Part III

If You're Selling a Business . . .

The 5th Wave By Rich Tennant

"In the interest of a future stock issuance, I highly recommend you *NOT* use your family name as part of your corporate identity, Mr. Defunct."

In this part . . .

Valuation is all about perspective. Which side of the deal you're on influences how you view the valuation of a company: yours or someone else's. In this part, we talk about your company. We focus on the sell side of a transaction, and our main advice can be summed up in one word: planning.

Think about it. Sellers don't want to be rushed into a transaction if they can help it. Even if sudden opportunities arise to sell — opportunities that are always welcome — the idea is always to be prepared, because preparation means you're likely to get an optimal price.

We also talk about how valuation research should be part of the seller's overall estate and succession planning for the firm, starting years (sometimes decades) before the sale of the company.

Chapter 10

Making Sure You're Ready to Sell

In This Chapter

- Considering the importance of timing
- Pinning down your motivation to sell
- Finding ways to boost value in advance of a sale
- Choosing the type of transaction

Timing is everything when it comes to a purchase or a sale of a company. This fact is especially true for sellers. The best possibilities for a higher valuation on the sale of a company come from planning in advance.

In reality, relatively few people have an exit plan in place for a company that they've either bought or worked hard to start years before. But exit planning is essential. You should do this planning three to five years in advance, and valuation is an important step in that process. Unless you know the value of your company inside and out — or the steps it will take to improve that value — you'll have a tough job making a convincing sale.

Preparation is the stuff of business opportunity. It means finding out everything possible about a business's operations and the specific markets you're interested in so you can grab opportunities when they happen. It means laying in the financial foundation — cash savings, liquid investments, or attractive financing — to afford those opportunities at the moment they happen.

Finally, it means conferring with particular experts who are familiar with your business plans, your finances, and your personal financial goals to make sure the opportunities you go after are absolutely the best fit for you. This chapter gives you the information you need to move in that direction.

Understanding Why Timing Is Important

Anita Roddick, the late founder of the cosmetics chain The Body Shop, viewed business opportunity this way: "I am aware that success is more than a good idea. It is timing, too."

Timing doesn't come only from luck or smarts, although they're both factors. Timing derives from an intimate knowledge of how a business works and of how to harness its repetitive patterns for the best effect.

Furthermore, you must look at the overall economy and the economy of the specific industry you're considering. You have to look at the quality of competing products in the marketplace. Then you must decide whether your particular place in the business cycle is best for staying in or selling.

Most owners wait too long to sell. Why? Poor planning and emotion, mostly. People without a game plan can't take advantage of opportunities when they happen because they're not emotionally ready to do so — and perhaps their families aren't ready, either.

Examining the Motivations behind a Potential Business Sale

Even in tough economic times, people believe that the sale of a successful business is a surefire ticket to retirement wealth or possibly a stake for a new venture. But particularly in the case of small businesses, owners sometimes forget that their businesses must overcome obstacles that many larger firms don't have on the way to a sale:

- A small business may be enormously profitable and very successful, but the owners have never bothered to create a financial reporting structure that woos potential buyers.
- Because private companies aren't required to make financials public as a public company does, benchmarking the values of a private company is tough without the aid of a database or a valuation professional.
- Potential sellers often don't consider due diligence on the attractiveness of their business in the current market before they try to sell.
- Emotional factors enter the picture. Founders may be reluctant to sell, and kids may have their own issues with the business that delay prudent actions at the right time.

Understanding buyers and what they want

You can't really develop a negotiating strategy for your business unless you really understand what kinds of buyers may be circling your company and for what reasons. Here are three primary kinds of buyers:

- **Financial buyers:** These buyers act a bit like investors in the stock market. They want to come in and spot value, and they'll spruce you up a little and sell. They like to see profitability and stability — or signs that profitability and stability are right around the corner. They're not looking to buy your company to merge it with another similar operation in your industry. They're not operators per se. They may even work out a deal to keep you in charge if they like what you're doing.
- **Strategic buyers:** These folks are already in your business or want a business like yours to complement what they already have. They're the buy-and-hold types. A strategic buyer can be a conglomerate or a big company already in your field that wants your company as a way to enter a new market or to add your products to a mix that's already doing well for them. But the purchase isn't just about products; it can be about people too. Management — particularly newer management that looks like it's on the verge of a turnaround — can be an additional attraction for a strategic buyer. Perhaps you have talent good enough to run their entire company someday!
- **Special-purpose buyers:** These buyers are typically private citizens doing private deals. A special-purpose buyer may be a father or mother who purchases a business for a son or daughter, or it may be a serial entrepreneur who has just sold a business and is looking for a new challenge.

Obviously, you want to see someone who knows your company well. You want to hear surprising insights from buyers, not questions that reflect ignorance about what you've done during your entire career.

Good buyers have more than the financial might to do a deal — though sellers do need to verify that ability. Good buyers also understand the emotional complexities involved in such a transaction. They should understand how an owner feels about leaving the helm of a business she has built, how she'd have her employees treated after she's gone, and what numbers would make the most sense to her.

Solid buyers are professional, knowledgeable, and empathetic to the issues of their target.

WARNING!

The Alliance of Merger and Acquisition Advisors reported in 2008 that many business advisors believe that although seven out of ten mid-sized businesses will transfer ownership in the next decade, at least 90 percent aren't prepared to do so. Why? They haven't kept up with the recordkeeping and documentation that qualified buyers want, nor have they made their businesses particularly salable.

Most experts suggest that small to mid-sized companies create a three- to five-year game plan before a sale or other major ownership transition (which we detail later). For now, this section looks at the primary reasons owners consider a sale.

Anticipating the owner's retirement

For business owners, retirement is either a welcome event or something they don't even want to think about. But all things must pass, and owners really do need to think about what a chance to step down — on their own terms — can mean for them.

We talk throughout the book about retirement and estate planning, and valuation is a key part of such planning. It determines virtually every aspect of an owner's retirement, from the timing of his departure to the amount of money he'll have available to support himself and his family members after work.

When you plan the sale of a company, you have more data to go on than rule-of-thumb estimates such as the one you always hear (that any company of less than $20 million in revenues should go for three to five times annual net profits at the time of sale). Without a clear, early look at valuation and specific actions taken to improve your entire operation and the timing of your exit, you're really just guessing.

The kids are taking over!

Business survival gets tougher for each succeeding generation (you hear a lot more about this topic in Chapter 11). And even though passing on a business to the next generation isn't always a sale situation that you find in the open market, owners must think of it in the same context as a sale process.

Even if the family members who take over the business from the owner have been with the company for a while and know it intimately, the current owner should speak with the family about the process of pass-down well in advance, and valuation should be part of the picture. As part of the long-term succession plan, the owner should have a professional value the company to determine whether the business should make certain operational, financial, or management changes before the targeted transition date to the new generation.

Most of all, that process should be transparent. If family is already working within the company, it's tough to do a valuation process without having everyone know about it, anyway.

Weighing the possibility of a merger or acquisition from a friendly suitor

If the owner of a family business expects — with good reason — that her company will sell at a premium if she decides to put it on the block, that's still a good reason to do an independent valuation so that the business has completed all value-building exercises before talks begin.

As we mention, owners sometimes have trouble seeing all the pitfalls and sometimes the hidden benefits of the companies they've created. A dream buyer may be waiting in the wings, so it makes sense to plug that possibility into the planning process, which includes professional valuation.

Changing market conditions are threatening a company's future

A proper valuation exercise doesn't stop at present value. It gives you an idea of whether a company will be viable in the next two to three years. A valuation expert can at least identify particular trends — both positive and negative — that may affect a company's future.

Knowing that the sun is setting on an industry or a particular type of product may be sad news if you've devoted your life to it, but selling to a larger and more viable competitor while prices are fairly high can make such a tough decision worthwhile. It can also help you with price strategy ahead of time.

Bringing Valuation into the Picture before You Bring In the Buyers

The scenario of planning three to five years beforehand gives a business owner time for ample thought and preparation on how she wants to exit her business. She also gets time to understand the myriad details that go into a sale and that must be worked out with the help of proper advisors in the linked areas of legal, tax, wealth management, business strategy, and, of course, valuation.

TIP

A preliminary business valuation is essential in the early stages of preparation to sell a company. You must know what your business is presently worth before you can take well-advised steps to improve its value.

Providing a reality check

Knowing problems ahead of time enables you to make repairs to a company's systems and, therefore, increase its valuation. Here we list only some of the items and issues to address before a formal for-sale sign goes out in front of a business:

- **Show profits and a steady growth trend not over months but over years.** A business must be doing those financials professionally throughout that time, preferably through normalized financial statements as time goes on. Even if you've never had to borrow for your business, approach the preparation and presentation of these numbers as if you were applying for a loan. Be sure to create pro forma data that adjusts for unusual or nonrecurring events and clearly identifies them.

  Are financial statements *normalized* or *adjusted?* Either term is fine because they mean the same thing: Normalized or adjusted financial statements have been adjusted to eliminate unusual items or anomalies and to enable clear comparisons. People use the terms interchangeably.

- **Be in the right place at the right time — that is, have the right products ready for the marketplace at the time customers want them.** Keep up with innovation, manufacturing, and distribution, particularly leading up to a possible sale date. The better your company looks, the better the value of your company looks.
- **Forecast how the economy — and your particular business cycle — will impact your business by a particular sale date.** The best time to sell a business (much as when selling a home) is in a healthy economy with interest rates at reasonable levels, in case your buyer needs to use financing to acquire your company. Make sure you can predict these factors with some degree of certainty, either alone or with expert help.
- **Consider personal goals.** Your personal goals are a huge factor. Everything from retiring to starting a family may be grounds for selling a company. Getting your personal wealth planning in order before you do your business plan makes a great deal of sense.

One early conversation in a negotiation is about the make-or-break aspects of the potential deal. Some prospective buyers ask whether the potential sellers care more about the down payment or the purchase price, for example. Because few buyers can do all-cash deals, the seller's answer helps give shape to a potential offer in terms of cash, debt, and other considerations. Be ready with an answer in case a prospective buyer asks you this question.

Transparency: Preparing for a sale

Transparency, in a business sense, is a policy of sharing both good and bad news with fellow owners and shareholders, suppliers, customers, and potential buyers. It derives from the traditional definition of the word: to see through something. In recent years, it's gotten a lot of usage because of companies that tried to hide problems in their balance sheets, in their facilities, and in their direct dealings with shareholders and customers.

REMEMBER

Do you want to attract the best buyers and business partners out there? Do you want to have an efficient deal process from overture to closing? If so, transparency is your first goal. It comes before valuation, and it certainly must come before negotiation.

The road to transparency involves carrying out the following tasks:

- **Auditing your financials on an annual basis:** Audited financials by a Certified Public Accountant willing to sign her name to her work is crucial if you're expecting to borrow money, seek investors, or in all but the smallest-company situations, secure a buyer. People want to know that numbers are for real before they'll sign a check, and they'll want to see several years' worth of audited figures, not just one year's figures.

  TIP

  If your company has been somewhat informal in its accounting methods — even if you or your designated chief financial officer have been handling your tax issues for years with no problems — it's time to start pricing the services of reputable CPAs to audit those numbers. Because accountants typically price their services on an hourly basis and those rates are priced locally, plan for a significant bump in your professional services bills.

- **Streamlining your data systems:** Any number of well-run and asset-rich companies issue handwritten paper invoices and keep critical data on Post-it notes, but if you're looking to make a deal, 20th-century record-keeping has to go. Due diligence (see Chapters 12 and 16) involves plenty of questions and demands from potential suitors that require you — or their representatives — to chase data in your file cabinets, computers, and stockrooms. If particular industry standards require you to upgrade your computer systems or at least straighten out your "intuitive" filing systems into something an outsider can understand, that's part of your prep work before valuation can begin.

- **Adopting a warts-and-all disclosure policy:** Got dirty laundry? Problem customers? A division with results that you absolutely know are going to stink in the next three to six months? If you're opening your doors to potential buyers or partners, it's best to develop an organization-wide philosophy of how you'll handle and disclose bad news, not only to outsiders but also to each other. Bottom line: You need to get stuff out there first so it's not discovered during due diligence. The more bad news others discover before you disclose, the worse it may be for the final number on your deal.

  REMEMBER

  Creating a disclosure culture is a very big challenge in a lot of private companies, particularly those with owners who rule with an iron fist. But if you're going to try to do a major transaction, you need candor in your financials, processes, and facilities for an important reason: Candor builds trust, and trust is necessary to making a successful deal.

Heading off problems to increase value

Clear up any problems within the business that make it less attractive to buyers. Whether such issues are related to customers, management, regulatory, financial, or legal, the time frame of three to five years represents a chance to clean up these problems.

Consider these steps to take to enhance your business's value:

- **Assemble a quality team of professionals to work with you throughout this process.** Not many owners have the experience to prepare a company for sale or shepherd it through the sale process. Working with financial planning or tax experts is a good first step in addressing your wealth-management goals, and it goes a long way toward defining the kind of transaction you end up doing. You can then work with the right valuation, legal, and business advisory specialists to determine your current business value and which tactics you can use to make your business more salable. We get to these strategies shortly.
- **Remember that price is secondary to the best deal.** A high offer for your company means little if buyers are mostly offering a promissory note rather than cash. A big part of why you're selling has to do with your ability to monetize your investment in the company. Make sure you can actually do that quickly instead of having to wait years for your money.
- **Understand that deals take time.** Deals are not done in a day. They may take a series of negotiations, and you have to allow a prospective buyer time to do proper due diligence. By the time you get serious about a particular buyer, it may take a whole year to get to closing.

- **Adjust that niche.** This point may sound obvious, but is your business as attractive as it could be? If you steer your company into a market niche that is destined to leave it less vulnerable to competitive attack, it's a salable point for the company.
- **Turn off the perk spigot.** To normalize financials, valuation experts eliminate items such as payments for company cars and other corporate perks. It may be a good idea to cut back on those nonessential expenses as you get closer to a sale. Even though they're legal, they cut into profitability, and that's what you want going into a sale: a highly profitable company.
- **Take a serious look at salaries.** You have to do a real balancing act: trimming above-market salary levels to match comparables at public companies without chasing away talent. Obviously, you're not going to slash salaries, but you may adjust benefits or salary levels that were once higher for incoming employees. Buyers will be basing their valuation on this information, so it's better to make the necessary salary adjustments while you have time on your side than to pay the price for failing to do so later.
- **Reconsider bonuses.** If you're paying any unnecessary bonuses, consider suspending them to make less of a drain on total profitability.

  Employees aren't stupid. Any adjustments that you make to compensation issues will hit the grapevine sooner or later. Freshen up the company before a sale with tact and intelligence so you don't push good people out the door at all levels of your operation.
- **Start thinking through succession.** Any buyer may waltz into a company and replace top executives with new picks, but good people are assets, too; buyers may hesitate to throw out talented managers just because they predate the new owners. However, prospective buyers may have justifiable concern that if owners — the ones who really want to take their money and run — are shouldering too much responsibility, the new owners may be stuck with a leadership vacuum. You may want to start handing off key responsibilities to talented managers who can make the transition into a new ownership situation.
- **Consider staying liquid.** Buyers and sellers can always agree on this fact: Cash has measurable value that anyone can see. If the fixed assets of your business may not produce that much value for you in a purchase negotiation, consider getting rid of those assets before you sell, and possibly lease what you need if it makes good financial sense for the business.
- **Settle up.** Various loans made by the company to its key shareholders or by shareholders to the company happen all the time, but buyers like as few potential claims on their assets as possible. Consider urging everyone to pay off those loans.

- **Buy some paint.** If your physical plant or office facilities are looking tired, dirty, or otherwise unattractive to visitors or customers, come up with an inexpensive way to spruce them up. Yes, in another nod to real estate sales, buyers like surroundings that are not only neat and clean but also attractive to anyone planning to spend money with the company in question. First impressions are everything — in financials as well as in furniture and window treatments. Who knows? You may even improve your current business climate by making your company more attractive to your current clients and customers.
- **Increase the firepower on your board.** One of the benefits of being a private company is that you can pretty much run governance how you want. But in these times, and if you're looking at a sale or merger of the company, you have to be much more sensitive to how your governance actually works and appears to an outside buyer. Consider appointing some impressive outsiders to your board who not only have marquee value but also can bring genuine value to the board discussions.

  Advisory boards are big at small, growing companies. An advisory board of noncompetitive individuals who are nonetheless smart about your business can also make your business look snappy to outsiders.
- **Always think about estate issues.** The centerpiece of all this discussion is the personal welfare of you and your family members. In speaking with your tax or wealth-management advisors, see whether you can employ strategies to limit your exposure to estate taxes on the federal and state level, particularly if your business will be split among heirs or possibly sold or liquidated after your death.

You may not have three to five years to get your ducks in a row. You may not even have a year or two before your personal objectives change, or the shape of your industry changes, or you have an offer waiting on your doorstep. That's why most experts tell you to do whatever it takes to get your company into an upward growth pattern. Hire better management if you need it, get those new financial controls and reporting systems in place, and get some solid advice on how much you should allocate for the costs of getting all these issues up to speed. In other words, be ready for anything — that's good business strategy in any climate.

As you spend more to grow your business, costs may outrun your revenues for a time. Thus, you need to plan growth carefully as part of your overall value strategy.

Estate tax turbulence is on the way

At the time this book was in production, considerable worry was circulating about how estate taxes will affect Americans — particularly business owners who plan to sell in the next few years.

Back in 2001, the Economic Growth and Tax Relief Reconciliation Act triggered a gradual increase in the dollar threshold of estates subject to the estate tax. In tax year 2008, estates valued at more than $2 million were set to be taxed as much as 45 percent, and in tax year 2009, the threshold was scheduled to rise to $3.5 million. In 2010, the tax was scheduled to be repealed for a year.

But in 2011, unless Congress acts in the meantime, the news gets bleak for business owners or anyone considered to be a high–net worth individual: The estate tax will be reset at up to 55 percent on estates at a significantly lower threshold: $1 million. That's a potentially big wallop for privately held companies, and businesses should seek guidance if they plan to sell in the next three to five years.

If you suspect that your estate or a relative's estate from which you may inherit may fall prey to the estate tax, enlist the help of experts right now — before you sell your company. Both personal and business assets may grow over time — sometimes considerably if your efforts are successful — and your estate may turn out to be larger than you think. Keep these issues in mind during those conversations:

- **Expected increases in assets:** A grantor-retained annuity trust, or GRAT, is an irrevocable trust that is popular among families with assets that are expected to increase, because such appreciation can be passed on to heirs with minimal tax consequences.
- **A gifting strategy:** Under current law, unlimited amounts can be left to a spouse and to charity, free of federal estate tax. Other heirs can receive a total of $2 million, tax free, based on deaths that occurred in 2008. If your assets are over the estate tax limit, it may make sense to devise a gifting strategy that spends down your total taxable estate while still allowing you a comfortable lifestyle. For instance, you may consider making direct payments for someone else's medical bills or education tuition. No gift tax applies for these items, so payments can be unlimited.

Determining the Kind of Transaction You Want

Valuation isn't just about making the business look nice and making the financial statements readable. Valuation can help you sort through the best transactional options for your business when the time comes to let go. Those options include the following:

- An outright sale
- Employee stock ownership plan (ESOP)
- Transfer of ownership to family members

You find more on those options in the following sections.

Outright sale

A valuation professional can help you determine the best potential buyers for your business and identify the issues that will make your company most valuable. They can also acquaint you with optimal transaction data that you and your negotiators can work with.

Employee stock ownership plan (ESOP)

Valuation assistance is essential as a company develops an ESOP. Business owners use ESOPs to exit their company at fair market value while keeping ongoing management in place and providing a financial incentive to employees without paying capital gains tax. An ESOP is a popular exit strategy for many small to mid-size companies, but a valuation by an independent appraiser is one requirement for a transaction between an ESOP trust and an owner of the company that establishes the ESOP.

An ESOP is set up as a trust, and it can't pay more than fair market value for the company stock that it purchases from the selling shareholder (the owner of the company).

The ESOP fiduciary (a board of trustees, an administrative committee, or an institutional trustee) uses the independent appraisal to ensure that the ESOP trust does not pay more than fair market value for the company stock, as determined as of the date of the sale. The ESOP fiduciary must conduct the proper due diligence to make this determination in good faith.

Ownership transfer to key family members

Valuation is a particularly important issue when passing down a business directly to family members. Whereas your goal may be to get the highest possible valuation if you're selling to an outside party, you may be looking for the lowest defensible valuation if you're transferring the business to children or other family members.

Owners of family businesses tend to gift shares of the business to a son or daughter over time for particular tax advantages. Confer with a tax professional in preparation for this process.

Chapter 11

Deciding What to Do about the Family Company

In This Chapter

- Why parallel planning for the family and the business is crucial
- Facts about family-owned companies
- How families hurt their business's valuation without even knowing it
- Ways to constructively manage family conflicts

Families own or control 90 percent of U.S. businesses. According to the Family Business Forum at the University of North Carolina in Asheville, only 30 percent make it into the second generation, and only 12 percent survive into the third. Fourth generation? Only 3 percent. A family business that makes it past one generation is a success story. Past two generations, it practically becomes a headline. Past three, it's a dynasty.

If you want to see a valuation fight that's possibly uglier than a divorce, just watch kids fighting over leadership of the family business or the money they think is coming to them. Family companies that last require plenty of planning, preparation, and open communication between family members and their advisors. When businesses pass from one generation to the next, they must plan for many contingencies. For example, in a family with several siblings, brothers and sisters working in the family business may feel they have a greater right to the company's control and assets than the siblings who haven't. These types of valuation squabbles are common in families that haven't planned.

This chapter details which specific actions to take to plan for transitions in the family business and the specific valuation situations that arise. This chapter also focuses on valuing a business from the perspective of both a working and a nonworking sibling.

Planning for the Worst Possible Scenario

Suppose you've built an incredibly successful business. You have three kids — one's 16 and already working at the company after school. She's already said she wants to come back and run it after college, although you can't really hold her to it — she's a kid, after all. The other two kids are still in junior high.

Today your business has nothing but promise, and you look forward to the day you'll be able to use this wealth to fund your kids' education, secure your retirement, and then pass the business on to your kids so they can take it even higher.

The next weekend, you and your spouse are killed in a car accident.

So what does this story have to do with business value? Isn't it mainly a personal finance matter? That all depends on what you'd want to happen in your business if something this horrible were to happen. Ask yourself these questions:

- Does your company have a management succession plan that designates leadership within the company to take over if you and your spouse were to vanish tomorrow? Would their talents be enough to keep the company going and help fund your kids' education, and would those leaders be fine with allowing your kids into the business full time if they chose? Is this plan in writing?
- Does the business have a contingency plan for a sale of the company if current management didn't want to stick with it and your oldest child were nowhere close to making a decision about her future? Does the sale plan outline an orderly plan so the company you created doesn't go at fire-sale prices?
- Do you have both personal and financial guardianship in place for your kids? Seeing that your kids may stand to inherit sizable assets from either inside or outside the business, it may be wise to separate that guardianship by bringing in a trusted investment advisor and estate attorney to confer on such matters.

Obviously, planning ahead is best, especially where family is concerned. But what if you don't have time, or your kids are already grown and you don't have a plan in place? You can still watch out for certain things, and you can take steps to fix your situation. Keep reading.

TECHNICAL STUFF

According to the Family Business Institute, about a third of family businesses have a chief executive who's older than 60, with an average age of 54. Eleven percent are older than 71 years old.

Examining the State of the Family Business

For many small to mid-size companies, the biggest potential complication in the valuation process is family. Why? Because families always bring added baggage to the business process. Favoritism runs rampant in commerce because it's supposed to be survival of the fittest. But the family business? The fairness doctrine applied to the family dinner table doesn't always translate to the boardroom.

The business news pages — and sometimes front pages — love stories about family squabbles over money and power. Just ask the Murdochs, Redstones, and Bancrofts — recent high-profile examples of families involved in huge businesses that couldn't agree on the future of their legacy.

Are we saying that family companies have a tougher time realizing the full value of their business? Not at all. But we do believe that founders who don't have a long-term plan to work with their families on the future leadership and valuation strategies of their companies risk devaluation at the time of their death or retirement. In this section, we discuss some special issues concerning family businesses.

Specific characteristics of family companies

A 2007 study by wealth-management firm Laird Norton Tyee indicates not only how important family-owned companies are but also why their longevity can erode over time:

- More than 80 percent of the firms polled had between 20 and 499 workers, with sales ranging from $5 million to $30 million.
- Though family-owned businesses generate 64 percent of the nation's gross domestic product, nearly 60 percent of majority-share owners in family businesses are 55 or older, and 30 percent are 65 or older; however, less than 30 percent have succession plans and less than 40 percent have a successor lined up.
- Family finances are too tied to business success — 93 percent of respondents have little or no income diversification, deriving the majority of the family's income and security from the business.

- Two-thirds of family businesses don't require family members to have the qualifications or related experience necessary to be successful when entering the business. Twenty-five percent think the next generation is not competent enough to take the reins.
- Nearly half of American family businesses are operating without a written strategic plan.
- In most family-owned firms — 75 percent — strategic decisions are guided by a board of directors, an advisory board, or both. More than 54 percent of these boards consist of family members only; however, over 43 percent of the firms polled have boards with a mix of family and nonfamily members alike. Of the firms that use boards, 77 percent agree or strongly agree that they make positive contributions to the direction of the business. The remaining 25 percent of firms say they don't have a board of any kind.

What does all this mean in the context of business valuation? That many companies may not be worth as much as the owners think, simply because their companies don't follow best practices for their industry, nor are their finances or business strategy in the best of shape.

How families hurt the value of their businesses

The worst problem that family businesses have is the failure to plan for succession. Nonfamily businesses generally see plenty of woe when they haven't addressed succession. Yet in the family context, this practice gets put off mainly due to the possibility of hurt feelings among various family members in the business or an unwillingness for the current generation to step aside.

Yet the succession issue is usually linked to other critical problems that threaten the value and future of the firm:

- **No succession planning? Probably no real wealth planning, either.** Most smart financial advisors who work with independent businesspeople say that entrepreneurs should do parallel planning that addresses the needs of the family and the business at the same time. Parallel planning is based on the idea that the family comes first — which makes sense — and that those wealth priorities should largely drive business strategy.
- **Strong owners can be weak at leadership development.** Family businesses with a strong, hands-on owner may not hire the best midlevel talent because the owner is focused solely on having a particular family member take over someday. Perhaps there's been an anointed heir apparent, but what if something happens to that person or her priorities change? Sometimes a little creative tension between family members

and nonfamily members in a business can be good for the overall performance of a company. Nevertheless, some owners of family businesses don't want to see outsiders jockeying for position.

- **No strict rules govern family members coming into the business — or back into the business.** Many owners are fine with having their kids and other family members work for other companies for a few years before they launch a career with the family business. Giving kids a choice — and a chance to succeed or fail somewhere else — is usually a good idea. But what if one of the kids chucks his job at age 40 and tells the CEO — who may be his mother, father, brother, or sister — that he wants to come back? What does that mean for the power or wealth distribution structure of the business going forward? Many families don't consider how family members moving in and out of the family business may affect the operations of its business or its wealth structure.
- **The next generation isn't trained to play nicely.** Just because you're related by blood doesn't mean you're natural collaborators. As with all workers in a business, family members must establish professional chemistry to get the job done. If a cousin and a son of the founder have never seen eye to eye because of some fight they had when they were teens, that shouldn't seep into the culture of the business — but often it does.
- **Families can be resistant to change, and so can their companies.** A big reason people start businesses is so they can do things their way. Unfortunately, that my-way-or-the-highway attitude can metastasize into "that's the way we've always done it" as founders and their children age in the business. Innovation and new product development — elements that are the primary drivers of value within any company — can face larger obstacles in family businesses when this is the case.
- **No formal compensation structure exists.** Asking Mom and Dad for money is a dynamic that starts early in most kids' memories. Without a formal compensation review structure, next-generation family members may feel they're going hat in hand to their folks for money, not demanding their proper compensation for the work they're doing, when asking for a raise or pay equal to one's peers in the industry at competing businesses.

  Family businesses that don't review compensation on a regular basis may find that they're underpaying or overpaying family members and other employees, which is their right on an ongoing basis, but it's something that may lower a potential sale price when valuation is done later.

Add general family conflicts inside and outside the business: Maybe someone's getting divorced in the family and both spouses work in the business; the owner retires but can't stop meddling; long-term sibling rivalries reignite; the ugly secret of unequal pay surfaces; or siblings may decide to start fighting like 8-year-olds again. Can all family conflict inside and outside the business be diffused with proper planning? Certainly not. But planning involves worst-case scenarios that families may not be aware of, and considering them is important.

TECHNICAL STUFF

Facts about family-owned companies

The following statistics were collected by the Boston-based Family Firm Institute:

- The leadership of 39 percent of family-owned businesses changed hands by the end of 2008.
- Thirty-four percent of family firms expected the next CEO to be a woman; 52 percent of participants hired at least one female family member full time, and 10 percent employed two female family members of the same status.
- Of CEOs age 61 or older and due to retire in 2008, 55 percent had not yet chosen their replacement.

Family wealth and business: Are they inseparable?

Many owners of family businesses haven't planned for a smooth transition to the next generation. In a 2003 Raymond Institute/MassMutual survey, less than a fifth of family business participants said they hadn't completed any estate planning other than writing a will, and less than two-fifths had written a strategic plan for their companies.

Our point is this: You should work with family members from the time they're young to gauge their interest and involvement in the business, because doing so will be crucial to valuation later. Enthusiastic and talented employees who just happen to be family tend to be much more dedicated to growing the company than family members who use the business as a fallback employer.

REMEMBER

Family members who know where they stand as participants or nonparticipants in the family business are likelier to pull together and do what's best for the business as transitions occur.

Separating family issues from business issues

Ask any loving parents who their favorite child is, and they'll likely answer, "I love them equally." And in most cases, it won't be simple diplomacy. They *do* love them equally, and they want them to inherit equal wealth.

In most families with nonbusiness assets, that kind of equal separation works as long as a proper will and supporting documents make that split clear. But when you have a family company in which all or some of the kids are employed, the story can be much different. Some parents may attempt the equal-split approach, only to find out that the kids who went on to work for Mom and Dad don't necessarily believe that their siblings who struck off on their own careers are entitled to the amount they're getting.

Consider this example: Dad created and grew a business over three decades, and he died suddenly without an estate plan or succession plan to guide the company's operations or potential distribution of assets. (This scenario happens all the time — just don't let it happen to you.) He had five adult children, but only one worked in the business. When Dad died, that sibling stepped up to the plate to keep the ship afloat and, like Dad, began to grow the company. After the funeral, this working sibling followed up with her father's verbal wish to split the ownership of the company five ways. For a while, all was fine.

Yet within a year, the new CEO began to regret her father's lack of planning. Two of her siblings were busy with their own affairs and happy with her leadership, but one — an older brother — started to involve himself more directly in the business. He said he was helping his sister as his father would have done; she thought he was second-guessing her leadership style.

As for the fourth sibling, she recently went through a divorce and was struggling financially as a single parent. To straighten out her finances, she wanted her one-fifth share of the family business. No plan covered this situation. Would the other siblings have to buy her out? Would the company have to take on debt to pay her the share of the business she was entitled to?

As you can guess, this scenario isn't an optimal situation under which to value a business. Any situation that involves time pressure — particularly the unpleasant emotional pressure among family members — leaves no opportunity to spot and correct problems that could improve its valuation later. And when such problems are spotted, that's even greater cause for conflict between family members.

Increasingly, families are looking at new ways to train their children for family business employment and diffuse the battle over family wealth creation. We get to that later in the chapter.

Does your business look like this?

Ivan Landsberg, a Yale University expert in family business, coined the term *succession conspiracy* — how business owners, their spouses, their family members, and non-family co-workers either consciously or unconsciously make damaging decisions that foil the effective succession of the business to the next generation.

He described three general types of family business management structures back in the 1980s:

- **Controlling owner:** A single owner is involved in every aspect of the business and makes critical decisions. Typically little or no planning occurs for this owner's departure.
- **Sibling partnership:** Siblings may share leadership, or a lead sibling may be designated — or designated by default — to make most of the business's key decisions.
- **Cousin consortium:** This structure is common among some of the biggest family fortunes in the world. When the business has been passed on to the children of prior sibling owners, eventually several branches of the family share ownership, and coalitions may be formed to create blocks of stock that represent more voting power.

Aligning with any of these ownership structures doesn't mean your family company is necessarily sliding off the rails. But if you recognize yourself in any of these structures, ask yourself whether the following also applies:

- The owner has created a succession plan that not only sets benchmarks for who the next-generation leadership will be but also comes with full buy-in from all family members, young and old, with a stake in the business.
- The owner and top family officers have spoken with family members recently either separately or in a group about their feelings about the business and whether any conflicts or issues need to be worked out. Better yet, is there a formal meeting structure?
- The owner has helped craft — with experienced legal and tax professionals — a quality transition plan that allows her the money and freedom to work in the family business if she's asked or to comfortably start retirement or a new phase of her career.

Why "equal" in a family business isn't always fair

A partial or minority interest is a very important concept in business valuation. By their very nature, holders of minority positions in a company don't have any say in the management of a company as those with majority positions do, and they also face an uphill battle to acquire the additional shares necessary to buy a majority stake in a company.

This is why in the valuation process, a discount for lack of control (also called a *minority discount*) is assigned when this structure is used. It's much easier to sell 100 percent of a company than it is to share a minority ownership position. And do very many owners of small to mid-size companies want to deal with minority owners who may not want to sell? No. It's a pain.

The value you lose through the partial interest discount can be pretty substantial. Valuation professionals say that between 25 percent and 75 percent of value can be erased in a sale situation.

That's why the equal split of shares among siblings and other family members is so fraught with danger. You need to single out people for performance, whether they're your family members or not. Also, with equal stakes, you may see the dynamic of the "cousin consortium" emerge — nonparticipating or less-senior family members may wrest control after combining their voting power based on their shares. (See the nearby sidebar "Does your business look like this?" for more on the cousin consortium and other management structures.)

The founder who splits the family business "equally" isn't doing her family many favors; she's simply creating the battlefield for a family war. If one family member wants control — or is already working in a position senior to the rest of his family members — he essentially would have to lobby the others either to purchase their stakes or to join with them as a voting bloc to award control, depending on the company's bylaws.

Getting Your Family Down to Business

Valuable companies do more than make money. They reflect a particular stability in terms of ownership and management consistency going forward. To accomplish this stability, leadership has to be established, contingencies have to be identified and planned for, and family conflict has to be dealt with in a businesslike way.

Does that mean that family can never argue? Of course not. Even when relatives are angry and yelling at each other, at least they're talking. What's important for a company's long-term valuation strategy is to set a firm management structure at the company and determine a means of settling grievances that arise — including talking openly about such issues as fairness, multigenerational issues, and unmarried partners (more about those topics later).

Bad estate planning can happen in the wealthiest of families. It's not unheard of in the richest of families for the matriarchs and patriarchs to die or become incapacitated without proper wills or directives for their heirs. Every adult family member — young or old — should commit to creating such documents and, as appropriate, have them written in a way that doesn't shipwreck the family fortune or mission, no matter how big or small it is.

TIP

So your kids are in grammar school? Plan anyway

Considering how the transfer of assets will go in a family can never start early enough. Your objective is to preserve the value of the business and personal assets you've created, no matter how old you and your kids are. As we discuss in Chapter 10, the uncertainty over the estate tax exemption in the next few years means that the best idea is to discuss strategy now rather than later.

Most financial experts advise that you revise your estate plan every five years or as lifestyle issues change.

Remember, the estate and valuation issues with your business don't exist in a vacuum. To ensure that the value of your business will benefit your kids and future generations, you need to do some very prescient planning.

Following a phased-in approach

If you're reading this book, you may be part of a mature family business that needs valuation for a specific reason. But if you're forming or buying a business and you're looking for ways to bring value-aware family members into the business as they age, consider this phased-in approach to do that:

- **Understand from day one that it's all about choice.** You made your own choice to go into business. Your kids must make a choice to join the family business later. You have to be prepared for them to say no — or for you to say no if they're simply not right for it.
- **Talk about the family business as early as possible in your kids' lives.** Share stories about your company, its purpose, and its people, and explain both the good and the bad parts of working for yourself. Mostly, communicate your passion about it. Teaching kids positive values about work and the importance of having the freedom to choose a career you love is good, and that part can't start early enough.
- TIP **If your kids are interested in the business, start the kids young and increase their job responsibility as they grow older.** See whether your children want to work in the family business to earn spending money while they're young (check with your tax advisor before you attempt this approach). Then let the kids decide whether they want to move into different roles as they get into their teens and through college. This way, you get to see as the child grows whether working for the family company is just about the money or about building a lifetime career. It's probably most effective management-development program you'll run.

- **Start putting together plans for a series of family meetings that discuss the business before your kids are out of college.** Between you and your advisors, come up with a plan that establishes how your children will own and control your business at the time of your death. Plan to hold your first official family meeting with all your kids (assuming that the youngest one is already involved in the family business in some way) to discuss the qualifications for ownership in your company after you die or hand over the reins. We get to some scenarios shortly.
- **When all or a few of your children are working full time in your business, make sure they're subject to the same types of salary and performance evaluations as your nonfamily employees.** The results of those reviews should also be factors in justifying their qualifications for various jobs within the company.

Based on the discussions you've had with your tax and estate advisors, make sure you have a system set up to meet annually or semiannually with your entire family to discuss the family business. Some call these *family business councils,* and their structure should expand over time with the size of the family and the members who are involved in the business.

If you want to know more about estate planning, we suggest that you read *Estate Planning For Dummies,* by N. Brian Caverly, Esq., and Jordan S. Simon (Wiley), for a broader view on the subject.

Setting your family meeting structure

Nothing is wrong with the living room for an annual family business meeting if you're talking about your immediate family, but consider these guidelines as your business evolves:

- Always have a formal agenda that all participating members contribute to in advance. As in any business meeting, you should be prepared with facts and exhibits, if necessary. Distribute this agenda before the meeting so everyone can review it.
- Designate a facilitator for the meeting — in small groups, the responsibility can move around (it's good training for the kids), but as the group gets larger, you may want to work with a professional facilitator or someone who can manage the event without a stake in it.
- Appoint someone to act as the meeting secretary to keep a running history of discussion in these meetings.
- Make it a priority to increase the growth and value of the company, and devote at least part of the meeting to report on how that's going.
- Set ground rules about anger and conflict. In family businesses, emotions run high, and unchecked emotion in family meetings can derail other critical business.
- As more family members join the business, consider neutral territory if doing so makes the crowd more comfortable and facilitates discussion.

Addressing the fairness question head-on

Nobody knows how his or her kids are going to turn out or which one will end up being the business genius who will take the family company to a whole new level. Here are your options:

- Assuming that one of your kids turns out to be the genius and the rest are merely good water carriers, the best solution may be to name her the heir apparent early and develop a plan to give proportional amounts of nonbusiness assets to the other children at the time of the transition of leadership or at your death. If you don't have the full amount of those assets in place now, you'll probably require an investment strategy to build them — and that should also be part of the planning.
- Another option is to give the child or children working in the business the opportunity to buy out their parents' share, which would give the parents money to live on in their retirement.
- A third possibility is for the dominant child in the business to arrange a plan in concert with the parents to buy out the other siblings before or after the deaths of the parents. Again, this is a critical issue to be discussed among family members and trusted financial advisors, but one option to pay off the other siblings may involve buying a life insurance policy for one or both of the parents that would secure the payment amounts to the other siblings.

Setting up the best plan for the generations

In families with significant assets or other pressing financial issues that involve businesses or dependents, each generation's wishes for the dispersal of shared or personal assets should be documented legally and shared with all the relevant parties.

In many cases, the main topic of discussion is the multigenerational family business, perhaps one of the most complex estate issues any family will face. In others, the assets may consist mainly of cash, property, and other investments, but similar problems can occur when not all parties are on the same page about who will get what.

In the following sections, we cover some of the issues related to generational concerns and address what needs to be done to keep the family business afloat.

Preventing problems

Estate planning isn't just about splitting up money — it's also about disaster planning. If a family hasn't planned for business succession, other damaging secrets may emerge, such as problems in the business or significant debt the family may be liable for.

Also, the sudden death or lengthy incapacitation of the head of a family may turn chaotic without proper healthcare or financial directives to manage the person's illness or the money and business issues that follow.

Multigenerational estate planning may not be the easiest task in the world to accomplish, given how families communicate — or don't communicate — about money. But such dialogue may be the smartest action any family takes together.

Supporting the family legacy

Proper discussion, documentation, and review of a family's assets — with the participation of the right legal, tax, and financial planning advisors — can keep more of those assets in the family and working to the family's wishes. In the case of a family business, generations of family members have built careers there or may otherwise be depending on that income to live.

Yet a business may not even be at the heart of an issue. Families may also have foundations or other charitable activities that they've supported for years with a certain mission that the people in charge don't want changed. More than a few families have imploded in ugly legal squabbles over these situations and more. The results can be lengthy legal battles with damaging tax consequences, a potentially unfair split of assets among relatives, or simple mismanagement of those assets going forward.

Considering unmarried partners

Not everyone gets married before starting a family. Multigenerational planning should also address estate and child custody arrangements for unmarried heterosexual or gay couples who may or may not have done the appropriate legal planning necessary to secure the estates of their current or past partners and their heirs.

At the very least, all family members should understand the need for such planning to avoid conflict later. As nontraditional families become more common, families need to be open to that discussion to protect family and business assets from disputes later.

Chapter 12

Due Diligence on the Sell Side

In This Chapter

- Understanding why sellers have to do due diligence
- Identifying the three stages of due diligence
- Making an informational game plan
- Gathering information on your own company

Valuation is an important part of the reality check every seller should make. Think about it — examining your own company without bias is tough. That's why you need professionals to focus on that. The bottom line is that a potential seller absolutely must conduct thoughtful due diligence months — and preferably years — before the business goes on the market.

Due diligence means investigating your company with the cold eye you'd bring to any target. For anyone doing the job, it involves reading everything, asking plenty of questions inside and outside an organization, and generally leaving no stone unturned in finding out what makes a company tick and how much it's truly worth. It involves not only basic research and calculations but also the ability to forecast how a company will do years from now.

This chapter focuses on the soft and hard skills necessary to value businesses successfully before you sell.

Looking at Why a Seller Has to Do Due Diligence

Due diligence is a process in which you ask for and obtain as much timely and accurate information about an organization as you can get so you can thoroughly evaluate a transaction. When people say to "do your due diligence" about something, they're essentially telling you to do your homework before you make a decision.

In the context of business valuation, today's concept of due diligence originated during the Great Depression. The Securities Act of 1933 handed broker/dealers (people licensed to sell investments) the due diligence defense. The act essentially allowed these professionals some protection against lawsuits from investors accusing them of inadequate disclosure of information before they purchased securities. As long as brokers conducted due diligence on the investments they sold and could prove it, they'd be allowed such protection in court.

If you're selling a business, consider these primary reasons for doing due diligence with an independent valuation professional:

- **You don't want to lose out on a potential transaction.** Whether your company is planning to sell soon or at a date relatively far in the future, a thorough look at the value of your firm's assets is a starting point for a sales strategy. The process gives you the following:
    - The current value of all your company's assets, both tangible and intangible
    - An unbiased view of how well you're prepared for retirement or to pass the business on to heirs
    - A value profile that you can compare to those of similar companies in the field and plug into the profiles of potential acquirers
- **You can't produce valuation information yourself.** Although you may be well tuned into the tangible and intangible information that helps you run a business, you may not know where to look for the information that helps you do a full valuation. After a valuation by an independent professional, you'll have a better idea of how to track and store information that's key to a future valuation process from a potential buyer.
- **You need to look at your company as if you were a potential buyer.** Having a trained professional do the valuation is wise because you need someone with the skills to look at a business both impartially and critically. Even the most hard-bitten member of your management team can't accomplish this process, because it's hard to value what one creates.
- **You want to get the best advice that fits your industry.** Valuation has a way of bringing a selling company up to speed on both its strengths and weaknesses. Part of the valuation process involves gathering benchmark data that reflects the best practices in its industry — practices to emulate before a sale takes place so that the value of the company will go up, not down. After the valuation, you can clean up any problems within the business that make it less attractive to buyers (see Chapter 10 for some ways to give your company a makeover).

REMEMBER

When valuation professionals evaluate a company, they look at plenty of information, but they don't bury their instincts. Obviously, this book is about the process and fact-gathering procedures of valuation, but due diligence is very much about what goes on with your eyes, with your ears, and inside your head through the simple act of observation.

Understanding the Three Stages of Due Diligence

We can't overemphasize the importance of people skills in valuation. So much of what valuation professionals do to build access to an organization involves building comfort and trust with the people inside. No matter what the valuation is, the process generally involves three steps, in which those people skills definitely come in handy:

1. **The meet and greet.**

   After companies have their initial discussion about a possible deal, the first stage of the process is generally an onsite meeting in which the valuation professional tours the facilities — sometimes with the client, sometimes without — and meets management and the key officers she'll be speaking with throughout the due diligence process. The purpose here is to figure out where all the key data is and which company officials will and won't be able to talk about the business.

2. **The hunting and gathering.**

   Otherwise known as the *data dump,* this stage is when company reports, financials, and other data are collected and then subjected to questioning and calculation under appropriate methods of valuation.

3. **The once-over.**

   This step involves the final fact-checking and review of any events that have taken place since valuation was done.

Beyond these basics are details that come up as a result of the type of business and people involved. For that reason, we can't devote much coverage to each of the steps, because each case is different. Just assume that you need to tailor each step to fit your particular circumstances and that you need to pay attention to any details that arise. The rest of this book can certainly help you get a handle on what to watch for.

Tricks of the Trade: Collecting and Exchanging Information

One important part of your informational game plan is setting up your rules of thumb, which we discuss at length in Chapter 9. Rules of thumb provide a good start for researching the types of other businesses that are for sale in your class. However, no company should begin and end the valuation process at rules of thumb. Without a clear look at your business, you're really just guessing.

When you plan the sale of a company, you have more data to go on — much of which you share with the potential buyer. In the following sections, we discuss confidentiality agreements and the kinds of company data you'll exchange.

Gathering your own company data

This section provides a very basic list of documents and data that companies typically exchange in the due diligence process. Most of this information comes from the company that's up for sale, but depending on the type of proposed transaction and the parties involved, some of this data may originate on both sides of the table.

In any case, if you're contracting a valuation before a sale process begins, knowing what material will change hands is a good idea. Here's the list:

- A summary of what's for sale, right down to the cash registers on the floor
- A summary of what's not for sale
- A history of the target company
- The balance sheet — or a reasonable summary — of assets and liabilities for the last three to five years (both annual and quarterly reports)
- The income statement — or a reasonable summary — of the company's profit-and-loss history for the last three to five years (both annual and quarterly reports)

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  Why use the term *reasonable summary?* Wouldn't this be automatic? Well, private companies don't have to act like public companies. Some target businesses have, shall we say, a rather informal approach to bookkeeping. If a business is looking for a buyer, a banker, or possibly public ownership someday, it should take a more formal approach to this data.

- The company's own five-year financial forecast (if it exists)
- Market share/demographic information (if it exists)
- Lists of competitors and the status of their products
- The company's ownership structure, with shareholder percentages (to explain who owns what and what voting rights they have)
- Bios of the company's directors and executives
- Tax returns for the last three to five years and information on who did them — and a record of the last year the company was audited
- A summary of all open and settled litigation for the last five to ten years
- Complete monthly payroll data, including the number of employees, their function, and their average hourly rate
- A summary of physical inventory for the past three years
- All executive and employee pension data, including information on whether various plans are fully or partially funded
- Organizational charts/résumés of top employees
- A discussion of international business (if any)
- A listing of all suppliers, domestic and international
- All customer data — invoices, payment records, order backlogs (if any)
- A listing of all sales and manufacturers representatives/commission schedules for the last three to five years
- Personnel contracts, as well as data on bonus programs, deferred compensation, stock options, and profit-sharing plans
- All data on employee insurance — health, life, disability, and so on
- All patents, copyrights, and license agreements
- A list of all legal, accounting, and consulting professionals working with the company

If you don't fully disclose your company's risk scenario to a potential buyer, it could lead to litigation down the line. Your advance due diligence efforts can pay off here. If you do a public-records data search, you can conceivably capture all the information you need on past lawsuits, liens, and even divorce and estate provisions that can delay or prevent transition of ownership. If your company's disclosure doesn't meet the results of your thorough research, buyers will see that as a red flag.

TIP

Databases to bookmark

Unless otherwise indicated, the following resources are free databases you can check in your pajamas at home, but you don't necessarily have to pay money to access the databases that aren't free — just start hanging out at the public library or, even better, visit your local college and university libraries, which generally offer access to paid databases that you can use for free. Start bookmarking these databases:

- **Library of Congress (`www.loc.gov`):** Literally the world's largest library, it's a free resource on virtually every subject out there.
- **LexisNexis (`www.lexisnexis.com`):** This is a paid service, and it can get quite pricey, so call your local library to see whether it has this one. LexisNexis has general news and publication databases that were the foundation of its business, but the company now has specialized databases for the legal, tax, corporate, and sales communities.
- **ChoicePoint (`www.choicepoint.com`):** This one is another paid service from LexisNexis, but it's a ready resource for bankruptcy and litigation records, tax liens, and commercial and incorporation filings in various states.
- **The Central Intelligence Agency (`www.cia.gov`):** Who would've thought the CIA would help the average information-hungry businessperson? No, this site won't tell you whether that strange guy down the street is really a spy (or something creepier), but it's the home of the World Factbook, which provides tons of information, including market data on virtually every country on the planet — right down to how many cellphones a nation has in use.
- **YouTube (`www.youtube.com`):** This ever-expanding video site has a surprising amount of business content. As companies large and small get more sophisticated about using video to reach people on various issues, you may find clips of annual meetings, analysts' briefings, and other specialized content. Just search for the person, company, or subject you're interested in and see what comes up.
- **U.S. Census/American Factfinder (`factfinder.census.gov`):** This database helps you gather key data on population, spending, education, and every other topic the U.S. Census covers.
- **ProQuest (`www.proquest.com`):** This is a leading database of academic, trade, and popular press publications; it's accessible mainly through colleges and universities.

Protecting your company with a confidentiality agreement

Maybe no sale is immediately in the offing, but before any financial transaction can happen, both buyer and seller have to know that sensitive information will be protected. That's universal for public and private companies — private companies may be notoriously secretive, but public companies also like to protect proprietary information from competitors and generally like to keep deal talks private until a deal is actually reached.

The due diligence process requires that both sides disclose lawsuits, debts, and other obligations that their companies face — and the most sensitive of all information: what people get paid. Thus, you typically need paperwork before due diligence can start.

Enter the confidentiality agreement. Such an agreement can be as general or as specific (mentioning exact data and documents you don't want disclosed) as you want, but above all, it should meet your specific needs and concerns for the deal at hand.

Having a template to work from is always helpful. Following is a plain-vanilla version of a confidentiality agreement signed between two parties. Attorneys or advisors may advise changes in wording and requirements, but here's the gist it should follow:

Confidentiality Agreement

By and between ABC and XYZ, nonprofit corporations incorporated in

______________.

ABC and XYZ are engaged in merger negotiations. As this process proceeds, sensitive, confidential, and/or proprietary information may be exchanged by the parties. In order to protect the privacy and business interests of each of the parties, they agree to the following terms:

1. At the conclusion of negotiations, if a merger is not agreed to, all copies of all documents distributed to each party by the other party or its agents will be returned to the originating party.

2. Neither party will at any time during the period of merger negotiations or after merger negotiations are concluded make known to any third party any information or furnish any documents containing information pertaining to the other party.
3. In the event a merger is not agreed upon, neither party will make any use or take advantage of anything it has learned about the other party's organization, board, staff, clients, finances, legal dealings, or operations, nor will it use anything it has so learned to compete with the other party.
4. In the event a merger is not agreed upon, the parties will agree upon a joint statement to be issued to any third party requesting information about the merger negotiations. This statement will reflect positively upon both parties.

This agreement is entered into this _____ day of _____, _____.

____________________	____________________
Chairman of the Board, ABC	Chairman of the Board, XYZ

Chapter 13

Case Study: Valuation on the Sell Side

In This Chapter

- Anticipating common valuation problems and preparing your family
- Establishing a prevaluation plan
- Doing the actual valuation

Most valuation professionals get a call when a triggering event occurs in a business owner's life or the life of his or her family. Maybe the owner just died. Maybe the owner is just burned out or suddenly realizes for a host of reasons that it's time to retire. Maybe family members are squabbling about taking over the business. Maybe the owner is terminally ill. The designated family member calls with a familiar panic in her voice. "We don't know if anyone wants to keep running the business," she says, "and we can't afford to keep it open." And then comes the all-important question: "How much do you think we'll get?"

At this point, the best valuation professionals often have to deliver the worst news: that without a plan made while the owner was alive, family members may not see much benefit at all from selling the business. Worse, they may actually lose money preparing the business for sale or closure.

The decision to sell without analyzing the tax consequences, advantages, or disadvantages of potential deal structures or how a sale would fit your personal and financial goals can be catastrophic to you, your company, and your family. This "sign today, sell tomorrow" mentality is common, and most experienced valuation professionals see it as a decision-making process without a process. In this chapter, we provide some case studies and attempt to show you how to make sure that your decision to sell isn't met with bad news.

You can see another case study on valuation of a business in Chapter 18, dealing mainly with the investigative process buyers need to bring to bear to decipher the correct value of a company. This chapter deals with common examples that show how critical planning is to a high valuation for the company you'll sell someday.

Heading Off Common Valuation Disasters

Thinking about the sudden death of the patriarch or matriarch of the family is never pleasant. But this situation happens, and it exposes all sorts of planning deficits.

One business owner was hit by a bus and killed when he was on vacation. The family members rallied to keep the business afloat for a while. Then they made a collective decision to sell the business; they were ready to let it go. The problem was timing. The overall sale process can take anywhere from 6 to 24 months, maybe even longer. During this period, the family member who took the reins of the company began to suffer kidney failure — definitely a worst-case scenario.

This is why business founders need to link their estate, succession, and exit planning as part of a whole to make sure their families have a road map to take the business into the future. That road map should also include contingency plans for the next generation. We discuss such preventive measures in this section.

Writing down your wishes

People write wills that reveal their deepest thoughts about where they want their money to go. They also write detailed plans for everything from how they want the children to be reared to who should run the business if something happens to the owners. Such plans may not be legally binding, but as long as the family respects the business owner's written wishes, this document is a critical guidepost for protecting the value of a business.

Here's a sample letter:

> *Date* [*very* important]
>
> Dear Merriam, Jamie, and Bobby:
>
> Our family business has been a joy for me to build and run. I'm proud that it has provided for our family so well for the past 30 years. That said, the business was my passion. I don't expect it to be yours. You have your own dreams to pursue and your own lives to live. As a result, I have created the following plan to be used in the event that I die or become disabled. I hope that it will make the process of dealing with our family business easier.

Management:

Day-to-day executive management should be turned over to John W. Smith, the company's chief financial officer (CFO). He should assemble a management team made up of Roger Jones in operations and Bill Graham in sales. Management oversight should be provided by a board made up of Smith, Jones, and Marybeth Freeman.

Compensation:

John, Roger, and Bill are covered under the stay bonus plan that I put in place last year. Under this plan, they will continue to receive their regular salaries but also will receive a bonus equal to 100 percent of their base salaries if they stay with our company during the transition period and maintain the company's financial performance. Jane Mercer has the file on the stay bonus plan. Ken Farmer drafted the plan and can answer any questions.

Disposition of the Business:

I believe that the company should be sold upon my death or disability. Although John, Roger, and Bill are great managers, I'm not sure that they have the drive or the vision needed to continue to make the company a success. I have had preliminary conversations with Richard Ford at ABC Co., an investment banking firm, about the possibility of selling the company. In 1999, ABC thought that the business might be worth approximately $10 million. I have a great deal of confidence in Richard and his team. Please engage them to sell the company for you. They will handle everything, make the process easy for you, and do a great job. Their contact information is on the contact sheet attached.

Making sure that your records are adequate

Data has to be current any time you perform a valuation. Are the company books in shape so that three to five years' worth of financial statements can be provided easily? What about supporting schedules and data, such as equipment lists, depreciation schedules, and customer lists, or a file with all significant leases and contracts, accounts receivable and accounts payable aging, and related operational items? These documents are just a few examples of the host of documents that a valuation professional needs to do a thorough analysis, so a business owner really has to think about whether she's truly prepared to begin a valuation or sale process.

TIP

The right amount of time varies, but if an owner is thinking about selling the business, the exit planning and valuation process should start three to five years before he plans to exit the business. This time frame provides adequate time for the valuation professional to collect the data, analyze the owner's goals, and take her time throughout the process.

Taking time to plan

When a company puts its operations in order before a sale, it keeps surprises down to a minimum when the company goes on the market or if an unexpected offer emerges. It also keeps the current owner from going for the knee-jerk decision when an offer appears on the table.

Planning for a sale goes well beyond sprucing up the company's facilities and financials. It allows the entire management team to envision specific sale scenarios that are right for the company — and those that aren't. So why don't companies do more of this?

Much of the problem comes from the fact that planning for mortality or the sale of a company that's become a life's work is very hard for some people to talk about. Anticipating change is hard, but leaving fellow co-workers and family members unprepared risks a family legacy. Do everyone — including yourself — a huge favor, and get into the habit of planning.

Considering confidentiality

Many times, owners don't have anywhere to turn, so they don't complete the planning or decision-making process. Often, they don't start it until they've made a definitive decision to sell, effectively putting the cart before the horse.

Privately held businesses are sensitive to confidentiality. Some owners never want anyone else to know that they're thinking about selling. When they investigate the value of their companies, they're scared that competitors will get wind of the investigation and use it against them. They're concerned that current employees will get scared and start looking for new jobs or defecting to competitors. They're concerned about how suppliers will react. You need to consider all the parties involved before deciding whether to keep things confidential.

Setting Up Your Prevaluation Plan

Valuation isn't about waving a wand — or a paintbrush — at the time of sale and making a great result happen. It's about planning, sometimes years or decades in advance. We like to call this type of planning *prevaluation planning*.

If you think that you already have a prevaluation plan, check your preparation by answering a few critical questions:

- Have you met with an attorney or a financial planner to organize your personal finances? Have your spouse and other key family members who are involved in the business done the same?
- Do you have a will and necessary powers of attorney governing your health and finances?
- Do you know how much money you will need to retire?
- Do you know the wishes of your children and other family members regarding going into or continuing the business in case you decide to leave or something happens to you?
- If you were to die at 5 p.m. today, who would you want to fill your chair at 9 a.m. tomorrow?
- Do you have a retirement date in mind and know the kind of retirement you want to have?
- Do you know the current competitive landscape of your business, and do you have a plan to stay competitive for the short and long terms?
- Do you have qualified advisors to work with you on business, personal wealth, and tax issues, and do you communicate with those advisors on a regular basis?
- Do you have a plan in place to minimize the tax consequences of selling or passing on the business?
- Do you have three reasons in mind that would lead you to sell to or merge with another company?
- Are your current relationships with investors or lenders in good shape, and would they change if someone else within the company had to take over?

If the answer to any question was *no,* you don't have a thorough prevaluation plan. This result isn't a reason to panic, however; it's a reason to plan. The next subsections present a template that you can use to get started.

Finding the problems

Valuation professionals who are actively involved in prevaluation planning make sure that their clients take the time to articulate what they want to do. The summary of their responses may look something like Table 13-1, which is a report on business owner Robert's prevaluation planning. It identifies key personal and business problems that should drive the valuation planning process.

Table 13-1 Sample Prevaluation Plan

Personal goals	Robert wants to retire at age 59 and spend more time with his family. He also wants to get more involved in his church. He and his wife, Sallie, want to take at least one major cruise each year.
Personal situation analysis	Robert currently works 60 hours per week and has little time or energy left at the end of the week to enjoy his new grandchildren. He has always traveled for business and never had the time to enjoy the places he's visited.
Business goals	Robert wants to sell his company within the next few years but only if he can net enough to retire comfortably. His children aren't interested in running the business.
Business situation analysis	Robert's company currently isn't positioned to be an attractive sale candidate. Additional work needs to be done to improve its value and salability.
Financial goals	Robert believes that he needs approximately $200,000 per year after taxes to support his existing lifestyle and to retire comfortably.
Financial situation analysis	Robert hasn't done any comprehensive financial planning. As a result, he doesn't have a good idea of whether $200,000 after taxes is actually sufficient. In addition, Robert doesn't know how much he would need to net from the sale of his business to generate the annual cash flow that he needs.
Estate goals	Robert doesn't believe in leaving children a large legacy of inherited wealth. He wants to leave his children a small financial legacy and leave his grandchildren enough money to pay for their college and graduate-school educations.
Estate analysis	Robert and Sallie have done no formal estate planning other than drafting simple wills and trusts about five years ago. They have done no sophisticated planning to minimize capital gains or estate taxes.

This example reveals a lack of overall financial planning and the need to focus on two key issues:

- Robert doesn't know whether $200,000 a year is sufficient to provide his yearly cash-flow needs in retirement.
- He doesn't know how much he would net if he were to sell the business to fund a $200,000-a-year lifestyle.

The sale of the company won't fix these two problems automatically, because for now, no one knows the value of the company or what his financial needs will really be.

Are you starting to get a chicken-and-egg feeling? That feeling comes from the realization that business planning and personal finance planning really do have to be linked. Chapter 20 gives you considerably more detail on the estate planning and gifting strategies you need to consider and on the expert help you should enlist.

Analyzing the prevaluation

Prevaluation helps you find out whether a sale is a reasonable option to explore. But keep in mind that various goals change the prevaluation process. Prevaluation planning is different for each of the following objectives:

- Creating an estate/gifting plan for heirs
- Preparing for an outright sale of the company with no need for succession
- Creating an employee stock ownership plan (ESOP; for more information, read Chapter 24)

We can promise that if you do a valuation for each of these objectives, the conclusion is going to be different in all three cases.

In Robert's case (see the preceding section), if he finds that he can't net from the sale of the business enough to fund his retirement adequately, his timeline for selling the business gets a lot longer. He needs to improve the value of the company to sell at an optimal price.

Robert's self-analysis also uncovers conflicting goals — always a valuable discovery before any actual transaction process starts and mistakes are made. If he needs to maximize the sale price of the company to reach his retirement goals, for example, there go any plans for the kids to get the company. Younger family members typically don't have the kind of money that would solve the entrepreneur's financial problem. Ergo, the kids can't buy the company because they can't afford it, and poor Robert can't give the company to them because he needs that money to retire.

See why this planning should begin more than five years in advance?

Performing the Valuation

In Chapter 4, this book gives you an idea of the three approaches to valuation and the various methodologies used for each approach. So although performing the math for various methodologies may be nice as an academic exercise, the math is what it is.

Now's the time to manage subjectivity. Owners need to find a way to let unbiased, skilled people weigh in on their plan. They need to bring in experts to tell a well-researched, straight story that can guide their actions. A valuation professional can provide that third-party objective analysis, and the business owner needs to come to grips with this analysis before putting the company up for sale. This section runs through the valuation process using Robert as a case study.

Taking valuation from fantasy to reality

Consider Robert from Table 13-1, earlier in the chapter. If he thinks that his business is worth $10 million and the net from a $10 million sale will fund his retirement adequately, everything is peachy. But what if Robert puts his company up for sale, and the highest offer is only $7 million? The net from a $7 million sale may still get the job done — or not.

When a business owner goes through the valuation process for a sale, he needs to be prepared for a realistic range of values and make every effort to put himself in the buyer's shoes.

Tables 13-2 through 13-5 contain worksheet ideas that can help an owner evaluate various factors in detail: intangibles (see Chapter 5 for more detail), operating expenses, investments, and other financial details.

Table 13-2 Intangibles

Value Factor	*Objective Score (1 = Poor, 5 = Excellent)*
Well-defined mission and vision statement	
Owner's particular product/services knowledge	
Management's knowledge, experience, and depth	
Motivated and dependable workforce	

Value Factor	***Objective Score (1 = Poor, 5 = Excellent)***
Key employees bound by noncompete agreements	
Organizational structure promotes efficiency	
Management succession plan in place	
Active outside board of directors	
Long history, reputation, and name recognition	
Management focus on growth and value creation	
Industry regulations affect company profits	
Business plan is continually monitored and updated	
Owner's personal relationships (with customers, for example)	
Loyal customers	
Few competitors	
Special barriers to competition	
Strong supplier relations	
Located in a growing geographical market	
Part of a growing industry	
Reputable company advisors	
Active and visible in community and industry affairs	
Economic conditions influence product demand	

Table 13-3 Operating Expenses

Value Factor	***Objective Score (1 = Poor, 5 = Excellent)***
Repeat customers/customer list	
Trained and knowledgeable workforce	

(continued)

Table 13-3 *(continued)*

Value Factor	*Objective Score (1 = Poor, 5 = Excellent)*
Proprietary products: Patents, copyrights	
Recognizable trademark or trade name	
Large market share	
Diversified: Products, customers, geographic (size)	
Special franchise arrangement	
Favorable location to customers, suppliers, and others	
Market intelligence systems in place	
ISO 9000 registered vendor	
Brand-name distributor	
Industry specialization	
Special niche market	
Well-defined product/service differentiation	
Unique manufacturing/production process	
Special services: Delivery, repair, warranty	
Creative use of Web site to sell products or services	
Strategic partnering and alliances	
Strategic planning processes in place	
Economic order quantity (EOQ) and other inventory-control systems in place	

Table 13-4 Investments

Value Factor	*Objective Score (1 = Poor, 5 = Excellent)*
State-of-the-art technology equipment	
Large inventory selection	

Value Factor	***Objective Score (1 = Poor, 5 = Excellent)***
Ongoing investment in information technology	
Additional capacity for growth (space, manpower, and so on)	
Well-maintained capital equipment	
Commitment to research and development	
Capital budgeting processes in place	

Table 13-5 Finances

Value Factor	***Objective Score (1 = Poor, 5 = Excellent)***
Key management have incentive compensation plans	
High margins due to efficiencies and so on	
Strong liquidity position	
Optimal financial leverage	
Optimal operating leverage	
Favorable tax structure	
Well-defined internal controls	
Properly insured against external risks	
Long-term, profitable customer contracts	
Purchasing power	
Favorable debt financing terms	
Financing plans in place to secure needed capital	
Funded buy/sell agreement	
Budgeting system controls costs and eliminates waste	
Systems in place to comply with laws and regulations	

The analysis of all these factors is where the rubber meets the road in the valuation process. Gross revenue is what gross revenue is; profitability is what profitability is. As we mention earlier in this chapter, valuation isn't just the basic math; the discount and capitalization rates are eventually used to convert the numbers to a value that become most important.

How a company performs in relationship to other companies in its industry is going to speak volumes about whether the subject company is good, average, or great. If the company is performing at the high end of the range compared with other companies in this industry, this performance will influence a potential buyer's perception of intangible factors related to the business.

Checking the structure of the deal

A major weakness of traditional valuation theory is that it doesn't take deal structure into account. The Internal Revenue Service's Revenue Ruling 59-60 (we talk more about this ruling in Chapter 18) assumes that a deal is all cash at closing. In reality, however, hardly any deals are all cash at closing, so a proper valuation needs to take deal structure into consideration. In this section, we discuss financing and tax concerns. In the next, you see how these concepts play out in a case study.

Financing

The first things to consider in the deal structure are how the transaction will be financed and how that financing will influence the timing of cash flows to the seller. If the company is engaged in manufacturing, distribution, or some other business that has significant tangible assets, a bank or some other lending institution may finance a greater portion of the transaction.

If the company for sale is a service business with few or no tangible assets, however, getting a loan for the transaction is very difficult. The buyer's ability to get third-party financing greatly influences whether the buyer can close the deal.

REMEMBER

Businesses that don't have many tangible assets can't be sold with the majority of the proceeds coming in the form of cash at closing. These transactions typically have a lot of structure involved — that is, the money is going to come over time in the form of a seller note, consulting agreements, or *earnouts,* which are agreed-upon payments in case certain post-acquisition performance targets are reached.

Basic corporate finance relies on the time value of money: A dollar received today is worth more than a dollar received in the future. Therefore, if you agree to sell a company, the price of the company is going to be contingent on how much money is received now versus in the future.

After-tax consequences

When a transaction is executed, you have to determine the net proceeds. Uncle Sam is going to get paid, and the deal structure determines what taxes are owed and how those taxes are calculated. One needs to consider the structure of the company, such as whether it's an S corporation or a C corporation. Whether the transaction is in the form of an asset sale of a stock sale is also significant. Owners need to examine the assets being sold and what the depreciated book value of those assets is versus the fair-market value of those assets.

Looking at an example of a deal in progress

In this section, we present an example of a deal. The target company, which is an S corporation, is grossing approximately $33 million in revenue per year, with operating income of around $2.5 million. The deal is going to be structured as an asset sale. The major assets to be sold are inventory, accounts receivable, and fixed assets (office furniture, trucks, and machinery).

The company is able to negotiate a sale price of approximately $10 million, plus inventory. This deal is very attractive for a company this size, because it translates into a multiple of earnings of about five. The owners are very happy with the price and decide to move ahead with the transaction.

Financing considerations

When the sellers examined how they would receive their $10 million, they didn't pay attention to how the deal was going to be financed. Their fixed assets (equipment, trucks, and machinery) were aggressively depreciated over time in such a way that the book value of those assets was approximately $2 million.

In determining the purchase price, the buyer stepped up the value of those fixed assets to an estimated fair-market value of approximately $7 million. Therefore, when the buyer approached the banker for a loan to fund this transaction, the bank was only willing to lend an amount far below the value of the tangible assets that would be transferred in the sale.

Combined with some cash down from the seller, the bottom line of $7 million would be available between the two sources as cash at closing. How do the parties make up the gap of the $3 million?

The total purchase price is $10 million, but the buyer can get hold of only $7 million cash at closing. The $3 million has to come over the course of time in the form of a seller note, essentially borrowing from the seller to do the deal. This situation doesn't sit well with the sellers, who anticipated that they would receive the entire $10 million at closing.

Depending on how far along the negotiation process is, the sellers could renegotiate the deal and ask for more money — maybe $11 million to $12 million. If the sale process is close to closing and they want to get a deal done, their hands may be tied.

REMEMBER

After a letter of intent is signed and both sides have spent significant time and money on due diligence, renegotiating a deal can have fatal consequences. Therefore, the seller has to be careful that the deal doesn't blow up days before a successful closing.

Tax effects

Before you get too far into the sale process, you have to analyze how the deal structure is going to influence the net proceeds.

The owners in this example didn't do any pretransaction tax analysis and assumed that any proceeds from the sale would be taxed at a capital-gains rate of 20 percent. In a $10 million transaction, the tax bill would be $2 million, so net proceeds would be $8 million. But because the company is an S corporation and the transaction is an asset sale, some or all of the proceeds (depending on the purchase price allocation of those assets) would be taxed at ordinary income rates of 40 percent instead of capital-gains rates of 20 percent, doubling the tax hit.

This situation is another reason you need tax and valuation expertise in any deal you're considering.

WARNING!

Tax consequences need to be in the forefront for any deal you do, and consideration needs to start early. If you wait until the eleventh hour and then try to renegotiate after you find out what the tax hit will be, then you'll most likely kill your deal.

Adding insult to injury, because of the way the deal was structured, the owners would receive only $7 million of the total purchase price at closing. Selling your company for $10 million and walking away with only $3 million at closing leaves a really, *really* bad taste.

The bottom line: In performing a valuation on the sell side, you can't just do the numbers and call it a day. You need to consider personal objectives, the buyer's ability to finance and structure the deal, and net proceeds. Make sure your expert advisors cover every detail.