WHAT YOU NEED TO KNOW WHEN SELLING A BUSINESS

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INTRODUCTION

The dynamics of modern society have significantly impacted the long-established tradition of passing business ownership from generation to generation. Fewer and fewer businesses are being transferred from parents to children. It is becoming increasingly common for business owners to choose to sell their businesses to a third party.

The majority of entrepreneurs, however, do not think about selling their businesses when they start them. With the excitement of a new venture, most business owners focus the majority of their energy and efforts on growing their business and achieving growth and expansion milestones.

Selling a business is a more complex process than many may think. In this eBook we would like to address the most commonly raised questions that business owners have when it comes to selling their businesses.

THINGS TO REMEMBER

There are many reasons why business owners decide to sell their businesses: retirement, relocation, health issues, a tragedy in the family, burn out, etc. All of these, however, are related to a decision to change one's existing lifestyle.

> ***It is important, when selling a business, to position it as attractively as possible to fit the lifestyle of the prospective buyers.***

From the buyer's point of view, the decision to buy a business is most often a lifestyle-change decision as well. Although the financial rewards of running a business are very important, the lifestyle associated with running a business is often the most important aspect for a buyer.

It is important, therefore, when selling a business, to position it as attractively as possible to fit the lifestyle of prospective buyers. Very often the lifestyle associated with a particular business is ingrained in the nature of the business. Even in the most demanding businesses, a lot can be done to make it more “attractive”.

Although general economic and market conditions definitely impact the “saleability” of a business, a lot can be done to attractively position a business for sale. Careful advance planning and preparation are strongly recommended before putting up the business for sale. In most cases, the areas that need to be addressed are: books and records, operating efficiencies and redundant costs, owning vs. leasing equipment and other fixed assets, operational and safety manuals and policies, and human resources.

It is often assumed that the process of selling a business is very similar to the process of selling real estate. Although there are similarities, businesses and real estate are quite different in nature. They each have significantly different associated risks and, as a result, different valuation and return expectations.

> ***…well-run profitable businesses are always in demand. …do everything in your power to keep the business at its best!***

SELL IT WHEN IT’S AT ITS BEST

The best time to sell a business is when the general economy is doing great, customers have a high confidence level and the business doing well and growing. Although the state of the economy and general level of customer confidence are outside of our control, well-run profitable businesses are always in demand. So regardless of the reason for selling your business, do everything in your power to keep the business performing at its best!

Too often the business owners who have decided to sell their businesses “slow down” in preparation for retirement, or focus their energy on the marketing and sale of the business instead of maintaining efficient operations and business growth. This is the worst mistake that you can make before selling and it will cost you dearly when an interested buyery comes along.

Preplanning is one way that smart business owners maximize their return when selling their business.

PLAN AHEAD

Preplanning is one way that smart business owners can maximize their return when selling their business. When it comes to selling, a business is a product and its financial and operational records will result in its being deemed either a desirable prize or a distress item to be acquired only at a bargain price.

Here are a few things you can do to positively position your business for sale:

- It is extremely important to have well-organized books and records. If you don't already have these, arrange a professionally prepared set of financial statements, preferably for the past five years, but as a minimum – for the past three years.

- If your business utilizes leased premises, make sure the lease is transferrable and the lease rate is comparable with current market rates. If the premises are owned, get them appraised and consider offering buyers the option to lease them from you instead of buying them outright together with the business.

- Review your business expenses and see if they can be reduced. If you lease vehicles or other equipment, consider purchasing them. This will increase your asset base and will lower your recurring expenses.

ATTRIBUTES OF A DESIRABLE BUSINESS

When the decision is made to sell a business, it is always important to remember what prospective buyers are looking for. The following is a checklist of characteristics that the majority of buyers would consider desirable:

- □ The business is profitable and trending towards continuing profitability.
- □ There has been proven revenue growth over the past 4-5 years.
- □ The asking price makes economic sense.
- □ The location is desirable, unless relocatable.
- □ The business has detailed and accurate financial information.
- □ There is significant operational history and brand recognition.
- □ The business is scalable.
- □ The seller is prepared to carry back a portion of the purchase price (seller financing).
- □ If the premises are leased, the lease is transferable and extendable at a reasonable rate.
- □ If there are equipment leases, they are assignable to a qualified buyer.
- □ The business is not too equipment/inventory heavy.
- □ The business has trained management and employees that are interested in staying on with the new owner.
- □ If the business is a franchise, the Franchise Agreement is transferable at a reasonable rate.
- □ The business/operating processes are transferable and not too specialized.

- □ There is operational capacity without the owner being present.
- □ The business holds a competitive position in the market.
- □ There are high barriers to entry.
- □ The business is for sale on an asset-sale basis vs. a share-sale basis.

Although very few businesses will possess all of these characteristics, the presence of at least 6-7 of these is critical.

SHARE SALE VS. ASSET SALE

Every incorporated business can be sold either in the form of a share sale or asset sale transaction. In a share sale transaction, all issued and outstanding shares of the existing corporation are transferred from the seller to the buyer. Typically, this consists of everything on the balance sheet, including cash, accounts receivable, accounts payable, assets and liabilities.

In an asset sale transaction, all agreed-upon assets of the business are transferred from the corporation controlled by the seller to the corporation controlled by the buyer. In most asset sale transactions, all tangible and intangible assets are transferred, including the name of the business, telephone number(s), customer lists, etc.

Both types of transactions have their own advantages and disadvantages.

Share sale **advantages** to the buyer:

- Established credit with suppliers
- Contracts and leases are in place

- Employees are in place with employment agreements
- WCB rates are established
- Corporate, tax, and employment numbers and documentation are in place and remain the same

Share sale **disadvantages** to the buyer:

- Legal, financial and tax “contingent liability” of the corporation prior to the purchase
- Assets are often fully depreciated on the books
- Tends to be a more complex and more expensive transaction to close from legal and accounting points of view

Remember, the majority of buyers prefer an asset sale.

The major potential benefit of a share sale transaction to a seller is the potential ability to utilize a lifetime capital gains exemption if qualified. It is strongly recommended to consult an accountant or a tax lawyer before positioning a business for sale in order to determine the eligibility and actual benefit of a capital gains exemption. Remember, the majority of buyers prefer an asset sale.

Asset sale **advantages** to the buyer:

- No “contingent liability” of the corporation prior to the purchase
- No liability for employees
- Step up in the cost base of the purchased assets (allows the buyer to increase the value of the fixed assets to their market value and take advantage of higher depreciation amounts applied against the taxable income)
- “Clean” credit, WCB, etc.

Asset sale **disadvantages** to the buyer:

- No established credit with suppliers
- Need to "re-hire" employees
- Need to negotiate the transfer of contracts and leases

VALUATION

It is always more beneficial, from a valuation point of view, to own equipment and other fixed assets rather than to lease them.

Although there are a number of different approaches that are used to evaluate businesses, two methods are most commonly used in valuating small businesses: the asset-based approach and the earnings-based approach.

With the asset-based approach, three types of assets are valued: inventory, fixed assets and goodwill. Inventory is valued at "landed cost" (cost of inventory plus shipping, customs clearance, etc.). Fixed assets are valued at "used replacement value" in an asset sale and at "net book value" in a share sale transaction. Goodwill is valued by applying a multiplier to a seller's discretionary earnings (adjusted net profit).

When using the earnings-based approach, the value of fixed assets is disregarded and the value of the business is determined by applying a multiplier (typically a higher multiplier than when using the asset-based approach) to a seller's discretionary earnings (adjusted net profit).

With each method, additional adjustments are made based on the specific nature of a particular business.

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CONFIDENTIALITY

…the unnecessary disclosure… may cause serious damage to the business.

Confidentiality is a very important part of the sale process. There is a very fine balance between how many buyer prospects learn about the fact that the business is for sale and the amount of proprietary and financial information that is disclosed to them. If not handled properly, the unnecessary disclosure of financial and proprietary information may cause serious damage to the business, as it can impact relationships with competitors, customers, suppliers, and employees.

FINANCING OF BUSINESS ACQUISITION

…the options for third-party financing when purchasing a business are very limited.

Unlike the acquisition of real estate, the options for third-party financing when purchasing a business are very limited. Although most financial institutions have various products for small business acquisition and expansion, most hinge on the ability to have collateral and on the personal balance sheet of the borrower. As a result, in most cases financing comes from the buyer's own capital and from seller financing.

TIMING

On average, it takes nine months to sell a business…

On average, it takes nine months to sell a business in North America, with some businesses selling as soon as they hit the market and some being listed for more than a year and never selling. There are a number of things that impact the time it takes to sell a business but the two most common factors are price and terms. The lower the price, the faster businesses tend to sell. When we refer to terms, we mean the terms that dictate how the purchase price will be paid and in most cases this involves an element of seller financing (or seller carry back).

SELLER FINANCING

There are two main reasons you should to consider offering seller financing:

- It will increase the pool of potential buyers who can afford to purchase your business.
- It provides a buyer with a greater level of confidence in purchasing the business when they know that you have a financial interest in the buyer's future success.

Buyer prospects who can only afford to purchase a smaller business will often need the leverage of seller financing.

Keep in mind that buyer prospects with substantial cash have the opportunity to leverage their way into many other available businesses, and often significantly larger businesses. Buyer prospects who can only afford to purchase a smaller business will often need the leverage of seller financing.

CREATIVE SELLER FINANCING

In addition to carrying back of a portion of the purchase price for qualified buyers, there are other ways that you can help buyers to leverage their way into purchasing your business. These include:

- Allowing the buyer to assume accounts payables
- Allowing the buyer to assume conditional sales contracts (i.e. car payments, etc.)

- Allowing the buyer to assume payments on insurance and/or benefits programs
- Allowing the buyer to assume debt service payments on some assets

INFORMATION FLOW AND SALE PROCESS

Depending on the parties involved the sale process will vary slightly but in most cases the following steps will take place:

<u>Advertising and Marketing</u>

A business broker advertises his/her client's business opportunity through various means of advertising locally, nationally and internationally, and exposes the listing to an opt-in database of pre-qualified buyers.

<u>Initial Inquiry</u>

An interested party inquires on the business listing via e-mail or by phone. The broker collects very preliminary information from the buyer prospect in order to understand in very broad terms if the business opportunity would be a good fit for the person or entity and asks the buyer prospect to fill in, sign and submit a Non-Disclosure Agreement. Statistically, only 35% – 40% of buyer prospects submit the Non-Disclosure Agreement.

<u>Information Package</u>

Once the Non-Disclosure Agreement is received, the broker provides the interested party with a comprehensive information package on the business opportunity, which includes the name and address of the business, information about the industry, competition, competitive advantages, operations, clientele, growth opportunities, buyer qualifications, equipment, etc., as well as general financial information and historical financial performance.

Buyer Pre-Qualification

If the buyer prospect is still interested in the business opportunity after reviewing the information package, they are asked to submit a pre-qualification form. Only 5% - 10% of all buyer prospects take this step. Of those who do, only 2%-3% clearly demonstrate their ability to successfully acquire and run the business.

Meeting between Seller and Buyer

With the seller's permission, the broker arranges an introductory meeting between the seller and the buyer and releases detailed financial information to the buyer. Most of the time, a follow-up meeting between the parties is arranged after the buyer has had a chance to review and analyze all the information collected on the business.

Offer to Purchase

The next step in the process is a submission of a conditional Offer to Purchase, together with a fully-refundable business deposit. The Offer to Purchase normally includes a number of conditions with time periods for their removal. The terms and conditions of the Offer to Purchase can be negotiated by the parties.

Due Diligence

Only after both parties agree on the terms and conditions of the Offer to Purchase, the buyer begins his/her due diligence. As the buyer moves along with the due diligence, the conditions are removed. The Offer to Purchase becomes binding to both parties and the business deposit becomes non-refundable when the last condition is removed.

Closing

After all conditions are removed, the seller and the buyer pass all information to their lawyers for closing. The buyer's lawyer normally drafts the final Asset/Share Purchase Agreement and provides the draft to the seller's lawyer for review. After all details of the final Purchase Agreement are worked out, the parties move to closing and the distribution of funds.

POST-CLOSING COMMITMENTS

The seller's involvement with the business rarely ends at closing. In most cases, the seller commits to a training period to accommodate a smooth transition of the business. Sometimes the seller stays onboard as an employee or consultant. In most cases, the seller commits to a non-competition clause. If there is seller financing in place, the buyer will begin fulfilling his/her commitments as to repayment of the seller financing.

WHY USE A BUSINESS BROKER?

99% of buyer prospects never buy a business!

There are many reasons to hire a professional business broker to assist in selling a business, but this one reason alone may be the most important: 99% of buyer prospects never buy a business! Once the decision to sell a business is made, it is extremely important for the seller to stay focused on the operations of the business and to increase the bottom-line profitability if possible. A professional business broker knows how to sort through many non-qualified buyer prospects to find the few who have the right skills, experience and financial means to successfully purchase and operate your business, so that you do not need to spend time on this.

Another very important reason to use the services of a professional business broker is to insure confidentiality, as a breach of confidentiality around the sale of a business may have an extremely negative impact on your business.

CONCLUSION

Since selling a business is often a lengthy and complex process, it is important to know what to expect during this process, to set realistic expectations and to focus on the operations and growth of the business, as this is what buyers are looking for.

…set up realistic expectations and focus on operations and growth of the business…

The seller, who takes a casual approach to selling or who waits for the “right” buyer to come along and offer the “right” price usually loses. In most of these cases a sale does not take place and confidentiality around the sale of the business is broken. Preparation and planning ahead when selling a business provide for successfull financial and emotional outcomes.

WE ARE HERE TO HELP

Signature Business Brokers is a full-service Business Brokerage that offers businesses for sale in Alberta, Canada. We specialize in valuating, listing, marketing and selling existing business opportunities, new business opportunities, franchises and Internet-based businesses throughout Alberta.

Signature Business Brokers is an Affiliate of Global Business Brokers International, a company with 30 years of business brokerage experience and well over 1,000 businesses sold!

Paul Marchenko is a Certified Business Broker (CBB) who has extensive managerial and leadership experience within both large and small business ventures, as well as substantial real estate investment experience. He has been involved in a number of startups and understands the challenges that small business owners encounter. Paul is experienced in dealing not only with a company's principals, but also with suppliers, employees and other stakeholders.

Paul holds a Masters Degree in Business Administration (MBA) from the University of Calgary and has a solid understanding of the legal, financial and tax aspects of a business.

For more information on Signature Business Brokers and the services we provide, please visit:

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