GOT A SURGE IN YOUR URGE TO MERGE?

It has occurred to most owners at one time or another that their companies could be strengthened by purchasing another company. And conversely many businessmen will, at some point, come to sell their businesses, because they or their children are uninterested in sixty-hour weeks

So the process of buying or selling a business is really of great interest, and if properly structured, can be of immense value to all concerned. If this is all true, why aren't there more business combinations? The answer is that *too often potentially useful combinations are stymied because the participants are unfamiliar or uncomfortable with the process*. Uncertainty can cause buyers and sellers to draw back from what would be a good deal for both. Let's take a look at some of these questions, and eliminate some of the unfamiliarity, and therefore, the uncertainties involved

THE PRICE OF SUCCESS

The first question that comes to mind when owner A begins to think about business B is: how much is business B worth? There are a number of other questions, of course, relating to taxes, risk, and financing, but there is no point in going into those unless the parties can agree upon a value for business B which will be advantageous to both A and B. So let's examine that process first.

One owns and operates a business in order to obtain profits (profits which do not include the wages of the owner/manager) If owner B chooses to sell to A, he is giving up the right to receive future profits, and therefore, the value of business B to its present owner is the present value of anticipated future profits. This somewhat elegant-sounding phrase means simply this: If B anticipates that his company's future profits will average $10,000 a year, and if he could obtain a return of 20% on an equivalently risky investment (and remember that small businesses are risky investments indeed), then the present value of those future profits would be $50,000, since he could invest $50,000 at 20% and receive $10,000 a year. So owner B should be in-different to receiving $50,000 now as a one-time payment, or $10,000 each year into the future. They are equivalent sums for him. If he received less than $50,000 for selling his business, his wealth would decline. Similarly, if he received more than $50,000 for the sale of his business, his wealth would increase; he would gain on the transaction for the difference between the amount received and $50,000.

It is apparent that the value that a seller has for his business is a minimum. If he accepted less than the stated sum, he would lose, and so will not accept such an offer. On the other hand, if he were offered more than the stated sum, he would gain, and he is happy to accept as big a gain as he possibly can. So he has a floor, but no ceiling.

Now let's turn to buyers. Just as the seller gives up the right to receive future profits, the buyer gains the right to receive future profits. In the example above, if a prospective buyer analyzes the business and anticipates that under his management future profits would average $12,000 a year, he should be indifferent to receiving $12,000 a year or paying $60,000 now (that 20% rate of return again). Here too, if he were to pay more than $60,000, he would lose by the amount of the excess, and if he were to pay less than $60,000, he would gain by the amount of the deficiency. The buyer's value represents a maximum. So he has a ceiling, but no floor.

Putting these two ideas together, if we match a buyer with a maximum that is a higher number than the seller's minimum, a transaction is possible in which both buyer and seller gain. And in fact, that is an absolute prerequisite of any buy/sell transaction. Both parties must gain or the deal won't work. One might also observe that transactions are therefore possible because the parties to them have differing views of the values involved. If they both had identical views as to the value of future profits and appropriate rates of return, then no transaction should occur. The buyer's maximum would be exactly equal to the seller's minimum, and completing the transaction would involve a lot of trouble to trade exactly equal commodities.

DOPE OUT THE OTHER GUY!

It is these differing perceptions of values which make transactions possible. The differences in perception are most evident on the part of buyers, who may be roughly classified into two broad groups. The first group consists of purchasers with ongoing businesses, and with physical capacity in terms of plant and machinery sufficient to handle the seller's business without any additions. As a result, the buyer could handle the seller's volume with increases in labor and material only. The acquisition target may be the chief competitor of the seller at the present time. In the second group are those buyers who have no existing business, or one which is completely different and not readily integratable with the seller's. These prospective purchasers would therefore continue to operate the seller's business with the seller's plant and machinery.

Now let's look at how both kinds of purchasers would be likely to measure anticipated profits. First of all, buyers in either group should anticipate some initial drop-off in sales. The owner-managed business is the norm in the graphic arts industry, and most owner-managers who have achieved some degree of success are the principal salesman for their business. Many of the customer relationships rely on the owner's integrity and skill, and customers have become used to dealing with his firm through him. Any change in this relationship can be expected to cause at least some customers to consider looking for alternative suppliers. This sales attrition is a natural by-product of any transfer of ownership, and is probably inescapable. With good cooperation between buyer and seller and careful planning, it can be minimized, but it probably can't be eliminated.

There is another effect that occurs, but only with those buyers who run existing businesses: the elimination of overhead. In the perfectly matched business, substantial reductions in overhead costs result from the elimination of the need for some of the seller's plant, equipment, or a portion of its office personnel. The buyer's overhead will now be more intensely utilized, and the seller's eliminated. The profit enhancement obtainable from the elimination of overhead usually will far outweigh any reduction in sales, and therefore for buyers of the first group, anticipated future profits will be greatly in excess of anticipated future profits for the seller. On the other hand, buyers in the second category will have no similar offset for the reduction in profits resulting from decreased sales, and therefore anticipated future profits for them will be less than for the seller.

We would expect that a buyer of the first type would have a maximum well in excess of the seller's minimum, thus opening up large potentials for gain for either party.

Whereas a buyer in the second group may well have a maximum below the seller's minimum, and thus offer only the prospect of a loss for either party. This theoretical structure is matched closely by real life experience, which finds that one's closest competitor is often the best prospect for buying one's business.

The point is that an immense advantage is given to the person who understands the other side's position. If as a seller you know where the buyer's maximum is likely to be, you have considerable leverage in bargaining because you can move the eventual purchase price closer to that maximum and away from your minimum. If as a buyer you know what the seller's minimum is, you can bargain the price closer and closer to that minimum. If, when you enter into such a transaction, your only thought is the value you anticipate receiving or giving up in the transaction, you are liable to be at a great disadvantage. The seller, thinking of his value is liable to accept a price only slightly above the minimum, when many thousands of dollars more were available for the asking. And buyer conscious only of his own value is liable to pay a price far higher than necessary.

"PROFITS": SOME REFINEMENTS

In all of the foregoing discussions, we have talked as though anticipated future profits were the only determinants of value. While that' s true in large measure, there are other value components that have to be considered. First of all, there's a definitional problem. The relevant "profit" which both buyer and seller expect the business to produce in future years should first be adjusted to reflect annual cash flow (or "cash throw-off ") by adding back to net book profit any depreciation expense or other non-cash charges. If net book profit, in other words, were $9,000, but $1,000 of depreciation expense were incurred, then the annual cash flow would be $10,000

And profit, as we said in the beginning, does not include the fair market value of the owner-manager's services. In some situations, an owner works 12 hours a day, 6 days a week, for little better than craftsman wages. Profits in such a business are obviously overstated by the wage subsidy provided by its owner. On the other hand, there are businesses where the owner takes, in addition to a very substantial salary, two country club memberships, five cars, a healthy expense account, and a host of other perks all discreetly hidden from the vigilant eye of the Internal Revenue Service. Profits in such a business are obviously understated by the amount of excess, i.e., above fair market compensation, being paid to the owner both in direct wages and in perks. Before we can talk about present value of future earnings, these differences have to be adjusted for.

Finally, one has to take into account the market position of the business in talking about future profits. Are 70% of the sales of the business coming from one or two customers? Is a major customer about to move to the Sun Belt? Such factors certainly would be relevant to the discussion of future risks the prospective buyer faces.

TAKE AN UNBALANCED VIEW

What about balance sheet values? We haven't talked at all about them. Ignoring the balance sheet was rather deliberate because, in general, balance sheets tend to reflect the economic value of most businesses only dimly. However, there are some exceptions to this. There are businesses around that are cash-rich, that have significant amounts of working capital in excess of the amounts needed for normal operation. These excess amounts may be added to the purchase price on a dollar for dollar basis. For example, if the agreed upon value for future earnings is $75,000, but an examination of the balance sheet reveals that there is $20,000 of excess working capital available, it is reasonable for the seller to pay, and the buyer to ask, for $95,000. And of course, the other half of that coin is that for a business which is, for all practical purposes, insolvent, and which requires a large infusion of working capital in order to survive, a subtraction is appropriate. If that same business which was profitable but badly undercapitalized required an infusion of $20,000 worth of capital to make normal operations possible, then its value would be reduced from $75,000 to $55,000.

There is also a question of salvage value. The salvage value of a business is the amount obtainable by disposing of the assets on the open market, collecting the receivables, and paying off all bills. The funds remaining are the salvage value. Even a business which is losing money, and whose present value of future earnings is a negative number, is worth as a floor, or a minimum to the seller, at least its salvage value. From a buyer's point of view, however, unless future earnings can be foreseen which will raise the value to the buyer above salvage value, the buyer is well advised to let the present owner liquidate the business.

TAXES: A ZERO-SUM GAME

Once this initial striking price is agreed upon, then the parties must take a look at some of the other issues involved. The first and most obvious one is taxes. There are a number of ways in which the transaction can be structured, each with different tax effects on both parties. Generally speaking, the revenue code has been drawn so that the trade-offs are sort of a zero sum game. Tax advantages which are good for the seller and bad for the buyer and vice versa. But because the underlying tax positions of the parties may differ, the deal may be structured one way or the other to take advantage of these differences. For instance, from the point of view of the seller, he would prefer, naturally, to have the whole of the purchase price directly ascribable to the assets or stock, in order to treat the gain as a capital gain and typically pay a lower rate of tax. The buyer, however, would prefer to have as much as possible of the sales price be attributable to a contract for his continued personal services, so that a substantial amount of that sales price would become a tax-deductible expense. This, from the seller s point of view, has the unfortunate effect of transferring part of the agreed upon price from a capital gain to ordinary income. It is obvious that the purchase price may wind up being adjusted somewhat to account for the different tax effects upon the parties.

One effect which, however, is probably going to be significant and advantageous to both parties is treating the sale on the installment basis. If the down payment for the business is less than 30% of the agreed purchase price, the seller need only recognize income from the transaction as it occurs over the course of several years, and not all at once—a significant tax advantage. And of course, the buyer gains from a considerably reduced pressure on his cash flow.

SHARE THE RISK

The second general area that buyer and seller will have to address, after they have agreed upon their initial striking price, is what might be called "risk allocation." Buying a small business is not like putting money in a federally insured bank account, or buying U.S. Treasury Bills. It s a risky event, and that risk may be handled in a number of ways. We can illustrate by taking a look at the extremes at either end of the risk allocation spectrum. The first one is where the agreed purchase price is absolutely and unconditionally payable either at once or over time, regardless of the future success or failure of the business in question. In a transaction organized in this fashion, the sellers profit is 100% guaranteed, and the buyer assumes all future risk. The opposite of this arrangement is where the agreed upon purchase price is established as a percentage of future sales, or of future profits. (However, heaven help the hapless seller who agrees to a percentage of future profits but lets the buyer keep the books!) In such an arrangement, the buyer assumes no risk. If the business fails, he pays little or nothing for it. Any adverse problem that occurs, is going to be the seller's treat. Like most real life situations, neither one of these extremes is very representative of the successful buy/sell arrangement although they may have some application. Where the seller is small, and the amount in question insignificant from the buyer's point of view, a sale for a sum certain may be arranged simply as a matter of convenience between the parties. And also, where the seller is insolvent, i.e., a candidate for the bankruptcy courts, and yet controls a significant sales volume, it may be useful to the seller to assume the risk, since he has nowhere to go but up. By assuming the risk, he can demand a higher price for his business.

In general, however, in transactions between solvent buyers and sellers, and firms of comparable size, risk is usually shared In some fashion with part of the purchase price being payable absolutely, and part of the purchase price being conditioned upon future retained sales. This is not only fairer but is an effective strategy to introduce an element of risk sharing, since it makes both sides of the transaction more willing to put forth the effort necessary to carry it off. If part of the seller s future compensation is based upon retained sales, he will be more concerned to see that customers are not lost, and if the buyer must pay part of the purchase price regardless of the future fortunes of the business, he will have a bigger incentive to see that the interests of his new child are not slighted.

PLAY A WAITING GAME

The final issue to be addressed is that of financing. As we mentioned above in talking about taxes, the seller normally has a strong incentive to recognize any gain on an installment basis, which means that payments will have to be spread out over time. The seller dealing with a buyer in whom he has confidence, i.e., one whom he believes has a good chance of making the merged business grow and prosper, is well advised to take payments over a relatively long period of time. This decreased pressure on the workings capital of the firm will make it more likely that the transaction will be a success, and the seller may enhance his income from the sale by receiving payments of interest, either explicitly on a promissory note, or implicitly by way of a higher purchase price. If he does the latter, he will receive ordinary income at capital gains rates.

The only time when this approach is ill advised is when the seller has significant reservations about the viability of the buyer. Under those circumstances, he obviously must get as much as possible of the purchase price in advance, so as to be protected against the possible failure on the part of the buyer. But if such important reservations are present, then we are probably discussing a bad marriage from the very beginning. Perhaps the seller ought to find another buyer in whom he has more confidence.

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