

---

# FAIR VALUE™

---

Reprinted from the Summer 1999 Issue

---

## PREPARING A COMPANY FOR SALE- OBTAINING THE BEST PRICE

By Banister Financial, Inc. Staff

**Introduction.** Preparing a company for sale cannot be effectively done overnight. Whatever the reasons for contemplating the sale of a privately held business, such as wealth diversification or the lack of family members to enter or carry on the business, owners should make preparations several years in advance. This article covers ten topics a seller needs to consider when preparing his company for sale. A thorough business valuation report can help in the sale of a business as it addresses all of the items discussed in this article as well as provides an unbiased estimate of value.

Assume for the sake of simplicity that there is one 100% controlling interest shareholder that has the ability to sell the entire company. Shareholder agreements, employee stock options and supplier agreements may hinder or prevent the sale of a company. How much stock the owner will sell is obviously a major control issue. A recent example of the power of control is the failed negotiations between George Shinn and Michael Jordan for the latter to purchase a 50% interest in the Charlotte Hornets. Jordan allegedly wanted control over both business and player issues with only 50% ownership and Shinn was speculated in the press to be unwilling to give up control of the business end.

**Working for a New Master- Not Always Easy for the Seller.** The current owner must also evaluate whether he can work for the new owner. The current owner in all likelihood will not be able to walk away

from the company, but will have to assist in the transition. This assistance usually takes the form of a multi-year employment agreement and a non-compete agreement preventing the seller from starting up a new business in the area or joining a local competitor. An owner might find it difficult no longer being the “top dog” and watching his company being managed in a direction he doesn’t agree with. The business press is full of examples where former CEO’s have been unable to function as the “number-two” man after a merger or acquisition (such as with NationsBank and Bank of America).

In summary, the seller must fully consider whether he has the ability to sell the company, is willing to work with the new owners during a transition period and is truly willing to exit the business by signing a non-compete agreement. Clearly, companies are sold without the current owner staying on, but buyers and sellers recognize the need of a transition arrangement to justify any “goodwill” or premium in the purchase price.

The following ten items should be considered by current management as steps in evaluating their company and preparing it for sale:

**Quality of financial statements.** Privately held companies operate in fundamentally different ways from public companies. Private companies often seek to minimize taxable income whereas public companies seek to maximize earnings. Private companies often have shareholder perquisites buried in their financial statements such as country club dues, personal travel and entertainment, personal educational expenses, etc. Whether or not these expenses are truly business-related is not the issue. The key is that discretionary or non-operating expenses decrease earnings and therefore

## PREPARING A COMPANY (continued)

value. Eliminating these expenses from the income statement several years in advance of a contemplated sale will allow the company's true earnings capacity to be seen, which is fundamentally related to value. If the owner doesn't wish to stop running such expenses through the company, at least be able to easily determine the total amount of such perquisites and where they are located on the income statement. This will allow the buyer to consider the effect of these expenses on earnings. Bear in mind, however, that buyers are inherently suspicious of "add backs" and may or may not choose or follow-through to add them back in setting the price they plan to pay. The far better course is to get rid of these costs years ahead.

Removal of non-operating assets such as boats, airplanes and marketable securities from the balance sheet can improve a company's financial condition. These items usually are retained by the buyer and represent non-operating assets that distort the company's profitability and efficiency. Pay off shareholder loans and advances, and loans to and from related parties if at all possible. Ideally, the balance sheet should contain only operating assets and liabilities.

The SEC requires two years of audited financial statements prior to the issue date for small companies offering stock to the public. Whereas the cost of audited financial statements may not be feasible for small businesses, "upgrading" compiled financial statements to reviewed financial statements may provide the potential investor greater assurance that the financial statements are not materially misstated. Those companies that only prepare financial statements for income tax returns should seriously consider paying for compiled financial statements with footnotes and a supplemental schedule detailing operating expenses and cost of goods sold, if necessary. Financial statements are usually prepared for two purposes in the United States, financial reporting and income taxes. Each method uses different standards, with income-tax basis statements based upon tax legislation. Financial reporting statements are prepared in accordance with Generally Accepted Accounting Principles (GAAP), which provides a better measure of economic earnings and value.

**Improve internal control.** One objective in preparing a company for sale is to assure the buyer that the transactions reported in the financial statements can be relied upon as accurate and that corporate assets are reasonably safeguarded against unauthorized use or disposition. Financial statements audited by an independent CPA helps generate such reliance as does

strong internal accounting controls (IAC). Strong IAC is not the norm in small businesses as employees often wear many hats and have broader responsibilities than in larger companies. Segregation of duties is often not possible. Appointing one or more outside directors can strengthen a small company's IAC as can engaging your CPA firm to express an opinion on your IAC system.

**Develop the next level of management.** Strong, effective management is often the most critical factor in a business' success. A company with a deep management team is likely a more desirable purchase candidate than a company with high key person risks. Given sufficient lead time, current management can establish a training program for junior executives that will eventually reduce reliance on a key person. Development of an organizational chart and formally defining job responsibilities can also be helpful in developing an efficient management team.

**Evaluate shareholder involvement.** A major consideration in valuing small companies is shareholder compensation and involvement in daily operations. For example, an honest evaluation of the need for both a shareholder CEO and a non-shareholder general manager may result in the conclusion that only one position is necessary. Compensation to non-employed spouses or children in lieu of dividends should stop so that the true earnings of the company are reported. A sound basis for shareholder compensation based upon market data is a good step toward improving the quality of a company's earnings. The owner-officer should be able to estimate how much salary and benefits he would have to pay an unrelated executive to replace himself.

**Estimate acquisition synergies.** Company A will pay more for Company B if A's management thinks that the value of the new company (A+B) exceeds the sum of A's and B's individual values. Synergy can be created by increasing revenues, decreasing costs, decreasing taxes or decreasing capital requirements. The seller can help increase the value of his company by identifying ways the prospective buyer can realize synergies, such as maximizing production capacity, eliminating overhead or utilizing tax loss carry forwards.

**Identify likely buyers.** A seller can help maximize the sales price of the company by identifying the most likely buyers in the industry and determining the key factors the buyer looks for in a purchase candidate. A good way to do this is to read the annual 10-K reports of the major players in the industry. These reports often state the desirable characteristics of company acquisition candidates such as location, target market and growth rates.

# PREPARING A COMPANY (continued)

**Define corporate strategy.** A strong mission statement can help a buyer determine whether there is a strategic fit between the seller and buyer. Is the company a low-cost provider or is it following a differentiation (niche) strategy where it can realize higher prices for its product or service? Does it target a certain customer group? Articulating a corporate strategy may give the buyer some assurance that management has long term goals and a vision for its place in the future.

**Know your competition.** An owner should be able to answer the following: what sets your company apart from your competitors and how will those characteristics transfer to a buyer? What is your market share and has it increased or decreased recently? Why? Has new competition entered your market and what has been the response by established players? How concentrated is your local market, do a few companies control most of the market or are there many small players with no real dominant market share? How will local competition react to the sale of your company?

**Know the industry.** Does the owner know the outlook for the industry? Is it a mature industry like carbonated soft drinks or automotive sales where market share is gained at someone else's expense, or is it a young, growing industry such as internet services where there is room for many competitors to earn economic profits? How important is government regulation and does such regulation hurt or help your company? Do customers or suppliers have power? Are substitutes for your product available? How responsive is demand and supply to price changes? Can price increases be passed along to the consumer or are they absorbed by the seller? What role does technology play and is your company equipped to address technological changes? Why would someone invest in this industry through your company?

**Identify company strengths and weaknesses.** Finally, every company has some weak spots. A thorough analysis of your company's financial condition, sales and profitability trends, capital requirements, working capital and financing needs compared to industry peers can help determine what is a reasonable asking price. Identifying weak spots allows you to determine what steps to take to improve and maximize value prior to placing the company on the market for sale. Buyers are (and should be) suspicious about what they are told about a company by its owner, expecting them to "puff" the good and hide the bad. An honest and straightforward look at your company (such as through a valuation) will help inspire their trust and confidence and hopefully lead to a more enthusiastic offer.

**Conclusion.** What do all of the above factors have in common? They are all covered in a good valuation report! A valuation report is certainly needed prior to the sale of a company. The owner is clearly the expert in the company, not the valuation professional, but the valuation consultant is an expert at analyzing the industry and the company's performance relative to its peers. In addition to producing a supportable estimate of value, a good valuation report will cover all of the above topics and will go a long way in satisfying the seller's disclosure requirements and in providing the buyer with the necessary comfort level. Banister Financial's valuation professionals all have many years of experience in analyzing and valuing companies.

As this article hopefully points out, preparing a company for sale ideally begins two or more years in advance. A key first step is to select a valuation firm that can provide the detailed work product to support an estimate of value and help identify the appropriate steps to take to maximize the future value when it is put on the market for sale. If you or a client is ready to begin preparing a privately held company for future sale, please contact Banister Financial at (704) 334-4932. ♦

---

**This article is an abbreviated discussion of a complex topic and does not constitute advice to be applied to any specific situation. No valuation, tax or legal advice is provided herein. Readers of this article should seek the services of a skilled and trained professional.**