A SELLER'S GUIDE

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HOW TO PROPERLY PREPARE & MARKET YOUR BUSINESS

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RULE #1

THINK LIKE A BUYER

RULE #2

BUYERS BUY CASH FLOW

RULE # 3

REMEMBER RULE #1

A professionally prepared business information package is critical to assist in the process of marketing your business. A Buyer will expect to see certain information in advance of the actual site visit. To assist you, the Seller of the business, and McLemore & Associates as your Broker, Business Brokers Network has developed a Confidential Memorandum and a Comprehensive Evaluation Report that professionally prepares a business for sale.

THE BUSINESS OWNER

There comes a time when every business must change ownership. It may be from the founder of the business to his children. Other times it may be to an employee or a group of employees. Most often it is sold to a total stranger.

When you decide that you are ready to sell your business, you will be confronted with many difficult questions. "How do I value and price the business? How do I find and qualify the Buyer? How do I offer the company for sale without the premature release of sensitive and confidential information? What and when do I tell employees about the sale? What will the income tax impact be on the proceeds? What are the steps involved in properly presenting the business? What information will be needed to get the maximum return? Will accounting, legal and brokerage fees eat up a large percentage of the sale price? How much outside professional help will really be needed?"

Properly preparing your business for sale greatly increases the value of your business; however, the average business owner is not prepared to handle the sale of his business properly, and thus becomes his own worst enemy. Because of the lack of marketing experience, little or no proper preparation is made, thus undermining the maximum proceeds from the sale, which are, in essence, the fruits of many years of hard labor. Too often in these circumstances, the business will either not sell, or it will sell at a price that is below the true market value. This can be prevented by carefully selecting the professional team that will help you obtain the best price for your business.

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FIRST THINGS FIRST

The first thing that you, as a business owner, must do is admit to yourself the real reason or reasons for wanting to sell the business. From the viewpoint of the Buyer, business owners attempt to sell their companies for both good and rational reasons, or because there are problems that are of a negative nature that the present owner either cannot or will not correct. Looking at two companies in the same identical business, with similar locations, age, and volume, one could be at the top of the good reasons for selling, and the other could be at the bottom of the negative reasons.

If the answer is for negative reasons, you must realize the effect this will have on the price. The selling price of the business will be decreased as long as these negative conditions or reasons exist.

FACTORS INFLUENCING SALES

The following are some of the most important factors which result in an unsold business, or a sale that produces a selling price lower than desired by the owner:

1. When the asking price of the business is too high for what is being offered, Buyers will simply pass and continue to look at other opportunities that make more economic sense. Asking a price that is unrealistic is the #1 reason businesses do not sell.
2. Unrealistic asking terms, even when the price is acceptable, have stopped many sales from being completed. Some owner financing is part of nearly every transaction. The higher the percentage of the total sale price the owner is willing to carry, the greater the likelihood of completing the sale.
3. The importance of well-maintained records and company data cannot be over-stressed. Sketchy and poorly prepared financial statements send out a signal to Buyers that the business is poorly managed or it is not being truthfully represented.
4. Even if the business has well-prepared financial statements, good data files, and systems for operational control in place, there is still a problem if it is April and there are no monthly statements available from January through March. Financial

information must be complete and timely when selling a business.

5. If the Seller is not really motivated to sell the business, the business is not likely to be sold. Testing the market to find out what the business would bring is a bad idea. The Seller who uses this tactic will often decrease the value of the business or may end up in a lawsuit with a potential Buyer. This type of action is not taken lightly.
6. Poor representation has prevented many sales from ever being completed. The problem may be the Seller, business broker, attorney, accountant or Buyer. Fully understanding what is involved to complete the transaction and maintain harmony between all parties is very important.
7. Many times the location of a business can hurt the possibility of obtaining a Buyer.
8. Many times new city, state or federal code requirements can adversely affect the sale of the business.

Every owner who is selling a business must realize that the business will be in competition with other businesses that are being sold. The prospective Buyer will be comparing each business with other opportunities. The Buyer will be comparing price, terms, additional capital needs, return on investment, historical information, ease or difficulty of operation, staff, growth potential, location, quality of information, and many other factors. Each Buyer will place different values on different factors of the potential acquisition.

Also, many business owners mentally compare selling a business with selling a home. This is a poor comparison for many reasons. A business owner spends more time with his business than with his family. Selling the business can be like parting with a child, thus emotion is more of a factor in a business sale than in a home sale. When selling a home, the owner may or may not meet the Buyer. They normally have very little interaction. The Buyer of a business looks beyond the visible features of a business and considers many intangible features such as cash flow, historical trends, personnel, etc. There is continuous interaction between the Buyer and Seller throughout the entire process; therefore, the complexity of selling a business is much greater than that of selling real estate.

Overcoming the emotional aspects of selling a business may be difficult. During the period of time between the offer to purchase and the closing, remorse and doubt may arise in both the Seller and Buyer. The degree of doubt will range from mild to almost being distraught with apprehension, and not being able to sleep at night to being considered impossible to be around by family and employees. This is a normal occurrence during the transfer of ownership.

Actually, this is a good sign to the other party provided it is not to an irrational extreme. Many thousands of dollars are at stake for both parties. The Seller wants to be totally sure that he will receive all that is owed to him and that the employees will keep their jobs. He will be concerned about the business continuing to grow and prosper. Can the new owner run the business as well as he did?

The Buyer wants to be totally sure that the business will provide enough profit to service the debt, produce an adequate return on investment, retain its employees, and that he will really enjoy the business.

The key words are "totally sure". In reality, "totally sure" is impossible to guarantee.

When you have determined that you are ready and committed to selling your business, and what the real reasons are for the sale, then it is time to hire the most valuable "employee" you have ever hired. Your qualified professional business broker will not cost you money. We will actually make you money by properly valuing and pricing your business, marketing your business only to qualified Buyers, and negotiating and structuring the purchase price where it is a "Win-Win" deal for both parties.

THE CONFIDENTIAL MEMORANDUM

The Confidential Memorandum has three (3) sections.

The first section provides general business information about the business, such as, purpose of the business, marketing strategy, industry information, employees, facilities, asking price, down payment, interest rate and other general information.

The next section is financial disclosure. This covers recasted balance sheets and profit and loss statements, plus actual financial statements on the business for the past three years.

The final section provides the Justification for Purchase Price. This section may include a Comprehensive Evaluation, or it can be as little as one sheet that shows the cash flow the business generates, less debt payment, new owner's salary, and return on investment. The remaining cash flow should be sufficient to replace capital equipment and provide a small cushion of safety.

The key item the Buyer will want to see is the Owner's Cash Flow Analysis. The Buyer will be looking for at least three (3) years of financial statements and/or income tax returns, and a verifiable Cash Flow Analysis that shows clearly how the Buyer can expect to pay for the business, and generate a good return on his investment.

A Buyer must feel comfortable with the information that is made available to him if he is going to proceed. Good packaging of information about a business is essential. Many times the prospective Buyer will be in another city or state, and may be another Broker's client. Buyers will not travel across the country to look at a business that is poorly presented.

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RECASTING THE BALANCE SHEET

This is one of the most important parts of the Confidential Memorandum, as this will determine the basis for the price of your business. Accuracy of the information provided is absolutely essential.

First, we must determine which assets will be included in the sale, and which assets will be excluded. Next, we must determine a realistic market value for such assets.

Assets commonly included in a sale are:

INVENTORY should be entered at book value, less all defective or obsolete items. If there are items in inventory that are being carried at a price higher than the current cost, these should be inventoried at the current market cost. Inventory is always valued at cost. So-called current wholesale values will not stand up to a Buyer's review. It is rare when items in inventory can be sold to a Buyer for a price that is greater than the owner paid for the item. If the business has dead, defective, out-of-the-box inventory, it should be separated from the fresh inventory. The visual appearance of the inventory will be critical when a prospective Buyer tours the business.

ACCOUNTS RECEIVABLE should only include those accounts that are current or within sixty (60) days (or within the industry norm) of being current. All older accounts receivable and any accounts that are not collectable should not be included in this amount. It is not uncommon to ask the Buyer to assume the accounts payable when he is receiving the accounts receivable. **NOTE: our valuation service will probably calculate the value of the business and structure the sale with accounts receivable included in the pricing recommendations; however, it may recommend that they not be included. Each business must be carefully analyzed to decide what will work best when determining how to handle the accounts receivable.**

FURNITURE, FIXTURES & EQUIPMENT categories are the ones that will require the most effort. Do not enter the original purchase price of these items. Likewise, do not value these items at an amount at

which they could be purchased at auction. You must determine what the fair market value **"in place"** is for these assets. In other words, what would you, the owner, pay for the same item in its current condition, if you were going to buy it? **It is the business owner's responsibility to prove to a Buyer that the assets are worth the claimed value!**

VEHICLES are the next category that must be addressed. It is a common practice to find one or two vehicles on the balance sheet of privately held companies that will not be included in the assets being sold. These are usually the owner's and the spouse's personal vehicles. Make certain that these items are not included on the balance sheet.

DO NOT INCLUDE ASSETS SUCH AS notes receivable, employee loans, cash values of life insurance policies, utility or lease deposits, or loans to officers or shareholders. These items are the responsibility of the Seller, and a Buyer will not purchase them.

LONG TERM LOANS, LINES OF CREDIT & SBA GUARANTEED LOANS are often involved in the operation of a business. Whenever possible, the most efficient manner in which to discharge these types of debts is Seller utilization of the down payment proceeds to pay off these debts. A line of credit is usually not an assumable debt. SBA guaranteed loans are assumable in some cases, and in others they are not. Before the business is listed, the business owner needs to discuss with his banker whether or not a SBA loan can be assumed.

LONG TERM and/or LARGE DEBTS create the most difficulties for the business owner. When they are too large to be paid in full at the time of closing, they must be assumed by the Buyer; ***however, when a large debt is assumed by the Buyer, the amount of down payment is usually less that on sales where no liabilities are assumed.*** There are several other negatives created when the Buyer must assume debts. The bank or lending institution will rarely, if ever, remove the original maker of the loan from the guarantee. They will simply add the Buyer to the note. Another negative to the Seller is that the note to the Seller (for the balance of the purchase price) will usually be in a secondary position to that of the bank.

RECASTING THE PROFIT & LOSS STATEMENT

Profit and loss statements do not reflect the true earnings of a business. Most businesses are operated in a manner to reduce income tax, not to see how much profit can be shown to pay taxes upon.

Business owners receive perquisites for their personal benefit that are paid by the business. Some of these are acceptable and legal in the eyes of the Internal Revenue Service, while others often cross the so-called "gray line". Examples of these include hospital and life insurance, personal vehicles that are owned by the business, travel that is not totally related to business, and many others.

The recasting of the profit and loss statement is an extremely critical area. The discretionary cash flow of the business must be calculated as accurately as possible. Overstated add-backs or those items that cannot be verified will only cause Buyers to pass on buying the business, or will produce lower price offers than desired. **The Cash Flow must be verifiable.**

It is to your benefit to list all provable perks and compensation that you have received from the business. What we are trying to determine is the total number of dollars of earnings that will be available to a Buyer to service debt, pay himself or a manager a reasonable salary, give him a realistic return on his investment, replace capital equipment, and provide a small cushion for safety.

The Cash Flow Analysis is the most vital information available to a Buyer when making an offer to purchase a business. It is THE major factor in determining the intangible value of any business. Cash Flow is not net profit before taxes. It includes many items that must be reviewed:

> Net Pre-tax Profits; Owner's Wages, Owner's Vehicle Expenses; Owner's Entertainment Expenses; Owner's Personal Insurance Expenses; Non-working Employee's Wages; Over-compensated Employees; Depreciation, Amortization, Interest Expense; Bad Debt Expense; One-time Major Expenses; Bank Charges; Penalties & Fines; Non-essential Business Expenses; Rent Expense; Other Expenses; Replacement Employees; Voluntary Labor; Gains on Sale of Assets; Other income; etc.

THE EFFECTS OF REAL ESTATE BEING INCLUDED IN THE SALE

The old statement, “Oil and water do not mix”, could be restated as “Business sales and real estate do not mix”, or “How NOT to sell your business”.

A Buyer is trying to purchase as much cash flow as possible with his down payment. He does not want to decrease the size of the business he can purchase because of real estate. He will not increase the down payment to obtain non-income-producing property. Real estate schools teach that there are two types of real estate – residential and commercial. They leave out a third category – this category is non-income producing business property. Real estate owned by most businesses does not produce monthly income, so it does not meet the general requirements of being commercial real estate.

Buyer’s attitudes toward real estate have changed drastically during the past ten years. Several factors have caused this change. Real estate in the 1980’s was increasing in value each year. Interest rates on real estate were low. Today, real estate is not increasing in value in most areas of the country, and interest rates being charged are higher. Logic tells us that when values are not increasing and interest rates are higher, real estate is not a good investment. The Buyer is not getting a reasonable rate of return on his investment.

Major retailers, such as Wal-Mart, Sears and J.C. Penny have all ceased to build their own buildings. Their new locations are all leased facilities. Wal-Mart has been closing company-owned locations and moving to new lease facilities since 1993. They are selling their old buildings because owning the property is economically unsound. These top retailers would not have made this change if owning the real estate were profitable.

It is important to understand that over ninety-five percent (95%) of all businesses in America lease their facilities. This should tell us that owning real estate related to a business has never been the goal of most business Buyers.

WHAT IS THE PROBLEM WITH INCLUDING THE REAL ESTATE?

The problem centers around the fact that the Buyer wants as much business (CASH FLOW) as can be obtained based upon the amount of money paid as a down payment. A business with $400,000 in assets and $200,000 in cash flow should sell for about $600,000 based upon a down payment of $200,000 and the owner financing the balance.

If we include real estate valued at $400,000, we now have an asking price of $1,000,000. The down payment would increase to at least $300,000 if not more. We have increased the cost to a Buyer, but we have not increased the earnings of the business. In most cases, the payments on the real estate portion will be higher than what the owner would have charged for rent. This causes a decrease in available cash flow that in reality should cause a decrease in the asking price of the business.

A Buyer could buy a business with $600,000 in assets and $300,000 in cash flow for the same $300,000 down payment as stated above.

Which business would you buy, using these two examples?

Buyers will not pay $100,000 more in down payment and decrease the available cash flow at the same time. The real way to look at this is that a Buyer will not give up $100,000 per year in cash flow for twenty years to get real estate that is worth $400,000. This is exactly what the Seller is asking the Buyer to do when he requires the Buyer to buy the real estate. Buyers will pass on the business with real estate and continue to look for a business that will give them useful cash flow.

You should also consider that selling the real estate and the business at the same time could cause severe income tax problems for the business owner. Talk to your CPA about the capital gains consequences.

If you own the real estate where your business is situated, the ideal situation for you, the Seller, will be to lease the facilities to the Buyer, with an option to purchase.

EFFECTS OF FINANCING ON THE PURCHASE PRICE

The vast majority of Buyers want to pay as little down as possible, while the Seller wants the highest price he can get, and at a minimal risk. Down payment and terms will have a major effect on selling your business and obtaining the best price possible.

Overpricing a business, or demanding unreasonable terms, will kill a deal before it even has a chance to be considered.

Realistic terms are critical if you want to maximize the selling price for your business. As emphasized at the beginning of this guide, "Think like a Buyer – Buyer's Buy Cash Flow".

Buyers are trying to buy as much business (Cash Flow) as they can get for the money invested in the down payment. Most business owners would like to sell for all cash and get the same price the business would produce with excellent terms. Intelligent Buyers will not pay the same price for a business when the owner is asking "all cash", as they will when an owner will take a reasonable down payment, finance the balance at a fair interest rate, and provide a reasonable length of time to repay the note portion of the sale.

The following chart of price and terms is based on analyzing thousands of business listings:

Down Payment Percentage	Price Realized Percentage	Properly Listed Business Closing Percentage
20%	120%	In excess of 80%
33%	100%	In excess of 80%
50%	80%	Less than 40%
100%	40 – 60%	Less than 20%

Twenty percent down will not produce a higher percentage of completed sales than one-third down, but it will produce a faster sale. This is because more Buyers can afford the down payment.

The most common transaction is one-third down payment and the owner financing the balance. Over eighty percent (80%) of all businesses sold in the mid-market arena since 1990 have been sold with one-third or less down and the owner financing the balance. This is normally the best way to obtain the full value of the business. A Buyer will have too much invested to let it fail. The Seller will have too much at risk to misrepresent the business. The Buyer and Seller will become a team. Both of your futures are dependent upon the success of the business. Since the Seller is financing the majority of the purchase price, the Buyer is less likely to get into hard negotiations with the Seller. Who wants to argue with their banker when they are trying to get a loan?

THE JOB OF A BUSINESS BROKER

The job of McLemore & Associates, as your professional business broker, is to make certain that you, the business owner, are well educated in the process that must be followed in order to successfully market your business. We require a professional valuation of the business, either a Confidential Memorandum or a Comprehensive Evaluation Report, in order to arrive at a value that justifies the price asked for the business. We then develop a business information package to be given to qualified Buyers on a confidential basis, enabling them to determine if they are interested in pursuing your particular business.

The next step is to get the Buyer and Seller together to determine the chemistry between them. In that meeting, you, the business owner, will have to sell the potential Buyer on the merits of your business (you know the business better than anyone else); while the Buyer will have to sell you on his ability to run your business, as well as his financial stability (to motivate you to extend credit to him). If you and the Buyer are comfortable with each other, then we will normally be successful in closing the sale.

After the initial meeting, and assuming that everyone is comfortable with each other and wants to proceed, then we will work with the Buyer to create an offer-to-purchase or letter of intent. You and the Buyer will then have to agree on the price and terms of the transaction. Next, we turn the contract over to an attorney of your choosing who creates the legal documents necessary to complete the transaction. We then coordinate all events through the closing of the transaction.

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CONCLUSION

If you want to open the door to the greatest number of opportunities to sell your business, and be a successful Seller when a willing Buyer is located, then take the time to appreciate the years of practical experience expressed in this Buyer's Guide. It is created especially for your benefit.

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