TODAY'S BUSINESS SCENE

the newsletter for privately held businesses

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Before You Sell Your Family-Owned Business

There once was a family-owned bakery that had sales in the millions. The bakery sold bread to restaurants, supermarkets and some retail outlets. The founder gave each of his five children 20 percent ownership of the business. The founder's children really didn't want to work in the business, so they turned the operation and management over to two members of the third generation.

Eventually the founder's children decided that they wanted to sell the business since they were close to retirement age. For some years the business had been operating on a break-even basis and sales were not increasing. A professional business intermediary was retained to sell the business. He contacted as many of the larger bakeries as possible hoping to find a suitable acquirer. There was very little interest. The intermediary continued his search to find a good buyer for the business. After a lot of work, he finally found a successful businessman who offered a price equal to 50 percent of sales – a generous offer.

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Before You Sell Your Family-Owned Business (continued from cover)

The intermediary presented the offer to the five children – all equal partners. Little did he know that he had walked into the proverbial "hornet's nest." A huge family argument ensued, and finally the intermediary was asked to leave the room so the five siblings could decide what to do.

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The offer was turned down flat. There was no counter-proposal or even any negotiation on price, terms or conditions. The offer was dead. The intermediary had worked on trying to find the right buyer, figured he had, all to no avail -- six months wasted.

It turns out that the major obstacle was concern that the operators of the business might lose their jobs even though the prospective buyer assured the sellers that he would keep the current operators on. Remember, the operators were third generation, related in one way or another to the five owners.

Flash forward some 20 years. The bakery is still in business with very little growth and still operating on a break-even basis. The five owners are now in their 70s; they have never received anything for their equity and have very little hope that they ever will.

The above is a true story. It shows how a family can own a business and become completely dysfunctional when it comes time to sell the family-owned business. Although the bakery is still in business (barely), its story also shows that the proposed deal could have satisfied all of the owners' goals and made their retirement years a lot more comfortable.

Family-owned businesses make up a lot of the non-public companies in this country and according to published reports, many of them will be up for sale in the near future.

It is important, if the family-owned business is owned by more than one person, that a meeting is held with all of the family owners prior to electing to sell it, unless a strong buy-sell agreement has already been agreed to. This agreement should establish specific guidelines about what happens if one family member wants out of the business.

The company attorney and accountant should be in attendance along with a business intermediary. The reason for the intermediary is that intermediaries know what the pitfalls are, what buyer concerns will be and what should be done prior to going to market.

One of the major problems when there is more than one owner is communication. What about when the one owner who is active in the business decides that he needs a new expensive car and that the company should pay for it? Strict guidelines should also be in writing concerning salaries, benefits, etc. When one family member is ready to cash out or another one spends a lot of money furnishing his or her office – it is too late to have an agreement drawn up to cover these issues. The time is now!

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What is the Value of Your Business? It All Depends

The initial response to the above question really should be: "Why do you want to know the value of your business?" This response is not intended to be flippant, but really needs to be answered.

Does an owner need to know for estate purposes?

Does the bank want to know for lending purposes?

Is the owner entertaining bringing in a partner or partners?

Is the owner thinking of selling?

Is a divorce or partnership dispute occurring?

Is a valuation needed for a buy-sell agreement?

There are many other reasons why knowing the value of the business may be important.

Valuing a business can be dependent on why there is a need for it, since there are almost as many different definitions of valuation as there are reasons to obtain one. For example, in a divorce or partnership breakup, each side has a vested interest in the value of the business. If the husband is the owner, he wants as low a value as possible, while his spouse wants the highest value. Likewise, if a business partner is selling half of his business to the other partner, the departing partner would want as high a value as possible.

In the case of a business loan, a lender values the business based on what he could sell the business for in order to recapture the amount of the loan. This may be just the amount of the hard assets, namely fixtures and equipment, receivables, real estate or other similar assets.

In most cases, with the possible exception of the loan value, the applicable value definition would be Fair Market Value, normally defined as: "The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts." This definition is used by most courts.

It is interesting that in the most common definition of value, it starts off with, "The price..." Most business owners, when using the term value, really mean price. They basically want to know, "How much can I get for it if I decide to sell?" Of course, if there are legal issues, a valuation is also likely needed. In most cases, however, what the owner is looking for is a price. Unfortunately, until the business sells, there really isn't a price.

The International Business Brokers Association (IBBA) defines price as; "The total of all consideration passed at any time between the buyer and the seller for an ownership interest in a business enterprise and may include, but is not limited to, all remuneration for tangible and intangible assets such as furniture, equipment, supplies, inventory, working capital, non-competition agreements, employment, and/or consultation agreements, licenses, customer lists, franchise fees, assumed liabilities, stock options or stock redemptions, real estate, leases, royalties, earn-outs, and future considerations."

In short, value is something that may have to be defended, and something on which not everyone may agree. Price is very simple – it is what something sold for. It may have been negotiated; it may be the seller's or buyer's perception of value and the point at which their perceptions coincided (at least enough for a closing to take place) or a court may have decided.

The moral here is for a business owner to be careful what he or she asks for. Do you need a valuation, or do you just want to know what someone thinks your business will sell for?

Business brokers can be a big help in establishing value or price.

What a Buyer May Ask a Seller

A business owner who is serious about selling his or her business should be ready to answer the following questions:

- How do you grow the company?
- What is the company's competitive advantage?
- If you had a $100,000 windfall deposited in the business' checking account, what would you do with it?

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What a Buyer May Really Be Looking At

Buyers, as part of their due diligence, usually employ accountants to check the numbers and attorneys to look at legal issues and draft or review documents. Buyers may also bring in other professionals to look at the business' operations. The prudent buyer is also looking behind the scenes to make sure there aren't any "skeletons in the closet." It makes sense for a seller to be just as prudent. Knowing what the prudent buyer may be checking can be a big help. A business intermediary professional is a good person to help a seller look at these issues. They are very familiar with what buyers are looking for when considering a company to purchase.

Here are some examples of things that a prudent buyer will be checking:

Finance

- Is the business taking all of the trade discounts available or is it late in paying its bills? This could indicate poor cash management policies.
- Checking the gross margins for the past several years might indicate a lack of control, price erosion or several other deficiencies.
- Has the business used all of its bank credit lines? Does the bank or any creditor have the company on any kind of credit watch?
- Does the company have monthly financial statements? Are the annual financials prepared on a timely basis?

Management

- Is the owner constantly interrupted by telephone calls or demands that require immediate attention? This may indicate a business in crisis.
- Has the business experienced a lot of management turnover over the past few years?
- If there are any employees working in the business, do they take pride in what they do and in the business itself?

Manufacturing

- What is the inventory turnover? Does the company have too many suppliers?
- Is the business in a stagnant or dying market, and can it shift gears rapidly to make changes or enter new markets?

Marketing

- Is the business introducing new products or services?
- Is the business experiencing loss of market share, especially compared to the competition? Price increases may increase dollar sales, but the real measure is unit sales.

When business owners consider selling, it will pay big dividends for them to consider the areas listed above and make whatever changes are appropriate to deal with them. It makes good business sense to not only review them, but also to resolve as many of the issues outlined above as possible.