the asset portion of the transaction could be in addition to the value based on EBITDA.
- The next most common valuation rule of thumb is based on a multiple of revenue.
  - The multiple of revenue can vary greatly between different industries.
  - Multiples will be highest in industries that generate a greater percentage of net income to revenue.

Valuation for an Acquisition

- A valuation for an acquisition is often accomplished by utilizing a "hybrid" approach which considers the fair market value of the company's net assets at a particular point in time to establish a "minimum value" for the business (i.e. orderly liquidation value)
- However, the fair market value of the net assets ignores the company's earning capacity and ability to generate future cash flow to owners which is reflected as "goodwill value" or "value of operations"
- Therefore, the best approach to value a professional business is to consider both the value of the net assets as well as the company's future earning capacity
- From a theoretical valuation perspective, this methodology is a "Capitalization of Earnings" model that adds excess operating and non-operating assets

Valuation of a Business

- This hybrid approach works very well with acquisitions of small businesses as the value is often split between an asset value, possibly that is kept by the seller, and a goodwill or operating value.

- Assets and liabilities are analyzed in detail to determine their "fair value" as of the date of valuation and represents a minimum value or floor value

- The company's historic income statement is analyzed in great detail to ascertain the company's future earning potential; key considerations include:
  - The trend in revenue
  - Financial ratio analysis and comparison to industry norms
  - Pre-discretionary net income available to owners
  - Risk considerations (both quantitative and qualitative) affecting the company's future earning potential

Valuation for an Acquisition

- In an acquisition, the value of operations is most often determined as a multiple of EBITDA
- The EBITDA used in computing the value should be after the potential adjustments to income for discretionary or unusual items.
- While buyers would prefer to take an average of the EBITDA from recent historical years, sellers will be more likely to focus on the most recent and/or most profitable years or even on higher projected EBTIDA in future years.
- The EBITDA multiple that is applied will depend on the risk associated with continue to achieve the level of income used along with how the purchase could be financed.
- The value based on a multiple of EBITDA includes the operating assets needed to generate these earnings including a reasonable level of working capital. The seller would then only be paid for or be allowed to retain non-operating assets or <u>excess</u> operating assets.

Due Diligence Process

- Potential buyer should thoroughly investigate target company
  - Due diligence should be a comprehensive process from the initial contact through consummation of a transaction
  - A detailed checklist should be utilized
  - Focus should be both on internal operations of the target company as well as external factors including the market in which it operates and its reputation and relationships
  - Consider obtaining support from outside experts including CPA firm as part of investigation of financial records
- Seller should also perform due diligence on potential buyer
  - Ability to consummate transaction
  - Ability to pay future amounts due in installment sales
  - Maintain employment and fulfill promises to employees
  - Protect and enhance reputation of business

Structure of Transaction

- The first and most significant consideration is whether the transaction will be an Asset Sale or Stock Sale.

- Considerations for structure that will apply to most transactions include the following:

  - Is the purchase price fixed or are their adjustments at closing or an earnout in future years
  - Is full payment made at the time of transaction or is there some form of installment sale
  - Will sellers become owners in acquiring entity.
  - Are there specific employment arrangements for selling owners

- Some purchases may include elements such as deferred compensation that are designed to improve tax efficiency of the transaction.

Asset Sale or Stock Sale

- Should the Transaction be structured as an Asset Sale or Stock Sale?
- Seller prefers a stock sale
  - One level of taxation at favorable long-term capital gains rate
  - No retention of liabilities
- Purchaser prefers an asset sale
  - Limitation of assumed liabilities
  - Step up basis of purchased assets
- Work together and think creatively to structure a deal that works best for both parties!
- Under certain circumstances, the buyer and seller may jointly elect under IRC Section 338(h)(10) to treat the stock sale as a sale of assets for tax purposes

Installment Sales

- Installment sales are a common funding arrangement in connection with the acquisition of small businesses.
- The acquirer may not have the funds for a full cash payment.
- In addition, the acquirer may will to have the seller hold a note to that risk is not fully transferred and the seller still has future incentive to make sure the transaction is successful.
- The term is of purchase notes is generally in the range of three (3) to seven (7) years, and this helps to align the cash flow from the acquired business with the required payments.
- Pursuant to IRC Section 453(b), any arrangement that provides for two or more installment payments payable in two or more taxable years will qualify as an Installment Sale and the gain can be spread over the years in which payments are received.

Purchase Price Adjustments

- Rarely is the purchase price completely fixed with no adjustments either at closing or based on future performance.

- Most frequently the purchase price will be based on a target for working capital.
  - The purchase price will then adjust up or down based on the actual working capital at closing.
  - However, such a working capital true up would not be needed in transactions where the seller keeps operating assets such as accounts receivable and is responsible for settling its operating payables.

- Less often acquisitions will also include earn out provisions that would increase (or in some cases decrease) the purchase price based on the future performance of the acquired business.

Future Ownership for Selling Shareholders

- Selling shareholders who intend to continue working for the acquired entity may receive some or all of the purchase price in stock of the acquirer.
- This may be desirable to the buyer as it reduces the cash needed for the acquisition.
- In addition, the seller then become a party to the buyers shareholders agreement and they have continued incentive to make the organization successful.
- Special consideration will be needed for when and how the sellers can divest of the stock they receive.

Continued Employment for Selling Shareholders

- It is often desirable for both the buyer and the seller to have the selling shareholders continue in their role as employees for some period of time following the transaction.
- In smaller companies, depending on the length of continued employment, the amount of future compensation to be received could actually be more than the purchase price.
- The terms for future employment should be addressed in the purchase agreement, including the specific commitment that is being made by both parties.
- In some situations there will be separate employment agreement, while in other transactions the selling shareholders will be "employees at will" but possibly with some protections as provided by the purchase agreement.

Required Agreements

- Non-Disclosure Agreement (NDA)
- Non-Binding Letter of Intent (LOI)
- Asset Purchase Agreement (APA) or Stock Purchase Agreement
- Covenants not to Compete and Non Solicitation Agreements
- Other agreements including notes payable for installment purchases, supplier and customer contracts, employment agreements and facility leases

Non-Disclosure Agreements

- The whole process with start with an NDA!
- The seller should make certain that the buyer is willing to sign and has signed an NDA before
- While it can be difficult in practice to enforce an NDA, it is a sign of good faith and it helps to begin a discussion of what information might be proprietary
- The NDA will often be provided and signed at the time of the initial information request
- There are many standard forms for the NDA that provide similar terms and while the seller may wish to use their form, a standard agreement from the buyer might also be acceptable

Non-Binding Letter of Intent (LOI)

- This is a critical step that should be included in all acquisitions!
- The LOI is non-binding so it has no legal substance, but it is critical to effectively outline the transaction while still in the negotiation stage.
- The LOI should provide the framework for all key terms of the agreement so that negotiation is still not taking place leading up to closing.
- Challenging key provisions of the deal at the time of the LOI also leads to a realization that some deals cannot be consummated before wasting more time and money!

Purchase Agreement

- The transaction is consummated with an Asset Purchase Agreement or Stock Purchase Agreement.
- This document will include the provisions from the LOI along with additional and more specific details.
- The agreement will be prepared by the either the attorney for the purchaser or the seller and reviewed by the other.
- The base purchase price and any adjustments or future consideration must be spelled out in sufficient detail so that there is not possibility for misunderstanding.
- The purchase agreement will also incorporate or refer to the other key documents discussed below.

Covenant Not-To-Compete

- A non-compete clause (or covenant not to compete) is a term used in contract drafting, and it refers to an agreement under which the selling shareholder agrees to not pursue a similar profession or trade in competition against the acquirer.

- Non-compete clauses typically are comprised of three elements:
  - The time frame during which the shareholder is restricted;
  - The geographical area in which the shareholder is restricted; and
  - The conduct/employment with respect to which the shareholder is restricted.

- The acquiring entity must have the selling shareholders sign non-compete agreements in order to truly acquirer the business that is being purchased.

- The acquisition should also include related agreements such as a non-solicitation agreement and a confidentiality agreement.

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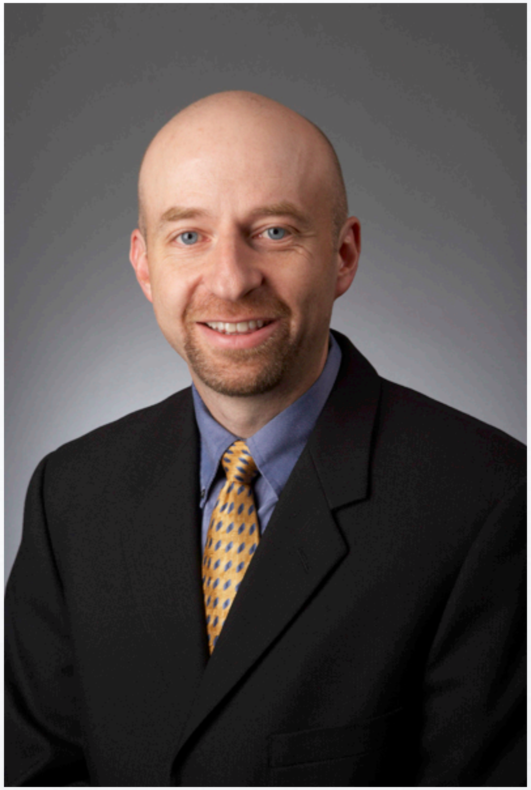
- The validity of these provisions is generally determined by state courts.
  - In a few states non-compete agreements are unenforceable
  - Courts in most states, however, do enforce non-compete agreements to at least some degree
  - New York State law "disfavors non-compete agreements as an unreasonable restraint of trade" but will generally enforce a non-compete if the restriction is reasonable
- Although courts determine reasonableness on a case-by-case basis, a non-compete can be reasonable only if it:
  - Is no greater than required to protect an employer's legitimate protectable interests;
  - Does not impose undue hardship on the employee;
  - Does not cause injury to the public; and
  - Is reasonable in duration and geographic scope.

Conclusion

- An external sale is something that should at least be considered as part of the long-term strategic planning of all companies.
- Small business owners sometimes wonder if they should just work until retirement and then "close the doors" – that is never a good idea!
- While valuations multiples are often lower for smaller companies, profitable businesses can still command a good value in an external sale.
- If the acquiring entity is a good fit, this will allow for a continuation of service to customers and future employment for staff and possibly the selling owners as well.
- Acquisitions of small businesses could also be the best way for the acquiring entity to expand and bring on new talent.

Questions

Contact Information



Victor W. Vaccaro, Jr., CPA/ABV, CFF, CDA
Principal
Dannible/McKee and Associates, Ltd.
221 South Warren Street
Syracuse, NY 13202
315.472.9127
vvaccaro@dmconsulting.com
www.dmconsulting.com

Dannible/McKee
and Associates, Ltd.