

Cashing Out

A guide for owners and their advisors
on selling a business.

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Introduction

For you, a business owner, selling your company is an once-in-a-lifetime affair. It is the biggest sale in the firm's history and one you rarely have an opportunity to do over.

Becker & Beggs's primary role is that of an intermediary in the sale or acquisition of small and mid-sized, closely-held companies whose values range from \$500,000 to \$25,000,000. Through hard-learned lessons, we understand how deals are done successfully in this market. This booklet describes the selling process and the business broker's contribution.

This material will be useful to you, the seller, and your accountant and attorney. It may be read at several different levels. If you want an overview of the process but intend to let others plan and execute the details, then this material is useful as a guide. On the other hand, you or your advisers will find the sections on pricing and structuring fairly specific and helpful to anyone wanting a better command of these often misunderstood subjects.

The broker's and seller's goals are the same -- to sell the company for the most dollars, to the highest qualified buyer, in the shortest amount of time, and with the least disruption. Achieving these goals can best be accomplished by adhering to a process and by not engaging in an unfocused, "let's talk to the next guy through the door" approach.

Experienced business brokers can properly execute each step, resulting in a successful sale. A business owner, juggling these activities alone with the demands of operating the business, rarely can be as effective. We hope you find this material useful.

Overview of the Process

The optimum sale scenario is to have several, qualified buyers actively bidding on your company, selecting the best offer, and then keeping that buyer honest through the due diligence/final negotiations by having the others waiting in the wings. Reaching that stage involves six distinct steps, each designed to advance your agenda:

- **Pricing and structuring** - The keystones to the selling process, involving in-depth financial analysis, and a sound understanding of valuations, financing alternatives, buyer motivations, and tax implications.
- **Developing and implementing the marketing plan** - Identifying the potential buyer groups and the most effective means of reaching them.
- **Preparing sales material** - A readable description of the business designed to encourage and inform qualified buyer prospects.
- **Soliciting and negotiating preliminary offers** - From direct mail to advertising to extensive personal contacts, the selling starts here.
- **Selecting an offer and negotiating the purchase agreement** - Choosing the buyer offering the optimum deal combined with a highest probability of closing and then guiding the parties to the finish line.
- **Closing and post-closing** - Maintaining emotional tranquility during the stress of conducting due diligence and preparing closing documents. Invariably, during this stage problems arise that are resolved by our coordinating the various professionals involved.

Pricing and Terms

Realistic pricing and terms are the keystones to a successful business sale. Priced too high or requiring excessive equity, the deal languishes in the marketplace, gathers a "shopped-around" aura, and knowledge the firm is for sale leaks into the marketplace. Potential buyers are turned off, making it difficult to revive their interest later with better terms. Too low, and you leave money on the table with no chance to recover.

If the business isn't priced and structured right, then all the four-color brochures, national advertising, and creative attorneys will not sell the business. Pricing is a subject in which there is the greatest variety of opinion and approaches. Our approach in arriving at that "right price" combines sound valuation theory tempered with the realities of the marketplace.

Valuation vs. Pricing - Valuation is an appraisal of value. It is the result of a process combining science and art that usually intends to arrive at a theoretical "fair market value" based upon a "hypothetical" buyer. It is often used in legal and tax arenas.

By contrast, in selling businesses, we focus on price, the amount that real world buyers will pay today for a particular company. In arriving at a price, we use traditional valuation procedures, tempering the results based upon our market and financing experience.

The vast majority of buyers are so-called "financial" buyers. These buyers, both individual and corporate, (1) have a limited amount of cash equity available for the down payment and working capital, (2) use borrowed funds provided by third party lenders and/or the seller for the bulk of the purchase price, and (3) do not bring any unusual synergy to the transaction in their ability to generate substantial additional sales and/or reduce expenses. Pricing a business for financial buyers using borrowed money is a rational process because the buyer is constrained by the need to service acquisition debt.

"Synergistic" buyers, with knowledge or experience in the target business results in "investment value to the buyer" who *may* pay more than a financial buyer will pay. The synergistic buyer that is also a public company with access to low cost equity capital can pay even higher prices and still meet its financial objectives.

Nevertheless, it is the financial buyer (or a synergistic buyer acting like a financial buyer) who is at the closing table in the great majority of small and mid-sized transactions.

Because of this preponderance of buyers guided by financial considerations, we devoted the following sixteen pages to explaining how to price a business for this market.

The information gathering and analytical process that Becker & Beggs undertakes to establish the selling price and terms of your business includes these steps:

- Investigate your company, its products and services, personnel, customers, history, and industry.
- Recast the reported earnings and cash flow and project a stream of future earnings.
- Analyze the assets to be sold and liabilities assumed and calculate their market and collateral values.
- Structure the probable debt.
- Discount the future cash flows after debt service and arrive at a price based on the business's income-generating ability.
- Compare the income-based price with market comparables and the assets' market values.
- Distill all of the above into a probable selling price and terms.

What Is The Selling Company About? - Businesses are not merely numbers on a financial statement. They are dynamic entities operated by individuals directing human, financial, and material resources towards producing goods or services at a profit in a competitive environment. Before we analyze the financial statements, we must understand the business.

To that end, we meet with the owner, to discuss the company's market, products, and competition, the basis on which the company competes (service, price, quality, delivery, etc.), how the company is organized, key personnel, role and contribution of the departing owner(s), physical facilities, customer base, distribution methods, management information systems, its strengths and weaknesses, industry trends, and anything else pertinent to the success of the company. Our knowledge may be supplemented by contacting industry insiders and researching trade periodicals and reference books.

If there are negatives, now is the time to disclose them. Sellers occasionally delude themselves into believing they can hide adverse, material information from the broker and buyers. In our experience, these issues become known to the buyer prior to closing, resulting in either cancellation of the sale, lowering of the purchase price or adjusting terms. Better to identify them at the outset and mitigate or solve them prior to taking the company to market. If the issues can't be resolved beforehand, then they need to be presented in the most constructive light possible.

Recasting Income Statements - The purpose here is to identify the company's historic cash-generating capacity. The prior years' income statements are analyzed, taking into account a minimum of three, and preferably five, years of operations. Recasting or adjusting is necessary because most closely held companies choose accounting methods that allow them to minimize reported earnings and in turn, reduce taxes. Further, the owner(s)' compensation and perquisites are often what the business can afford to pay and may not reflect the true, economic worth of the services rendered.

Extraordinary income or expenses that are not representative or are not likely to occur in the future are eliminated. Depreciation is adjusted, it is usually replaced with the capital expenditures needed to maintain the revenue and earnings. Interest expense is eliminated in order to view the company on a debt-free basis. If the real property is owned by the business or the business's owner and is occupied by the business, then the market rate for a triple net lease on the property is substituted for the existing expense.

The results of these adjustments are the "earnings" upon which we base our pricing. These adjusted Earnings Before Interest and Taxes (EBIT) are the funds that are in excess of the business' operating and capital expenditure needs and which can be used for debt service and distributions to the new the owner.

Selecting a Stabilized Adjusted EBIT and Projecting it Forward - Having identified the adjusted EBIT for each of the prior years, the next step is to select a single amount that is representative of the past and then project it in the future. If there is no pattern to the historic EBIT and no other logical basis to establish a stabilized amount, then an arithmetic or a weighted average may be the appropriate figure for the business' cash generating capacity. If one or two year's results have been distorted by highly unusual circumstances (not merely changes in the business cycle), it may be appropriate to remove them (or minimize) when averaging. If a consistent, upward trend exists, then we may be

justified in using the most recent earnings as the stabilized basis for projected adjusted EBIT.

Why Historic Adjusted EBIT? - Buyers decide *whether* they buy a business based on its future but their *purchase price is largely influenced by its past*.

It's to the seller's advantage to present the company's future positively, describe all of the possibilities and accompany them with projections of a *supportable* future stream of adjusted EBIT. An early stage or growing business that hasn't reached maturity yet may warrant a fairly aggressive projected growth rate. However, many businesses for sale are mature with modest growth potential.

In justifying a higher purchase price, sellers will point out how sales and profits will improve by the buyer bringing new capital, energy, management, etc. to the firm. While these statements may be true, *buyers usually commit to a price based on the current business condition*. They believe improvements in performance will be due to *their skills and resources*, for which they shouldn't pay the seller. Further, the lenders, who are putting up the bulk of the purchase price, will rely heavily on past earnings to retire their debt. The result is that buyers are conservative about the growth assumptions and tend to use flat or nominal growth rates for projections.

Having identified the historic and projected earnings from which the buyer will repay debt, pay taxes, and receive a return on investment, the next step in the pricing process is to estimate the debt that will likely be available to fund the purchase.

DEBT PORTION OF THE PURCHASE PRICE

Third Party Financing - The amount and repayment terms of third party debt available *is the single most important element in pricing the business*. If the asking price doesn't meet the cash flow and collateral standards of the lender (the party with the most dollars in the deal) a sale won't occur.

The debt level and interest rate from third parties can be accurately estimated because lenders have fairly uniform underwriting standards. The amount of debt available is determined by (1) the historic and projected adjusted EBIT to service the debt, (2) the amount and quality of the business' assets used as collateral to secure the loan, (3) the risk

inherent in the business, and (4) the lender's opinion of the buyer's character and management ability.

Market and Collateral Value of the Assets - The tangible assets and liabilities are first converted from book value to market value. Trade receivables may be subject to some moderate downward adjustment, reflecting possible uncollectible accounts. Inventories may be adjusted either up or down depending on historic accounting methods, the amount of slow-turning merchandise, and current versus historic costs. The market value of machinery and equipment is generally higher than its book value in a going concern. Real property is almost always worth more than the value on the books. Intangible assets, in this calculation, don't have any value. The market value of the liabilities is generally their book value.

What is being Sold or Retained? - In an asset sale, the assets and liabilities need to be allocated between those sold or assumed by the buyer and those retained by the seller. Those assets that generate revenue are distinguished from those that are either excess or personal in nature. In an asset sale, the seller typically retains the cash, any personal assets such as a car and life insurance cash values, and probably the accounts receivable and sells the remaining assets and pays off all liabilities.

The conveyed assets are also the collateral used by the buyer to finance the purchase and are generally an important factor in how much can be borrowed and the repayment terms. However, projected adjusted EBIT may be the primary basis supporting the financing in many service, distribution or technology businesses that have minimal assets, particularly if historic results have been consistent over a number of years. The amount and form of the debt are the foundation in determining the buyer's debt-equity mix, which along with the adjusted EBIT, establishes the selling price.

This table shows a representative asset re-valuation plus a typical allocation with the seller retaining the accounts receivable (see Working Capital discussion on page 19).

ASSET SALE WITH SELLER RETAINING ACCOUNTS RECEIVABLE

	VALUE		ALLOCATION	
	BOOK VALUE	MARKET VALUE	SOLD OR ASSIGNED	RETAINED
ASSETS				
Cash	\$31,548	\$31,548	-	31,548
Investments	92,055	92,055	-	92,055
Acct's receivable	226,987	215,000	-	215,000
Inventory	410,671	375,000	375,000	-
Machinery & equipment	226,540	425,000	425,000	-
Vehicles	73,102	65,000	65,000	-
Furniture & fixtures	68,002	45,000	45,000	-
Leasehold improvements	107,567	125,000	125,000	-
Total Assets	\$1,236,472	\$1,373,603	\$1,035,000	\$338,603
LIABILITIES				
Accounts payable	\$197,548	\$197,548	-	\$197,548
Accrued expenses	72,909	72,909	-	72,909
Line of credit	316,000	316,000	-	316,000
Equipment/vehicle loans	126,720	126,720	-	126,720
Total Liabilities	\$713,177	\$713,177	-	\$713,177
EQUITY	\$546,509	\$660,426	\$1,035,000	(\$374,574)

On the asset classes below, lenders will generally loan up to these amounts:

ASSET	MAXIMUM ADVANCE	LOAN	TERM
Accounts Receivable	85% less than 90 days	Revolver	Evergreen
Inventory	65%	Revolver	Evergreen
Machinery & Equip.	75% of orderly liquidation	Term	5-7 years
Real Estate	80% of fair market value	Term	5-20 years

In the above scenario, the seller conveys \$1,035,000 in assets for a yet-to-be-determined selling price. Once the price is established, the seller deducts \$374,574 from the purchase

price for the liquidation of the retained assets and liabilities to determine their net sale proceeds, before transaction expenses and taxes.

Along with the collateral being considered, the basic limit on the loan is the maximum amount that can be comfortably amortized with the projected adjusted EBIT. In normal times, lenders will consider a loan with annual principal and interest payments of up to two-thirds of the available adjusted EBIT. For example, if the stabilized EBIT is \$400,000 a year and historic fluctuations have been nominal, the lender would lend an amount that results in annual principal and interest payments totaling \$275,000. Over five years, this debt service supports a loan of about \$1,130,000 at an 8% interest rate.

Lenders' willingness to make adjusted EBIT-based loans that are greater than the collateral value, ebbs and flows with the times. When the economy is contracting and banks are incurring loan losses, their loan advances tend to be closer to collateral value. When times are good and banks are bullish, cash flow lending comes back into vogue.

A consistent source of cash flow loans for smaller transactions are SBA-guaranteed loans. If the buyer's financing needs are in the \$100,000 to \$2,000,000 range and there is a steady earnings history, SBA lenders will lend a greater amount and for a longer term than a commercial bank without the SBA guarantee. If financing is primarily based on collateral, the SBA makes loans under its 7A program having these parameters:

	Loan to Value	Term
Equipment	80%	10 years
Real estate	90%	20 years

Interest rates are variable and are at 1.5 to 2.75% over prime as established by the lender. Up-front fees are in the 1-2% range. While the rates and fees may appear high compared to commercial loans, SBA-guaranteed loans frequently enable a buyer buy a business that they otherwise couldn't purchase.

Seller Financing - This is the remaining piece of the debt structure. As discussed above, a bank or commercial finance company will loan the buyer part of the purchase price if the historic and projected cash flow services the debt with a comfortable margin, if there is adequate collateral in the business, and if the bank believes in the buyer's capabilities. However, there is often a gap between the sum of the buyer's cash equity plus the third

party debt, and the value of the business, requiring the seller to step in and finance the remainder.

In the majority of transactions in our market, the seller provides at least part of the financing. While it is usually not their preference, *if the seller wants to receive full value from the sale*, they participate in the financing. The many forms of deferred seller remuneration include:

- Note
- Equipment or real estate lease
- Non-compete agreement
- Consulting agreement
- Employment agreement
- Commission agreement
- Seller retains certain assets
- Seller owns common, preferred or convertible stock or warrants in the new company
- Contingency or earn-out payments
- “Life-style” agreement
- Buyer pays Seller’s personal expenses
- Seller’s family employment

Seller financing is an important and necessary tool in selling closely held businesses. It represents some risk for the seller but has many benefits. Seller financing can (1) increase the total price, (2) close the deal by convincing buyer and lender alike of the seller’s faith in the transaction, (3) provide income to the seller at above market rates, and (4) defer taxes through installment-sale accounting.

Generally, the larger the amount of seller financing, the greater the selling price. However, the amount of financing the seller is willing to carry may be limited by several factors. In most asset sales, the seller is conveying the business free from liabilities. Consequently, the seller usually needs, at a minimum, sufficient cash proceeds at closing to pay off the liabilities, any taxes arising from the sale, and any transaction costs such as broker commission, legal fees.

The third party lender has a first and priority security interest in the business assets and may stipulate that part of its loan be repaid before the seller begins receiving principal payments on his note. A common structure is for a three to seven year term on the third party loan with principal payments on the seller financing beginning after the bank loan has been reduced by a third or more. Seller financing is subordinate to bank financing in priority of repayment and in collateral rights.

The seller note is *rarely fully secured by tangible, liquid collateral*. At a minimum, the note is usually secured by a second mortgage on the business assets and the buyer's personal guarantee. A pledge of additional buyer assets is often sought by the seller but is only occasionally obtained. Seller financing must be well documented and properly recorded.

With seller financing, the business must be successful under the new ownership for the seller to receive the entire purchase price. All the more reason to price realistically. Building in unduly optimistic assumptions about future earnings increases the likelihood of failure and default on the seller note.

With the debt assumptions in place, the loan payments are then deducted from the projected adjusted EBIT and the remainder used by the buyer to recover their equity investment and pay income taxes.

EQUITY PORTION OF THE PURCHASE PRICE

These future, after debt service cash flows, are discounted back to today's present value at the buyer's target rate of return on equity. The resulting present value tells us the equity a buyer will put up to achieve their objective.

Selecting an equity rate of return for a given business is more subjective than selecting a debt rate because it is a function of the perceived risk. The equity portion of the investment is largely unsecured by hard assets, since they are pledged to the primary lender. If the business defaults on the secured debt and the lender liquidates the collateral to repay the loan, very little, if any, of the collateral's value will accrue to benefit the investor. The equity is truly risk capital, only secured by and paid out of that portion of the actual cash flow that is not allocated to debt service. In short, the question is, "How assured are we of the cash flow continuing in the future?"

A minimum rate of return for typically required for equity capital has historically been 20%. A study of publicly held, small-cap stocks in the period 1966 through 1986 revealed that the average rate of return for these issues was about 19%. Considering that an investor in these stocks had liquidity not available to the owner of a closely held business, the 20% floor is reasonable. The maximum equity rate for an established company with special risk attributes is 35 to 40%. Above that level, the market is dealing with high-risk, venture capital situations.

Given this range of rates of return, we consider the factors determinate of a company's success or failure and assess a relative level of risk. The factors include:

- Stability of historical sales and EBIT
- Importance of the selling (and departing) owner(s) to the business
- Quality of the remaining managers and work force
- Industry trends
- Competition
- Technology changes
- Age and obsolescence of the fixed assets
- Requirement for additional capital for sustained growth
- Product or service lines and demand
- Market-shrinking or expanding
- Distribution and quality of customers
- Presence and effectiveness of management information systems
- Overall attractiveness and desirability of the business

If, after considering and weighting these factors, the business is considered to have a higher than average risk, then the required rate of return for equity capital will tend toward the high end of the range at 40%. If the risk is seen to be lower than average, the rate may be below the 20% lower limit.

These target rates of return on equity apply to most transactions. Occasionally, a “life-style” business, such as a country inn, comes on the market and individual buyers accept a lower rate of return in exchange for the increased psychic satisfaction.

A qualified buyer should have cash equity between 15% and 30% of the selling price. A seller should not expect a buyer to make a larger down payment, regardless of the company's profitability. Buyers intend to leverage their equity and if they have \$600,000 to put into a deal, they will use it to buy a business worth \$1,500,000 to \$3,500,000, not one worth \$1,000,000.

All of the pricing elements discussed in this section - projected adjusted EBIT, debt structure and payments, cash flow after debt service, discounting these cash flows at the buyer's target return rate, and calculating equity - are applied in the Case History section.

MARKET COMPARABLES

Using comparable transactions is a valuable pricing technique because it reports actual buyer behavior. However, there is a limited amount of accurate, consistently-reported, published data concerning the sales of closely-held businesses. Unlike residential and commercial real estate sales where all transactions are recorded by public agencies and properties share certain things in common such as square footage, acreage, construction material, age, etc., making comparisons easier, few sales of closely-held businesses are recorded and for those that are, it is often difficult for an outsider to ascertain the true cash flow of the business sold and the market value of the assets purchased.

There are two sources we use for market comparables. The Institute of Business Appraisers, begun in 1978 with over 2,000 members, collects transaction data from its members and has data on more than 30,000 transactions. This database describes the sale prices as multiples of revenue and of earnings. The IBA database is particularly useful in pricing smaller retail and service companies of which it has numerous transactions.

Pratt's Stats, a newer publication, includes nearly 14,000 transactions, most of which are in the \$500 thousand to \$25 million sale range. This resource includes greater detail than the IBA database.

These databases are searched to identify a meaningful number of sales that are comparable to the seller's company by SIC code and revenue size. Inconsistencies between the comparables and the subject company, such as what assets and liabilities are included in the selling price (see below) have to be reconciled.

Comparables are at best a rough guide. However, *they warrant consideration when the comparables price varies significantly from that derived by the income approach.*

Suppose it is determined, using the income method, that a given company with \$6 million in sales and an \$800,000 adjusted EBIT is worth \$5 million. By contrast, suppose the industry comparables show that the median selling price is 4.2 times adjusted EBIT (\$3.4 million) and the top quartile of prices is 5.1 times adjusted EBIT (\$4.1 million). Our \$5 million price is at the very top of the curve and unless the company has highly unusual attributes, prior buyer behavior tells us that it is unlikely that the company will be sold for that amount, at least without an earn out as part of the consideration

Finalizing Selling Price and Terms - Now it is time to put theory and practice together and arrive at an asking price.

Our discounted cash flow analysis tells us that the business is worth X. Should we raise or lower that price depending upon other factors? Where is the industry heading? What is the quality of the financial statements upon which our adjusted EBIT was predicated? How critical is the current owner to the continuing success of the company? Is the equity required within reach of a wide range of buyers? Are the skills and knowledge required by the business narrow and specific or can the buyer be successful with general management and people skills? How does the business show? Are there strategic buyers that will put a premium on the company because of the potential synergies? How much goodwill (intangible assets) are included in the price?

These are a few of the subjective and objective factors that go into setting a final price. These individual company and industry circumstances are also impacted by the availability of third party financing and the seller participating in the financing.

Becker & Beggs and other experienced business brokers and intermediaries, in the market every day, weigh all of these factors and arrive at the price and terms that will sell the business within a reasonable period.

Form of the Sale - The form of the sale has significant legal and tax ramifications to both parties. The seller's accountant and attorney must be involved after the price has been fixed and before the deal is packaged for sale. The primary sale variations are:

- Asset sale with seller paying off all liabilities
- Asset sale with buyer assuming some or all of the liabilities
- Stock sale with all assets and liabilities transferred
- Stock sale with adjustments to the assets sold and liabilities assumed
- Exchange of buyer's stock for seller's stock

Each of these scenarios may be modified by one or more of the various forms of seller remuneration discussed earlier under Seller Financing. Moreover, each must take into account that the pricing was predicated on a discounted cash flow analysis with certain assumptions. For example, if the seller retains the receivables in an asset sale, how does that affect our cash flow assumptions? If the seller's funded debt is assumed by the buyer, how does that compare with our debt assumptions in the analysis?

The tax implications of the various alternatives are so great that *the after tax proceeds to the seller and the after tax cost to the buyer can vary by as much as 30%, depending on which structure is used*. Sellers should go to market with the form that maximizes their after tax proceeds but be prepared to negotiate alternative structures and understand the cost of the concessions.

There is a strong bias among buyers and their attorneys to purchase assets rather than stock. Purchasing assets provides the buyer insulation from legal claims against the selling corporation that pre-date the sale of the business. Asset purchases also provide the buyer with greater tax benefits in the form of higher depreciation and/or amortization expense. Virtually all of the purchase price becomes deductible because the acquiring entity can depreciate its cost of the tangible fixed assets and amortize its cost of the intangible assets.

What is Included in the Sale? - A continuing source of confusion to buyers, sellers, and their advisers after establishing a price using the income and comparables approaches is "What assets and liabilities are included in the sale?"

Sellers ask experienced business intermediaries this question and receive varied answers. Our position is the sale includes the (1) fixed assets required to produce the revenue, (2) the inventory, and (3) the intangibles such as the name, company records, drawings,

prints, contracts, telephone number, web site, etc. The seller retains the cash and accounts receivable and all of the liabilities. Let's call this the "Basic Deal".

If accounts receivable are included, then there should be a dollar-for-dollar increase in the purchase price. If liabilities are assumed, the price remains the same, but the cash paid and notes delivered to the seller at closing are reduced by a like amount.

Need for Working Capital - In order to produce the revenue and earnings, the company requires working capital to fuel the enterprise. Working capital is the excess of the current assets (primarily cash, accounts receivable, and inventory) over the current liabilities (accounts payable, accrued expenses, customer deposits, and debt due within one year). It is this excess that allows the business to pay its maturing obligations on time while waiting for inventory to turn into receivables, and receivables to turn into cash.

The amount of working capital required is unique to every industry and every firm. A manufacturer with significant raw materials, work in process and finished goods inventories may require \$1.50 to \$2.00 in current assets for every \$1.00 in current liabilities. By comparison, a restaurant with no accounts receivable and minimal inventory can operate on only \$.25 to \$.40 in current assets for every \$1.00 in current liabilities.

The Basic Deal includes only a moderate amount of working capital - the inventory - which by itself, is unlikely to contain enough liquidity to fund operations.

Adjusting the Purchase Price for Lack of Working Capital - Assume a company for sale traditionally needs \$300,000 of working capital in order to meet maturing obligations on a timely basis. If the buyer only buys inventory valued at \$200,000 and assumes none of the seller's current liabilities, the buyer is \$100,000 short of the required working capital. If the buyer puts \$100,000 in cash in the bank account the day he acquires his new business, then this \$100,000 *comes out of the cash flow stream upon which the purchase price was predicated*, justifying a \$100,000 reduction in the purchase price.

As an alternative, the seller can make the buyer whole by adding \$100,000 in accounts receivable to the purchase so there is the requisite working capital. The seller retains any remaining current assets for their own account.

These adjustments are apropos when the business is priced based on its income and includes goodwill. When it has little or no income and is priced based on its assets, then there is no adjustment for working capital, the sale price being the sum of whatever assets are included.

Assuming Liabilities in an Asset Sale - Buyers often assume some of the seller's liabilities which can be treated as either (1) a means of paying part of the agreed upon purchase price, or (2) an addition to the purchase price, depending upon how the agreement is worded. For example, in an \$1,000,000 asset sale, the buyer can pay the purchase price by paying \$800,000 in cash and notes and assuming \$200,000 of the seller's liabilities. However, if the purchase agreement calls for paying \$1,000,000 *plus* assuming \$200,000 in debt, then the purchase price increases to \$1,200,000. The parties need to be clear, particularly in early negotiations, exactly what is intended when liabilities are assumed.

Does the Deal Make Sense? - Comparing the required debt service for the financing against the adjusted EBIT is usually the ultimate pricing test. If the debt can be repaid with a margin for error (for example, higher interest rates and debt service on floating rate loans or decline in sales in a cyclical industry), then the pricing is in the ballpark. On the other hand, if the price requires a 50% down payment to reduce the amount of financing so the debt can be comfortably repaid, then the price is probably too high. The vast majority of sales of companies in our marketplace have buyer equity of 15 to 30%, third party financing of 40 to 60%, and seller financing of 10 to 40%.

If the business is properly priced and the buyer pays 15-30% down, the buyer should be able to repay the third party and/or seller financing in three to ten years, depending on the life and value of the assets conveyed. If real estate is part of the sale, a longer term is justified. Conversely, if the asset value is light in relation to the selling price or the assets are short-lived, then a three to five year loan amortization period is reasonable.

A buyer shouldn't attempt to justify an unreasonably high price by stretching out the term of the financing so that it exceeds the useful lives of the fixed assets or the goodwill. Eventually, the acquired machinery and equipment requires replacement or upgrade either because of technology advancements, changing tastes, or wear and tear. If the new owner has to replace the fixed assets before the acquisition debt is paid off, he may be in a bind, having to pay for both the original and the new assets.

Another reality check is to compare the price based on income to the assets' market value. The selling price of profitable companies will exceed their asset value, but rarely by more than 2:1 in capital equipment intensive industries and 3 or 4:1 in service industries.

Variable Payments or "Earn outs" - If the business has an upside opportunity but the buyer is unwilling to pay the seller in advance for possible improved earnings, then the parties may agree to contingent payments or "earn-out" over and above the committed price, based upon the business reaching selected benchmarks. This approach helps the seller obtain more of the company's unrealized value. If the seller stays on after the sale as an officer or as a consultant, he can help influence the outcome.

Contingent payments based on easy-to-interpret and monitor benchmarks such as sales are recommended. Benchmarks predicated on operating or net income are difficult to define and control and lead to controversy. Regardless of the formula, the seller needs to have rights to audit the buyer's books and records and to levy a penalty for underpayment.

Because of the prevalence of seller financing, the seller and buyer are frequently joined together "at the hip" until the seller is fully paid out. For a mutually successful deal, the price and terms must be right, and the buyer must have sufficient equity, appropriate debt, and the management ability to operate the business profitably.

Stating A Purchase Price vs. Make an Offer - We strongly favor listing a business with a stated selling price and terms. It allows the prospective buyer to consider the purchase in the context of a specific investment. It also sends a clear message of the seller's expectations and needs, separates the tire kickers from the qualified prospects, and controls the range of offers.

Occasionally, if circumstances make it difficult to assess the level of future earnings, or if there are intangible assets with hard-to-assess values, or if a purchase by a strategic buyer places an entirely new dimension on the company, we don't state a selling price, allowing the market place to set a value. In that event, however, we reach an understanding with you before-hand as to your minimum, acceptable terms with the goal to achieve more.

Selling an Unprofitable or Marginal Company - The discussion above concerns pricing profitable companies for sale. If the seller is unprofitable or has only marginal earnings,

then pricing is driven by the business' asset value, not its income. *Without an earnings history, buyers will not pay for goodwill, regardless of how many years the firm has been in business or how well known it is.* The goal in these cases is to sell the assets based on their in-place, going-concern value, rather than their liquidating value.

Pricing for Sale to a Public Company - The above pricing discussion applies to our typical transaction, i.e., small and mid-sized companies selling to financial or strategic buyers for a combination of equity and debt. Occasionally, a company will be acquired by a public company in exchange for cash, notes, and/or the acquirer's stock. Usually this purchase is part of a strategic plan on the acquirer's part. The seller may have a product line or market niche that the acquirer values highly. If the acquirer's stock is selling for a high multiple of earnings, it may be willing and able to pay a premium to the seller over and above a value justified using the pricing process and logic described earlier.

In these sales to public companies, arriving at an asking price becomes more art and less science. Calculations are made of the business's adjusted EBIT, asset values, and discounted cash flow as we normally do, but we also attempt to gauge the potential synergy as well as the acquirer's alternatives including buying another company, if available, or starting from scratch. Obviously, if there is synergy, or if the buyer's alternatives are limited and/or more costly, the value of your company to this public company buyer is higher. Accordingly, our pricing strategy is to place a premium on the Company over and above what the analysis usually justifies.

Public companies have a strong preference in making acquisitions that increase earnings, or in Wall Street's terms, are accretive to earnings, not dilutive. For example, assume a public buyer's shares have a price/earnings ratio of 15 (the price per share is 15 times after-tax earnings per share) and a 35% effective tax rate. Because the seller's EBIT is a pre-tax figure, the buyer can pay up to 9.75 times the seller's EBIT without the transaction being dilutive to the buyer.

If there are truly strategic buyers willing to pay a premium for the seller's Company, it is wise to initially restrict the exposure to those parties only. The asking price will initially reflect the assumed demand. Then if the seller is unsuccessful in reaching a deal with the strategic buyers, the Company can be offered to a wider buyer population at a lower and more "normal" price, without looking as if it has been "shopped around."

Finding Buyers

The Marketing Plan - Developing a marketing plan begins by understanding the business, the company's strengths and weaknesses, and the markets in which it operates, then identifying the potential buyer groups. The list may include direct competitors, other industry firms with different product lines or geographic markets, suppliers, customers, private investment groups, and financial buyers, both corporate and individual. Each group has their own agenda and criteria.

At the top of the list are buyers who create the greatest value with the acquired company. These buyers have the ability, following a purchase, to increase the company's market share and revenue and/or cut costs. They are the most motivated because they believe they can increase future earnings.

If these prospects are in your industry, they are identified through a combination of industry directories, databases, *Thomas Register*, trade associations, and your personal knowledge. As a long time participant in the industry, you know many of the players and the possible synergies.

We also access Dun & Bradstreet's listing of 13 million US businesses, updated quarterly, which includes each firm's primary and secondary, eight-digit SIC code, its annual sales, and number of employees. With this powerful resource, we concentrate our efforts by identifying those prospective buyers occupying the same or similar space as the seller.

For local buyers, we use our own carefully cultivated database of 4,400 local, regional, and national companies. It is a compendium of *Who Does What* in our business community and includes the officers, sales, number of employees, SIC code, and number of years under the current ownership. This information is updated annually. It is supplemented with data from the Chamber's Business & Industry Directory, newspaper articles, and personal contacts. Sellers are well advised to use intermediaries with similar prospective buyer information and the approach described here.

The Becker & Beggs database also includes 1,850 local and regional attorneys, accountants, lenders, realtors, other business intermediaries, and other referral sources in our community, some having clients who are potential buyers for the Company. It is an

effective tool to make the company known to most regional area buyers through their professional advisers.

Locating one or two potential buyers is relatively easy; competitors, customers and suppliers being obvious choices. Companies in the industry, however, particularly competitors, are usually reluctant to pay for much goodwill unless the Company has some unusual product or market position that is difficult to duplicate. Buyers from outside the seller's industry but in a related field are often willing to pay a higher multiple of earnings or book value as the cost of entry. We don't restrict our search to trade buyers. In an effort to find that right strategic buyer we cast a broad net.

In addition to reaching strategic buyers, we present the Company to local and regional buyers who approach the business from an investment standpoint. Buyers in this group are individuals or companies who may either hire a manager or manage it themselves. At any given time, we will have upwards of 200 such registered buyers, each with their own criteria regarding equity, earnings and ROI objectives, industry choices, and geographic preferences.

Private Equity Groups - There are about 1,600 private equity groups ("PEG's") in North America, most of them pursuing a buy, build and sell strategy. Typically they identify a particular industry sector that they want to pursue, then acquire a company in that sector as a "platform", and then grow the platform organically and through acquisitions or "add-ons". In their typical game plan, a PEG acquires a \$50 million platform with an 8% EBIT paying 4 to 6 times EBIT, grows it in five years to \$150M with an 11% EBIT, and then sells it to another PEG or a public buyer for 6 to 8 times EBIT.

In general, the major PEGS are not interested in purchasing firms with sales of less than \$10-\$15 million as platforms unless they have some particularly desirable market niche, technology, or proprietary product. However, some smaller sellers may be attractive as add-ons to an existing platform. When we list a business for sale that falls into this category, all 825 PEGs in our database are contacted.

From all of these sources, we draw up a list of potential buyers for the seller's review so that they retain control over who gets to look at the Company. Some will be eliminated because of competitive considerations or other conflicts. For specific targets in the

strategic buyer category, we mutually decide what the possible synergies are and how to approach them.

The marketing plan has to be balanced between generating a substantial number of qualified buyers and the seller's need for confidentiality. Initial written and oral contacts are sufficiently vague as to not identify the Company.

The Becker & Beggs marketing plan combines both the rifle and the shotgun approaches. In addition to direct contact by mail and telephone to a pre-identified prospect list, we run classified ads in trade magazines, trade association newsletters, the *Wall Street Journal*, local general circulation newspapers, and the local business newspapers. The Internet plays a major role in selling businesses. We regularly list our companies for sale on three proven web sites along with our own site, www.beckerbeggs.com.

No matter how thorough we are in pre-identifying prospects, we are often surprised by the quantity and quality of prospects reached through broad-based advertising.

Advertising is kicked off in all of the media venues simultaneously. Rather than sending out the business description to prospects as they execute confidentiality agreements, we wait until a meaningful number have been received and then send them all at once. This approach allows the seller to better gauge demand rather than be in the difficult position of receiving and having to respond to one offer without knowing the other buyers' positions.

Timing is critical in maintaining competition among buyers. Concentrating the process results in higher prices, better terms, and reduces the breaches in confidentiality that often arise when a business is on the market for an extended period.

Our marketing goal is to obtain 15 or more signed confidentiality agreements from qualified buyers, have 8 or more make on-site visits, and 3 or more make offers. Multiple offers mean a bidding environment and a better deal for the seller.

Sales Materials - This critical material has three levels of detail. The first is a one-page summary ("Blind Flier") of the business designed to stimulate interest, presenting the major features of the transaction without identifying the Company. It is circulated to a wide range of buyer prospects and intermediaries. For a sample Blind Flier, see page 62.

After a buyer prospect has responded to the summary and has signed a confidentiality agreement (see page 63) and Becker & Beggs is reasonably assured that they have the capacity to acquire your business on the described terms, we provide them with a Confidential Business Summary. Again, you may want to exclude certain prospects at this stage.

The Confidential Business Summary is an 8 to 20-page document that addresses the core issues. It normally includes the Company's history, product lines, pictures of the facilities, organization, position in the market, biographies of key personnel, reason for selling, description of the assets, restated financial statements, growth areas, projections, selling price, and proposed transaction structure. The amount of detail in the document is great enough to motivate qualified buyers to make an on-site visit. It excludes sensitive information to be made available only after the buyer's intentions and qualifications are clearly established.

A prelude to a buyer offering the highest justifiable price for the business, is having them understand what they are buying. The Confidential Business Summary has to be organized, readable, emphasize the positive aspects, and minimize the negatives. It needs to be a stand-alone piece that conveys the Company's story because it may be circulated by the buyer prospect to their professional advisors, lenders, and investors.

The third document is a reference book we maintain containing confidential material such as staffing details including payrolls, customer and supplier lists, contracts, leases, loan agreements, and patents. This material comes into use during the buyer's due diligence, after a letter of intent has been signed. This information is shared with buyers only on a need-to-know basis, after we obtain the seller's approval.

Conscientious buyers are thorough in their investigation. To give sellers an idea of the areas and detail that a buyer might research, refer to the Buyer's Business Analysis Checklist beginning on page 51. Part of this information is gathered by the buyer prior to making an offer, and part during the post-offer, pre-closing, due-diligence phase. Sellers must be prepared to undergo the examination and have the right answers and the supporting documentation.

Generating Offers and Negotiating the Purchase Agreement

This is the grind-it-out phase of converting buyer prospects into qualified bidders. It entails phone calls, faxes, e-mails, follow-up calls, badgering, follow-through calls, communicating, scheduling visits, proposing, clarifying, drafting, handholding, cajoling, and all of the other selling steps.

Initial showings of the business are preferable during working hours when buyers can see activity. Nevertheless, to maintain confidentiality and reduce possible employee anxiety, on-site visits are also scheduled evenings and weekends. The intermediary is present to control the showing and keep the meeting on track. Buyers are required to have read the Confidential Business Summary before arrival so they understand the basics. First meetings are not for negotiation but for the parties to gain a feel for each other and their respective organizations.

Businesses do not sell themselves. It takes a knowledgeable intermediary with the ability to make the buyer see the benefits while keeping the pressure on to tender realistic offers.

Selling the intangibles of the Company come into play now. So far, we have been concentrating on the firm's nuts and bolts -- the financial statements, product line, facilities, personnel, etc. Almost as important in bringing prospects to the table are the intangibles distinctive to the Company. These difficult-to-quantify characteristics may include areas such as life-style quality, work-force motivation and esprit, product or service quality, environmental considerations, and customer quality. If they are an intrinsic and positive part of the business, Becker & Beggs will emphasize them to the prospects.

Throughout the process, we work hand in hand with you and your professional advisers. For most companies, selling is a one-time-only activity. It requires an experienced quarterback to lead the team and ensure that the right information and negotiating posture is being consistently delivered to potential buyers.

Negotiating with buyers and structuring deals requires an understanding of finance, accounting, contract law, taxation, and buyer/seller motivations. With this background, we bring the parties to the table to consummate a mutually acceptable deal. Closing deals requires perseverance, hand-holding, and constant communication with both parties including their attorneys, accountants, and occasionally, financing sources.

We not only set out to obtain the greatest gross dollars for the seller, but also to structure the transaction to minimize taxes, thus providing the greatest net dollars as well. Whether the purchase is of stock or assets, how the purchase price is allocated, whether the proceeds are paid to the corporation or the principal -- these and many more structuring issues have tax ramifications to the buyer and seller. We work closely with several tax attorneys and estate planners specializing in this area to insure that the sellers receive the maximum net sale proceeds.

Eventually, the buyer prospects are narrowed down with the objective of receiving several offers in the form of letters of intent. These are usually non-binding documents, limited to 2 or 3 pages, which spell out the major terms of the buyer's offer. Included is the price, assets purchased and liabilities assumed, closing date, contingencies such as third party approvals and financing, retention of key employees, etc. A clear, well-drafted letter of intent reflecting the parties' understanding of the key business issues is a keystone to making a deal. Sticky issues shouldn't be deferred until the purchase documents are negotiated but addressed and resolved at LOI stage, before extensive legal expenses are incurred and the parties expend time and emotions.

To control the range of offers, insure that buyers address all the critical deal points, and make the offer and counter process as concise and direct as possible, we provide prospective buyers with the deal points written from the seller's viewpoint. Requiring buyers to respond to the seller's goals rather than letting them work from a blank slate enhances the likelihood of consummating a deal on the seller's terms.

With the letters of intent in hand, sellers choose who they want to go to the dance with. The best buyer is not always the bidder with the highest dollars. All the prospective buyers are believed to possess the required financial capacity and management capability. Before accepting an offer, however, the buyer needs to demonstrate they have the resources to close on the purchase. And, if the seller is financing part of the purchase price

either in the form of a hard note or an earn-out agreement, sellers need to be confident the buyer can successfully operate the company.

Closing and Post Closing - At this juncture, sellers have accepted a letter of intent and the most stressful part of the process begins as the buyer engages in his due diligence and the parties negotiate the definitive purchase agreement. The intermediary's role in this phase is to assist the buyer in generating the detailed information on the company that he needs to finalize his decision, to establish and supervise a timetable of events preceding closing, and to coordinate the document negotiation and preparation.

Perhaps the intermediary's most important contribution is to buffer and filter the emotions that frequently result in broken deals. In many transactions, there will be one or two occasions when one party or the other will want to walk away, either feeling that the aggravation is not worth it or because some recently uncovered information requires revised terms. The seller may feel the sale was finalized when he accepted the letter of intent, whereas the buyer, as he does his due diligence, may uncover information that makes the business less attractive than originally perceived, and one or the other may become impatient and jump the traces.

When this occurs, we move into the void, doing whatever is necessary to bring the principals back to the table. Often problems that arise are resolved by our coordination of the knowledge and expertise of the various professionals involved.

Structuring the Sale

There are numerous considerations for buyers and sellers in determining whether a transfer of a business should be structured as either a sale of assets, a sale or exchange of stock, or a merger. *This material is intended to be used solely as a guide to current law and to federal income tax regulations and is not intended to be legal or tax advice. Readers contemplating the sale or purchase of a business should consult with attorneys and accountants experienced in commercial transactions of this nature before making any commitments.*

The seller's business can be owned in the form of a sole proprietorship, a partnership, a limited liability company, or a corporation. A corporation is the most frequent form and it takes one of these forms:

- C corporation - Earnings are taxed first at the corporate level at the corporate rate and then taxed to the shareholders at individual rates when dividends are distributed. A C corporation selling assets presents the greatest tax challenges to the seller because of this double taxation.
- S corporation - Earnings, whether distributed to shareholders or not, are only taxed once at the shareholder level, at the shareholder's personal tax rate.

In the following discussion, it is assumed the selling business is in the corporate form unless otherwise stated. However, many of the points discussed below may apply no matter what form of entity is involved.

The great majority of small and mid-sized business sales are structured as asset purchases as opposed to stock purchases, exchanges or mergers. Buyers have a strong bias towards asset purchases because:

- Buyers usually can step up (increase) their depreciable basis in selected assets, thereby increasing deductions and reducing taxable income in future years.
- Undisclosed and/or contingent seller liabilities stay with the seller's corporation.

Despite the preponderance of transactions structured as asset sales, both buyer and seller should be aware of the tax and non-tax implications of the alternative structures. Sellers

in particular, must analyze the after tax impact of the various structures and, if there are significant advantages in one form over the other, should build that form into the negotiations, early in the process. Otherwise, the seller runs the risk of negotiating long and hard with the buyer on the purchase price and then ends up with an unfavorable structure, resulting in higher than anticipated taxes.

Sellers insisting on a stock sale should be prepared to discount the purchase price 5 to 15% to compensate the buyer for the buyer's reduced tax benefits. Further, the buyer will often hold back a portion of the sale proceeds for a year or two, giving time for any undisclosed liabilities to surface.

TAX CONSIDERATIONS

Discussions about individual and corporate taxation are about as interesting as watching paint dry. Nevertheless, poor or no tax planning on the sale of a business can lead to an enormous variance in the after tax proceeds to the seller and in the after tax cost to the buyer. Because both buyer and seller are required by the IRS to treat the transaction consistently, the allocation of the purchase price has to be agreed upon by the parties. This is practically a zero-sum game - a structure that incorporates tax advantages to one party usually disadvantages the other. Accordingly, the structure and the allocation of the purchase price often are critical aspects of the negotiations.

Ordinary Income versus Capital Gains Treatment - Sellers want to structure deals emphasizing capital gains income versus ordinary income. The federal ordinary income, marginal rates in 2011 for couples with taxable income above \$212,300 is 33% and above \$379,150 is 35%. Tack on to that another 5 to 7% for state income taxes in states such as Ohio and sellers can pay income taxes of up to 42% for gains treated as ordinary income.

With federal capital gains rates at only 15% plus say 6% for state capital gains, high-income sellers have a strong predisposition to structure the sale in a manner that emphasizes capital gains, such as selling stock. A stock sale is taxed to the seller as capital gains on the amount of the purchase price in excess of the seller's cost ("basis").

Tax Free Exchange - If the seller's shareholders exchange their stock for the buyer's stock and no other consideration is involved, then any gain or loss is not recognizable by the seller's shareholders until they dispose of their buyer stock. Their basis in the buyer

stock is the same as their basis was in their seller stock. To qualify as a tax-free exchange, the buyer's shares that are exchanged must be voting securities.

The transaction can be structured as a merger where the seller is merged into the buyer or a buyer affiliate and the seller ultimately goes out of existence. In a stock-for-stock purchase or a merger, the buyer receives seller's basis in all of the assets in the acquired or merged corporation.

Buyer's Asset Basis in a Stock Sale - The buyer receives no tax benefits from a stock purchase during their ownership period, other than depreciation and/or amortization resulting from the depreciable assets in the acquired corporation at the time of sale. Only if they subsequently sell the stock does the buyer get to deduct their cost of the stock.

SELLING ASSETS

Purchase Price in an Asset Sale - The buyer's basis in the purchased assets is the sum of the cash, notes or other consideration paid or delivered plus any seller liabilities assumed plus buyer's acquisition costs if they are capitalized and not expensed.

Allocation - The buyer and seller must mutually agree on the allocation of the purchase price among the various assets and each is required to file a Form 8594 with their respective tax return in the year the sale is consummated. The allocation of the purchase price as to inventory and accounts receivable is pretty straight forward since the parties will, in the due diligence phase, agree on the true market value of these two asset categories and usually without material variance from book value.

It is the allocation to the remaining assets, typically the personal property (equipment, furniture and fixtures, vehicles, computers, etc.), real estate, goodwill, covenant not to compete, and consulting or employment where negotiations take place because each category has different tax consequences to buyer and seller.

After making the purchase price allocations for inventory and receivables, if the remaining assets are purchased for more than the seller's book value, the buyer will usually want to allocate the remainder of the purchase price first to machinery and equipment, much of which can be depreciated over five to seven years. After allocations

to equipment and other tangible assets, any remainder is then allocated to intangible assets, principally goodwill and a covenant not to compete.

IRS requires the allocation of the buyer's cost to any asset not be any greater than the asset's fair market value. We have been involved in many transactions where the seller's equipment book value (cost less accumulated depreciation) was 25% or less of original cost and the agreed upon allocation was 50% to 75% of cost (good for the buyer, bad for the seller - see below).

Tax Consequences to the Seller in an Asset Sale - For the seller, if the sum of the amount received plus the liabilities assumed less any commissions incurred in selling the assets exceeds the seller's basis in the assets, then the excess is generally taxable to the seller.

If seller is a C Corporation and is liquidated following the transfer, the transaction may result in two levels of tax. If the assets are sold for more than their basis, then that gain is taxed at the corporate level. If the net proceeds to the seller's shareholders from the subsequent liquidation exceed their basis in the shares, then they are taxed on that gain, also.

If the seller is an S Corporation, there is only one level of tax since gains and losses are passed through directly to the shareholders.

Any gain (sale price in excess of basis) realized by the seller on the sale of inventory, accounts receivable, and personal property up to its original cost, is taxed at ordinary income rates. Gain on personal property in excess of original cost is taxed as capital gain. For real estate, the amount of gain arising from the use by seller of accelerated depreciation instead of straight-line depreciation is taxed as ordinary income, and any remainder is taxed as capital gain.

Consulting Agreements - A consulting agreement frequently is part of the sale of closely-held businesses. The buyer wants to insure the intangibles he is paying for, particularly the product and customer knowledge, are transferred and accordingly, the principal of the selling company enters into an agreement to provide a prescribed amount of time with the buyer to convey this information.

Sellers usually want to limit consulting payments as part of the purchase price because they are taxable as ordinary income for federal income tax purposes. Adding to their tax burden, for self-employed individuals consulting payments are “earned” income and are subject in 2011 to social security taxes of 10.4% on the first \$106,800 received annually and 2.9% in Medicare taxes, with no income cap. These rates and ceilings are likely to ratchet up each year. Annual consulting payments of \$100,000 could create federal and state income and social security taxes of up to \$54,300 to a highest tax bracket seller compared to \$21,000 in federal and state capital gains taxes if treated as goodwill.

For buyers, consulting payments have the advantage of being deductible in the tax period paid. To protect the characterization as a consulting agreement and not be treated as part of the purchase price, it should be documented in a separate agreement and not be part of the purchase agreement contract although it can be referred to in, and be a condition of, the purchase contract. The amount of the consulting payments should be reasonable in relation to the value of the services rendered.

Covenant Not to Compete - The buyer usually want the seller and/or the seller’s shareholders to agree they will not compete and take customers from the newly acquired business. Such covenants have been generally upheld in the courts if they are reasonable in terms of duration, geographic area, and restrictions imposed. From the buyer’s tax standpoint non-compete agreements are amortized over 15 years, regardless of the term of the agreement and whether they are paid for at closing or over time. For the seller, a covenant not to compete is taxed as ordinary income, as received.

Personal Goodwill - Because C corporations selling assets often face double taxation, one means to minimize this is have part of the purchase price paid directly to the seller’s shareholder for their personal goodwill. This concept is built on the notion that a shareholder who is actively engaged in the business may *individually* have the knowledge, unique skills, reputation, and customer relationships that significantly contribute to the company’s success.

The shareholder owns that goodwill, not the corporation. If that’s the case, then that portion paid to the shareholder as personal goodwill is taxed as long term capital gains individually by the shareholder and is amortized as goodwill by the buyer.

The personal goodwill concept has the greatest applicability in smaller entrepreneurial firms providing personal services where the shareholder is a rainmaker. By contrast, if there are multiple shareholders, or the shareholder is absent for extended periods, or the business sells off-the shelf goods to a wide customer audience, then there's little likelihood personal goodwill exists.

Other Means of Mitigating Double Taxation - There are a few specialized financial services firms that claim to reduce C-corporation gains and double taxation. We don't endorse them and haven't studied their approaches. We can provide you their contact information and the seller and his professional advisors can perform their own due diligence.

Summary of Preferences on an Asset Sale with Gain - If (1) the total consideration is greater than the seller's aggregate basis in the assets and (2) the seller and its shareholders are in the highest incremental tax brackets, then the parties will prefer to structure the deal along these lines:

Seller Preferences:

If seller is a C corporation - Minimize the sale proceeds paid directly to the corporation that are in excess of the assets' book value and maximize the remainder paid to the shareholders, individually (as consulting, covenant not to compete, or personal goodwill, as appropriate), bypassing the possible taxation at the corporate level.

If seller is an S corporation - Sell the assets for book value (no taxable gain) and allocate the remainder of the purchase price to goodwill, paid either to the corporation and/or the individual shareholders, depending what makes business sense.

Buyer Preferences:

Allocate the purchase price so that the inventory, receivables, and machinery and equipment have the highest value that can be justified, then allocate the excess to a consulting agreement. Buyers want to minimize the allocation to real estate, intangibles and goodwill because of their longer write-off periods.

In every case above, it is assumed that both parties are profitable and that income taxes are the paramount consideration.

ALLOCATION OF PURCHASE PRICE - FEDERAL INCOME TAX CONSEQUENCES TO SELLER AND BUYER IN AN ASSET SALE		
ASSET SOLD	SELLER'S STANDPOINT	BUYER'S STANDPOINT
Inventory	Difference from seller's book value is ordinary income or loss	Deductible as cost of goods expense when sold
Accounts receivable	Difference from seller's book value is ordinary income or loss for seller reporting income on an accrual basis. For a cash basis taxpayer, the purchase price allocated to AR's is taxed as ordinary income	Treated as income when collected and deducted as a cost offsetting the income.
Tangible Personal Property - Machinery, Equipment, Furniture & Fixtures	Price in excess of book value (cost less depreciation) taxed as ordinary income up to cost, capital gains thereafter	Price establishes basis and buyer depreciates according to IRS useful life schedules - generally 5 to 7 years
Leasehold Improvements	Price in excess of book value (cost less depreciation) taxed as ordinary income up to cost, capital gains thereafter	Price establishes basis and buyer depreciates according to IRS useful life schedules - generally 15 to 39 years
Buildings	Price in excess of book value (cost less depreciation) taxed as long term capital gain on excess over book value as determined by straight line depreciation, if accelerated depreciation was used, taxed as ordinary income on the difference	Price establishes basis and buyer depreciates according to IRS useful life schedules - generally 39 years
Land	Taxed as long term capital gain or loss	No tax benefits
Covenant Not to Compete	Taxed as ordinary income as received	Amortized over 15 years
Goodwill	Taxed as long term capital gain	Amortized over 15 years
Consulting	Taxed as ordinary income as received, subject to payroll taxes	Deductible when paid

S Corporation Built-in Gain - An S corporation that was formerly a C corporation is subject to a tax on its "built-in gain" for the ten-year period after conversion to S corporation status. This regulation was added to bar a C corporation that was planning on selling from converting to an S corporation to avoid the double taxation.

Built-in gain is the gain on the sale of any asset, except to the extent that at the time the corporation converted from C to S status, the corporation establishes either that it did not hold the asset when it became a an S corporation or that the recognized gain exceeds the gain that existed. The tax is computed at the highest marginal federal tax rate, currently 35% under the 1993 Tax Act.

Installment Sales - The installment method allows the seller to defer a gain and is usable in stock or asset sales. Under this method, gain is prorated and recognized over the years in which the payments are received. The amount of gain from an installment sale that is taxable in a given year is calculated by multiplying the payments received in that year by the gross profit ratio for the sale. The gross profit ratio is equal to the anticipated gross profit divided by the total contract price. Gain on inventory and gain on real and personal property to the extent of their depreciation recapture are excluded from the calculation and are taxable to seller in the year of sale.

In the case of installment sales of real or personal property, any recapture income must be reported in the year of disposition, whether or not an installment payment is received in that year. To defer that gain over time, the seller could lease the fixed assets to the buyer. Properly structured as a true lease (and not a disguised installment sale), the buyer can deduct the lease payments as an operating expense while the seller offsets the taxability of the lease income with his remaining depreciation.

The seller's gain or loss is generally recognized when installment obligations are sold, disposed of or satisfied at other than their face value.

NON-TAX CONSIDERATIONS IN CHOSING AN ASSET SALE VS. A STOCK SALE

Number of Shareholders - If the buyer wants 100% ownership and there are few seller shareholders, the buyer can negotiate separately with each shareholder for their stock.

The buyer does not have to pay each shareholder the same consideration. However, if there are numerous shareholders and/or the shareholders have diverse goals and objectives, it may be difficult for the buyer to obtain 100% approval.

In that case, the buyer negotiates with the seller's management or principal shareholders on a merger or an asset sale, which only requires two-thirds or majority shareholder approval (depending how the corporate charter is worded). Dissenting shareholders have rights under Ohio law to an appraisal remedy and subsequent payment in cash for their shares.

Asset Profile - If the seller has potentially difficult-to-transfer critical assets (such as real estate owned or leased, contracts, distribution agreements, licenses, titled vehicles, etc.), a stock sale may be easier. Before going down this path, these contracts need to be examined to see if a change of ownership triggers a default, allowing the other party to cancel or rescind the agreement.

Seller Liabilities - In a purchase of seller's stock, all of seller's liabilities, known or unknown, accompany the stock, a risk that the buyer may not want to assume. If the buyer acquires the seller's stock and the seller is not merged or consolidated into the buyer, the seller's creditors can only reach the seller's assets and cannot touch the buyer's assets.

If seller and buyer merge, under Ohio law seller's liabilities become those of the buyer's and all of buyer's assets are exposed to seller's creditors. If the buyer wants to merge with the seller but remain insulated against the seller's liabilities, the buyer can form a thinly capitalized subsidiary and merge the seller into that entity without exposing the parent company or other subsidiaries.

In an asset purchase, seller's unsecured and general liabilities usually don't follow the transfer of the assets. However, even if the buyer follows the above procedures in an asset purchase, the buyer may still be liable under the "successor liability" doctrine for the seller's direct and contingent liabilities such as product defects, labor contracts, environmental issues, and pension and profit sharing plans. This is particularly true if the seller is acquired as a going concern or if the transfer is made for the purpose of avoiding these liabilities.

In an asset sale, the buyer usually requires fewer purchase agreement representations and warranties compared to those contained in a stock sale purchase agreement.

Securities Issues - An acquisition of the seller in which all or part of the consideration is the buyer's stock or debt instrument may require compliance with federal and state securities laws.

Reiterating what we wrote at the beginning of this section, *readers contemplating the sale or purchase of a business should consult with attorneys and accountants experienced in commercial transactions of this nature before making any commitments.* If you need recommendations in this area, Becker & Beggs will provide you with names of several competent firms.

Case History

The purpose of this case history is to show how the previously discussed pricing concepts are applied. Although the Company used in this example is not an actual client, the Company's background and financial statements are representative of several manufacturers with which Becker & Beggs have worked. The issues are typical of asset sales involving a privately held corporate buyer or an individual buyer with limited equity and access only to traditional debt sources.

All the numbers and analysis referred to in this section are contained in pages 48 - 51.

THE SELLER

In our case history, ABC Manufacturing is a very profitable, sixteen-year old, contract manufacturer that machines metal parts for a variety of end users. It concentrates on short-run production, with jobs running up to 500 parts at a time. A sub-specialty (15% of volume) is building special machinery to a customer's design, for one-time applications.

Customers are for the most part local and regional original equipment manufacturers ("OEMs") who purchase component parts from the Company. They include industrial equipment manufacturers that serve the food and chemical processing, construction, mining, and communications industries.

Customer concentration is not an issue. The top five customers, all with relationships of more than five years, account for 34% of the Company's revenue with the top customer accounting for 12% in 2010. Approximately thirty customers make up the remainder. The Company appears to compete on the basis of quality and delivery. The owner claims that the Company is not always the low bidder but enjoys the repeat business because of its ability to ship goods on time, within specification.

The owner's role in the Company is to price and schedule the work and interface with the customers. He does very little conventional sales activity. The owner is 57 and was advised by his doctor to slow down because of a history of heart problems. He has been only working four or five hours a day for the past 18 months without any apparent loss of Company productivity.

There is a highly competent and well compensated, 36-year-old vice president and production supervisor, with the company for six years, managing all of the manufacturing functions, with occasional overview from the owner. The thirty-one hourly production workers are non-union, highly skilled, and capable of setting up the machines and performing the work with little supervision. The Company has followed the practice of not laying anyone off in lean times and of not expanding the work force significantly in flush times, choosing instead to use more overtime. As a result, the work force is unusually loyal, with little turnover.

The production equipment is a mix of highly automated machining centers and NC lathes for medium and long run production and 25+ plus year old boring mills and vertical turret lathes for the low volume, large part machining. The equipment has been maintained, replaced and upgraded continually.

In 1999, the owner built a freestanding, 33,500 square foot building on five acres in a developed suburban industrial park and leased it to the Company at higher than market rates. The building has a 22-foot ceiling with a twenty-ton overhead crane that traverses the production floor. Both the real and personal property appear to be suitable for the Company's needs for the next decade, assuming the normal replacements and upgrades are undertaken.

RECASTING THE INCOME STATEMENTS AND PROJECTING EARNINGS

The Seller's Statements - The Company provided four years of compiled financial statements and tax returns for the S corporation, prepared by their outside CPA. The information on the financial statements is consistent with the corporate federal income tax forms filed for those periods. The income statements were spread for comparison on pages 48 and 49.

These financial statements show why restating is necessary to determine a business' actual cash generating capacity and the true value of its assets. The Company's cumulative pre-tax *book loss* as reported in its financial statements for the four years totaled \$265,553, whereas the adjusted Earnings Before Interest and Taxes ("EBIT") totaled \$721,040, a *gain of \$986,593* and a truer picture of ABC's cash generating ability.

The adjustments made to the reported book income and expenses on page 49 are typical. Depreciation and amortization are added as non-cash expenditures. The owner's salary and perks are added because they exceed what would be normal and customary in compensation paid to someone for managing the Company. Interest expense is eliminated because the Company will sell the assets debt free. Legal fees in 2009 to defend a product liability claim are considered one-time and extraordinary and certain travel expense was unrelated to the operation of the business. Finally, the rent charged by the owner for the building is in excess of market rates.

Deducted from book income are the four year average of the actual capital expenditures, net of dispositions. These amounts represent the real depreciation that took place in the form of the actual equipment replacements and additions. Also deducted is the market salary for an owner's labor (\$125,000 in 2010 and reducing 3% a year for each earlier year) and market building rent (\$4.15/SF and reducing 3% a year for each earlier year) the seller has agreed to charge the buyer.

The reported revenue and operating income with adjustments looks like this (000's omitted):

Year	2007	2008	2009	2010
Sales	\$2,656	\$3,194	\$2,855	\$3,656
Book Income (Loss)	(72)	(17)	(213)	36
Adjustments	107	205	356	318
Adjusted EBIT	\$35	\$188	\$143	\$354

Selecting a Stabilized EBIT as a Basis for Projections - Forecasting how ABC will perform in the future versus how it has performed in the past takes insight and critical judgment. The buyer is about to make substantial debt and equity commitments and they better be accurate regarding the future free cash flow available to retire debt and provide a return on investment. There is a host of adjusted EBIT's to consider. The buyer can choose numerous arithmetic and weighted averages ranging over two, three, and four years, the most recent year at \$354,295, or some other number.

The owner acknowledges the 2010 performance will be difficult to replicate in the next year or so because last year included an unusually profitable \$560K contract.

We eliminated 2007 from our analysis because it's the most dated and most removed from current conditions plus it's Adjusted EBIT is 20% less than the 2008-2009 average. We then selected the three-year (2008-2010) weighted average of \$256K as a representative figure for the stabilized EBIT because the weighted approach emphasizes current conditions.

MARKET AND COLLATERAL VALUE OF THE ASSETS

On page 50, the Company's balance sheet is converted from book value to market value. There is a small reduction in the value of the accounts receivable for some questionable accounts. A note from a former employee is discounted to 50% of its face value. No adjustment is required of the inventory because 95% of the value represents work-in-process against contracts. Two used machinery dealers made desktop appraisals of the machinery and equipment and the \$1,164,950 figure represents the average.

Converting all assets from book value to market value increased their value 8%, from \$2.1 million to \$2.25 million.

The assumed allocation is for ABC to sell the inventory, machinery, equipment, furniture and fixtures, the 1T truck, and all of the intangibles - name, phone number, customer lists, drawings, website, etc. - and retain the remaining assets and all of the liabilities.

The working capital included in the sale in the form of inventory totals \$237 thousand. Separately, it was determined the Company normally has about \$325 thousand in working capital to finance operations. This shortfall of \$87 thousand needs to be injected into the new entity shortly after closing by the new owner and reduces what they can pay the seller for ABC's assets.

DEBT, EQUITY AND DISCOUNTED CASH FLOW

Third Party Financing - on page 51 is shown a likely financing scenario. Because ABC's inventory is all custom engineered for individual customers, it has no collateral value from the bank's viewpoint. All of the fixed assets have an in-place market value of \$1,219,000 and an estimated liquidating value of 60% of market, or \$731,000 (line 3). An SBA guaranteed lender would normally be willing to finance more than the liquidating value given ABC's adjusted EBIT. However, because astute buyers want to manage their

risk and given the cyclical nature of the capital goods market, we believe they would borrow something less than the maximum. Further, if the lender perceives a possible decline from 2010's revenue and earnings, they will also rein in their advance.

A loan of \$800,000, repaid over seven years at 6.5% results in annual debt service of about \$142,550. ABC had the adjusted EBIT to meet that debt service in the past three years. Only if the business falls to 2007 levels with a \$35K adjusted EBIT would it be underwater but the enterprise has the alternatives of reducing the owner's salary and perks and/or deferring capital expenditures to free up cash flow to make debt service.

Seller Financing - Also shown on page 51 is Seller Financing, the remaining piece of the debt structure. How much the seller is willing to carry, over what period, and at what rate also influences the selling price. In the Company's case, we assume the owner will lend \$125,000 over seven years at 6%, secured by a second mortgage on the assets and the personal guarantee of the buyer.

If the buyer liquidates the business during the first few years, it is unlikely there will be adequate proceeds from the collateral to pay off both the primary lender and the seller in full. This is a typical risk in seller financing when there is a secured lender with a prior claim to the assets.

Having the seller participate in the financing sends a positive note to the buyer and the lender.

Equity - After the probable debt is structured, the Projected Cash Flow after Debt Service is calculated. The stabilized EBIT of \$256,312 (line 7) is assumed to grow at 3% annually. In the last year the business is assumed to be sold for four times the then adjusted EBIT. Each year, the debt service is deducted, resulting in the Cash Flow after Debt Service (line 10).

This projected seven-year stream of pre-tax cash flows totaling \$2.037 million, is the buyer's return on equity, the amount of which is unknown at this point. By selecting a target rate of return (or hurdle or opportunity rate), we discount (present value) these cash flows back to a value today, and identify the amount of equity that a buyer will be willing to put into buying the Company.

In the Company's case, 30% was selected as an appropriate rate for equity, because we believe it represents a median risk. Contract machining is a mature industry and change is evolutionary. The present owner does not have any unusual, difficult-to-replace skills and, in fact, the Company appears to prosper without much managing on his part. The facilities are adequate for the near term and the historic rate of reinvestment in equipment appears to be satisfactory to maintain the stabilized earnings. The primary risks to the new owner is managing the business during the peaks and valleys of capital equipment cycles and the movement off-shore for sourcing parts.

Arriving at a Price - When the Cash Flow after Debt Service is discounted at 30%, the present value is \$497,479 - the buyer's equity (line 12). In theory, this is the amount a rational investor will put up in cash today to receive those future payment streams, assuming they targeted a 30% pre-tax return on cash.

The previously calculated working capital shortfall of \$87,458 comes out of the purchaser's equity, dollars going into the business and that are not part of the purchase price. The total of the debt and equity in the deal is about \$1.335 million made up as follows:

Purchase equity	\$410,021
Bank financing	800,000
Seller financing	<u>125,000</u>
Total price	\$1,335,021
Assets retained by seller	786,222
Liabilities retained by seller	<u>(732,174)</u>
Net to seller	<u>\$1,389,068</u>

In summary, using the Income Approach to pricing, we believe the selected assets will sell for about \$1.3 million with the seller carrying \$125,000 on a subordinated basis. If the seller carries more, the price increases slightly because the buyer's equity is reduced. Expensive equity capital at 30% is replaced with debt capital at 6%, and a greater number of buyer prospects can be brought into the deal.

Testing the Deal - The \$1.3 million selling price works from several standpoints. The seller receives a significant portion of the purchase price in cash, netting about \$1.2 million in cash at closing after liquidating the retained assets and liabilities. The bank is

adequately secured having loaned an amount equal to the collateral's estimated liquidating value. The combined bank and seller annual debt service of \$164 thousand was covered by the Adjusted EBIT in two of the last three years. Because the seller note is subordinate to the bank, the bank can require a deferral of seller note principal and even interest payments if cash flow gets too tight.

The \$1.335 million sale price is 3.8 times the last year's adjusted EBIT, 5.2 times the three year weighted average adjusted EBIT, 1.0 times the book value of the assets, and .9 times their market value, all reasonable ratios for a company with above average profitability and a decent asset base.

A possible shortcoming in the deal is the \$497,479 of cash equity (line 12) required by the buyer. The typical individual buyer for a machining business of this size may have \$200 to \$300 thousand to purchase the Company, but few with liquid assets of \$500 thousand or more, assuming they won't use all of their equity to acquire a business. The third party and seller debt can't be increased substantially without putting the business at risk.

Assume that an otherwise qualified buyer has \$300,000 in equity, about \$200,000 short of what's needed. The solution is for the seller to either increase the seller financing or take an equity interest in the buyer's new Company. If the seller financing is the route chosen, then the first \$125,000 (part of the capitalization described earlier) is a firm term note with mandatory payments. The additional \$200,000 needed to consummate the purchase is repaid on a contingent basis, dependent upon how the Company performs.

Let's say when sales are at least \$3.2 million, ABC Mfg. can comfortably repay the \$800,000 bank note and \$125,000 mandatory seller financing. The buyer and seller may agree that in years when sales are in excess of \$3.2 million, *the buyer pays the seller a percentage of the excess* until the additional \$200,000 thousand plus interest is retired. Often there is a cap on the number of years that payments are made. This structure doesn't burden the buyer in periods when earnings are depressed.

In lieu of a variable payment note, the seller can become a minority shareholder in the buyer's new Company. Typically, the majority owner's salary and perks are capped with any excess earnings being distributed to the shareholders. The seller would receive distributions on a prorated basis with the majority owner based on their relative

percentage of ownership. After a certain period, the seller may have the right to require the buyer to purchase their shares on an agreed upon formula (a “Put”).

Pricing for the Market - The above analysis results in a price and terms on which the seller should be prepared to do business. Nevertheless, if we were taking the Company to market, we would present it differently.

Remember that \$256,312 was selected as the stabilized EBIT despite the 2010 \$354,295 EBIT. An optimistic buyer may conclude that the historic four-year trend is a permanent upward track and be willing to pay more. If \$354,295 is a valid EBIT for the future, ABC Mfg. could be worth \$1.8 million. Consequently, we would present the Company in that light, argue that the seller has put the company on a continuous, upward path and price it at \$1.8 million.

If a buyer agrees to the higher price, *it is unlikely, however, that the seller will receive any additional cash up front.* The third party lender will not advance more just because the price is higher. And we already discussed the limitations on equity for buyers of a company like ABC. The higher price just means that the seller’s carried interest is greater, whether it is in the form of an earn out or ownership in the new Company.

Again, this example points out the need to find buyers that not only have the financial capability to purchase the business but also to manage it successfully so that sellers ultimately receive their full value.

ABC MANUFACTURING - INCOME, EXPENSE, AND ADJUSTED EARNINGS

Year Ended Dec 31-	2007	%	2008	%	2009	%	2010	%
INCOME	2,655,560	100.0	3,194,178	100.0	2,854,613	100.0	3,655,922	100.0
COST OF SALES								
Purchases	174,915	6.6	309,627	9.7	257,781	9.0	318,544	8.7
Freight	8,819	0.3	10,167	0.3	35,991	1.3	48,556	1.3
Labor	913,377	34.4	1,007,940	31.6	882,075	30.9	1,136,790	31.1
Supplies	80,836	3.0	102,087	3.2	94,202	3.3	123,660	3.4
Outside	91,361	3.4	100,161	3.1	86,504	3.0	100,788	2.8
Perishable Tools	49,547	1.9	60,921	1.9	57,066	2.0	94,404	2.6
Small Tools	12,115	0.5	7,089	0.2	14,535	0.5	11,961	0.3
Maint & Repair-Equip	28,714	1.1	15,924	0.5	19,584	0.7	28,564	0.8
Depreciation	155,795	5.9	112,611	3.5	170,394	6.0	146,811	4.0
Total Cost of Sales	1,515,479	57.1	1,726,527	54.1	1,618,132	56.7	2,010,078	55.0
GROSS PROFIT	1,140,081	42.9	1,467,651	45.9	1,236,481	43.3	1,645,844	45.0
OPERATING EXPENSES								
Salaries	543,125	20.5	709,782	22.2	684,119	24.0	725,277	19.8
Advertising & Promotion	13,185	0.5	13,287	0.4	18,459	0.6	35,247	1.0
Automobile	30,075	1.1	49,578	1.6	59,332	2.1	71,754	2.0
Bad Debts	5,925	0.2	30,360	1.0	1,509	0.1	18,075	0.5
Cleaning	765	0.0	1,305	0.0	1,317	0.0	1,260	0.0
Commissions	12,228	0.5	0	0.0	0	0.0	0	0.0
Casual Labor	3,420	0.1	1,806	0.1	378	0.0	2,526	0.1
Contributions	1,617	0.1	2,127	0.1	(441)	(0.0)	3,054	0.1
Amortization	0	0.0	0	0.0	0	0.0	0	0.0
Depreciation	14,781	0.6	9,657	0.3	7,644	0.3	6,588	0.2
Dues & Subscriptions	2,265	0.1	543	0.0	363	0.0	1,374	0.0
Employee Welfare	9,249	0.3	13,536	0.4	13,830	0.5	11,916	0.3
Insurance	110,451	4.2	153,612	4.8	131,555	4.6	152,384	4.2
Interest	41,961	1.6	20,685	0.6	23,931	0.8	16,086	0.4
Uniforms	18,297	0.7	18,519	0.6	17,128	0.6	22,173	0.6
Professional Fees	22,827	0.9	22,149	0.7	40,443	1.4	26,655	0.7
Miscellaneous	189	0.0	462	0.0	5,886	0.2	2,355	0.1
Office	17,022	0.6	13,101	0.4	14,427	0.5	21,012	0.6
Postage	825	0.0	3,732	0.1	3,426	0.1	6,354	0.2
Rent	169,500	6.4	216,000	6.8	216,000	7.6	216,000	5.9
Repairs & Maintenance	6,489	0.2	1,929	0.1	5,139	0.2	9,360	0.3
Taxes - Payroll & Property	138,783	5.2	142,767	4.5	141,688	5.0	191,826	5.2
Telephone	10,629	0.4	14,961	0.5	11,823	0.4	17,910	0.5
Travel & Entertainment	0	0.0	3,213	0.1	7,479	0.3	6,375	0.2
Utilities	38,199	1.4	41,673	1.3	44,091	1.5	43,932	1.2
Total Operating Expenses	1,211,807	45.6	1,484,784	46.5	1,449,526	45.4	1,609,493	44.0
INCOME (LOSS)	(71,726)	(2.7)	(17,133)	(0.5)	(213,045)	(6.7)	36,351	1.0

ABC MANUFACTURING - INCOME, EXPENSE, AND ADJUSTED EARNINGS

Year Ended Dec 31-	2007	%	2008	%	2009	%	2010	%
INCOME (LOSS)	(71,726)	(2.7)	(17,133)	(0.5)	(213,045)	(7.5)	36,351	1.0

ADJUSTMENTS TO FINANCIAL STATEMENT OPERATING INCOME (LOSS)

Expenses Reduced or Eliminated

Depreciation & Amortization (1)	170,576	6.4	122,268	3.8	178,038	3.8	153,399	4.2
Principal's Salary & Bonus (2)	93,525	3.5	198,755	6.2	276,415	9.7	298,809	8.2
Principal's Perks (2)	17,500	0.7	31,800	1.0	37,350	1.3	28,200	0.8
Unnecessary Travel (3)	0	0.0	9,500	0.3	8,600	0.3	14,750	0.4
Interest (4)	41,961	1.6	20,685	0.6	23,931	0.8	16,086	0.4
Extraordinary Legal Fees (5)	0	0.0	0	0.0	17,500	0.6	0	0.0
Rent (6)	169,500	6.4	216,000	6.8	216,000	7.6	216,000	5.9

Expenses Increased or Added

Avg. Capital Expenditures (1)	(137,250)	(5.2)	(137,250)	(4.3)	(137,250)	(4.8)	(137,250)	(3.8)
Principal's Market Salary (2)	(114,393)	(4.3)	(117,824)	(3.7)	(121,359)	(4.3)	(125,000)	(3.4)
Principal's Market Benefits (2)	(7,321)	(0.3)	(7,541)	(0.2)	(7,767)	(0.3)	(8,000)	(0.2)
Market Rent (6)	(127,200)	(4.8)	(131,100)	(4.1)	(135,000)	(4.7)	(139,050)	(3.8)

Net Adjustments	106,898	4.0	205,293	6.4	356,458	6.4	317,944	8.7
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Adjusted EBIT	35,172	1.3	188,160	5.9	143,413	4.5	354,295	9.7
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AVERAGE ADJUSTED EBIT	FOUR YR	THREE YR	TWO YR	ONE YR
Average	180,260	228,623	248,854	354,295
Weighted Average (SOYD)	225,891	256,312 *	284,001	354,295

* Selected Stabilized Adjusted EBIT

- (1) - The non-cash accounting entries are replaced by the average four year net capital expenditures
- (2) - Actual salary, bonus, and perks are replaced by a market salary & benefits for a manager of that size enterprise
- (3) - Travel unrelated to the business
- (4) - Buyer is not assuming any of seller's debt.
- (5) - Expense of defending a product liability claim, the first in sixteen years of operation
- (6) - Actual rent paid on facility owned by principal replaced by a market rent charged to new owner

ABC MANUFACTURING PRICE ESTIMATE

CONVERT BOOK VALUE TO MARKET VALUE AND DETERMINE WHAT IS SOLD AND WHAT IS RETAINED

Assets and Liabilities as of March 31, 2010

		VALUE			ALLOCATION		
		COST	BOOK VALUE	MARKET VALUE	SELL / ASSUME	RETAIN	TOTAL
ASSETS:							
1	Cash	89,476	89,476	89,476	-	89,476	89,476
2	Accounts Receivable	671,416	671,416	651,274	(a)	651,274	651,274
3	Notes Receivable	24,800	24,800	12,400	(b)	12,400	12,400
4	Inventory	237,542	237,542	237,542		-	237,542
5	Furniture & Fixtures	127,956	51,036	40,000	(c)	-	40,000
6	Machinery & Equipment	2,409,644	963,856	1,164,950	(d)	-	1,164,950
7	Vehicles	91,724	26,092	39,000	(e)	25,000	39,000
8	Prepaid Expenses	8,072	8,072	8,072		8,072	8,072
9	TOTAL ASSETS	3,660,630	2,072,290	2,242,714		786,222	2,242,714
LIABILITIES:							
10	Trade Payables	190,608	190,608	190,608		190,608	190,608
11	Customer Deposits	84,202	84,202	84,202		84,202	84,202
12	Notes Payable-Bank	328,544	328,544	328,544		328,544	328,544
13	Accrued Expenses	74,184	74,184	74,184		74,184	74,184
14	Accrued Taxes	54,636	54,636	54,636		54,636	54,636
15	TOTAL LIABILITIES	732,174	732,174	732,174		732,174	732,174
16	EQUITY	2,928,456	1,340,116	1,510,540		54,048	1,510,540

ADJUSTMENTS

- (a) - 3% reduction for doubtful accounts
- (b) - 50% reduction in receivable from former employee
- (c) - Broker's estimate of going concern value
- (d) - Average of two dealers' appraisals
- (e) - NADA retail value

WORKING CAPITAL

237,542 WC included in sale

325,000 WC required

(87,458) WC shortfall

ABC MANUFACTURING PRICE ESTIMATE

ESTABLISHING PRICE USING DISCOUNTED CASH FLOW

DEBT

A - THIRD PARTY FINANCING - SBA LOAN

	COLLATERAL	MARKET VALUE	LIQUIDATED VALUE	ADVANCE	ADVANCE \$	TERM (MOS)	RATE (%)	PAYMENT
1	Acc'ts Receivable	-	-	NA	-	NA	NA	NA
2	Inventory	237,542	23,754	NA	-	NA	NA	NA
3	All Fixed Assets	1,218,950	731,370	109%	800,000	84	6.5%	11,880
4	TOTAL	1,456,492	755,124		800,000			11,880

B - SELLER FINANCING

	COLLATERAL	MARKET VALUE	LIQUIDATED VALUE	ADVANCE	ADVANCE \$	TERM (MOS)	RATE (%)	PAYMENT
5	Second Mortgage - All	656,492	(44,876)		125,000	84	6.0%	1,826

EQUITY

A - PROJECTED CASH FLOW BEFORE AND AFTER DEBT SERVICE

	YEAR	1	2	3	4	5	6	7	TOTAL
6	EBIT*	256,312	264,001	271,921	280,079	288,481	297,136	306,050	1,963,981
7	Sell @ 4 X EBIT	-	-	-	-	-	-	1,224,200	1,224,200
8	(Debt Service-3rd Party)	(142,555)	(142,555)	(142,555)	(142,555)	(142,555)	(142,555)	(142,555)	(997,882)
9	(Debt Service-Seller)	(21,913)	(21,913)	(21,913)	(21,913)	(21,913)	(21,913)	(21,913)	(153,390)
10	Cash Flow After Debt Svc.	91,845	99,534	107,454	115,612	124,014	132,668	1,365,782	2,036,909

*Based on four year weighted average, growing at 3% annually

B - EQUITY CALCULATION

11	Buyer's Target, Pre-Tax Rate of Return on Equity	30%
12	Present Value of Projected Cash Flows, After Debt Service, Discounted at Target Rate	497,480
13	Amount Required in the New Company for Working Capital	(87,458)
14	Purchase Price Equity	410,022

TOTAL SALE PRICE AND NET TO SELLER

15	Buyer Purchase Equity	30.7%	410,022
16	Buyer-3rd Party Financing	59.9%	800,000
17	Buyer Assumed Liabilities	0.0%	-
18	Seller Financing	9.4%	125,000
19	Total Sale Price	100.0%	1,335,022
20	Assets Retained by Seller		786,222
21	(Liabilities Retained by Seller)		(732,174)
22	Net to Seller		1,389,070

RATIOS - Sale Price as a multiple of -

23	2010 adjusted EBIT of	354,295	3.8 X
24	3 year weighted average of	256,312	5.2 X
25	4 year average EBIT of	180,286	7.4 X
26	Book value of assets	1,278,526	1.0 X
27	Market value of assets	1,456,492	0.9 X

Business Buyer's Check List

Serious investigation of any potential acquisition requires sifting through masses of information. Checklists used by buyers to analyze business operations vary greatly depending whether the business is involved in manufacturing, wholesaling, contracting, retailing, or services. Owing to the many variables and characteristics of each type of

Products:

- What is the description, relative importance, market share, growth trend, anticipated longevity or life cycle, and principal competitors for each product line?
- What market share is held by each of the seller's competitors?
- Are the product lines complete, or are additional "tie-in" products needed?
- Are the seller's products licensed or subject to license rights? What are the terms?
- Has any product planning been done by the seller? What new products are in the pipeline?
- How stable is each product line?
- Are any products threatened by new competition or government regulation?

Customers:

- Who are the major customers?
- What sales in terms of dollars and percentages are generated from each major customer?
- How long has the seller sold to each major customer?
- Do sales contracts exist and if so, what are the terms?
- Are major customers likely to remain with a new owner?
- What is the percentage of sales to foreign customers? To the military or the government? Low-profit customers?
- How financially sound is each of the major customers?
- Is repeat business increasing or decreasing? How does it compare with industry norms? Is there threatened loss of a major customer? What pending or future orders exist? Are anticipated?

Sales:

- How are the seller's products marketed?
- What percentage of total sales is produced by each sales or marketing method?
- Is the outside sales organization well organized?
- Is the inside sales unit well organized and sufficient in size to handle both present and projected sales volume?
- Are sales and marketing costs comparable with industry averages?
- Are salesmen paid on a salary or commission basis?
- Does the sales compensation program provide sufficient incentive? Are territorial allocations proper or should they be adjusted?
- Is the sales staff adequately supported by advertising?
- Are the average sales per salesperson in line with industry norms? What changes in the sales approach are needed to handle new products or prospective customers more effectively?

Advertising:

- Is there a formal advertising or promotional program?
- Does the advertising program use institutional or product advertising, or both? Is the mix appropriate?
- How are advertising costs as a percent of sales compared to industry norms?
- Is the advertising handled by an outside agency or internally, or both?
- Is the agency under contract? If so, what are the terms?
- How long has the agency represented the company? How effective have they been?
- Are additional advertising expenses required to bring sales to acceptable levels?
- Are extraordinary advertising expenses needed to launch new products?

Management:

- What are the roles of the departing principal(s) and how critical are these individuals to the success of the company?
- Is there a formal organization chart with clear delineation of management function?
- Are lines of authority and responsibility adequately defined?
- Is the organizational structure appropriate for the size and nature of the business?
- Will the structure require major revision under new ownership?

- Are major administrative departments over or under staffed? Are the executives rated or paid on performance?
- Are key managers on employee contracts? If so, what are the terms?
- What fringe benefits and perks are provided to executives and managers?
- How does management compensation and fringes compare with industry norms?
- Is total management compensation in line with sales?
- Will key managers remain after the sale?
- Will higher compensation be necessary to retain managers after the sale?
- How strong is management morale?
- What is management's reputation in the trade?
- Is management centralized or decentralized? Does one person run the organization, or is decision-making balanced?
- Will additional or replacement managers be required? Are they readily available?
- Can management personnel be terminated without difficulty or expense? Are key managers bound by non-compete agreements?

Employees:

- Is the company unionized or not?
- Is there the threat of future unionization or a history of prior collective bargaining attempts?
- Is the business or industry vulnerable to unionization?
- Would an organizing effort be successful?
- How is compensation presently structured? Are wages competitive within the industry?
- What percentage of employees is highly skilled? Unskilled? Professional?
- Can personnel in each job category be readily obtained?
- Can employees be hired and terminated to meet varying production or sales needs?
- Do working conditions compare favorably with industry standards? What are the primary personnel policies and procedures?
- How does employee turnover compare with industry standards?
- What employee changes are required upon acquisition?

Research and Development:

- What research and engineering is planned?
- What are the short- and long-term objectives of the research and development program?
- How much is spent on research and development? Do costs compare favorably with product revenues? Industry standards?
- What projects are presently under way? What projects appear promising?
- How many research personnel are employed? How are they allocated between supervisory, technical, and non-technical personnel? How productive has the research effort been in successfully developing new products?
- What reputation for developing innovative new products does the department enjoy?

Market and Competition:

- What are the market demographics for the company's products or services?
- Is the market growing? Stable? Declining?
- Does the market exist, or is it emerging?
- What market share does the company enjoy? Is market share growing or declining?
- What internal factors will influence future market share?
- Who are the major competitors? What are their strengths and weaknesses?
- What strengths and weaknesses does the company have compared with its competitors?
- What future competitive changes are foreseeable?
- Are there any pending or threatened legal matters to influence product demand?
- What changes are required to maintain market share and competitive position?
- What investments and expenditures are required to achieve potential growth?
Required growth?

Facilities:

- Is the location stable?
- Is the location adequately close to its market?
- Are facilities adequate for present needs?
- Can the facilities be expanded to accommodate future growth?
- What renovations or improvements are required to improve efficiency? Are facilities adequately served by public utilities? Transportation and shipping?

Lease:

- Are facilities leased or owned? If owned, is the property included under the proposed sale?
- Is a sale and leaseback possible if the facilities are to be acquired?
- Is the lease sufficiently long to justify the investment?
- Are lease terms acceptable? Can the business be relocated at reasonable cost?
- Are rents reasonable both on a square-footage basis and as a percentage of sales?

Material and Equipment:

- What equipment, machinery, furniture, and fixtures are owned and included in the sale?
- What are the lease terms on equipment? Are leases in good standing? Assignable?
- Is equipment in good working order?
- Is equipment suitable for alternate uses?
- What additional cost is necessary to upgrade equipment?
- What is the value of the equipment and other capital assets included in the sale?

Inventory and Purchasing:

- Who are the present and past suppliers to the company?
- Are inventories adequate, overstocked, or depleted?
- How and how often is inventory counted and recorded? Owners of many small businesses frequently under state their closing inventory thus reducing gross and net profit and income taxes.
- What additional inventories are required to bring the business to its full potential?
- What inventory is shopworn, obsolete, or unsalable?
- Is inventory of appropriate mix?
- Does the company buy on competitive terms?
- Does the company have open credit or restricted credit?
- Is the company obligated to purchase under vendor contracts?
- How long have vendors sold to the company?
- Are vendor relations satisfactory?
- Are alternative sources of supply available on equally advantageous terms?
- Does the company rely on any one supplier? If so, is continuity of supply assured?
- Do prices compare favorably with competitors' prices?
- Are purchasing procedures well organized and functioning properly?

Legal:

- Have there been any significant changes in legal services in recent years? If so, why and when were they made?
- What are the major provisions of the firm's charter, registration, or license to be a business? Are any unduly restrictive?
- In which jurisdictions (states, counties, and local areas) is the firm authorized to conduct its business?
- What lawsuits, if any, have the firm initiated in recent years? Against whom and for what claims? Of those that have been settled, were the outcomes favorable or unfavorable to the interests of the business? Which, if any, are still active?
- What lawsuits have been filed against the firm claiming damages and compensation for injuries resulting from accidents, negligence, or other causes related to operations? Of those that have been settled, what liability has the firm suffered? Are any cases current or pending? And what is the outlook for settlement?
- Has the firm experienced any claims for product liability? Is the business covered by product liability insurance? If so, in what amounts and coverage? What is the status of any such claim?
- Has the firm been denied any insurance coverage, or has any insurance been withheld?
- Are any of the firm's operations seriously affected by federal, state, or local laws and regulations?
- Is the firm subject to any lawsuits seeking compliance with such laws and regulations? Are any criminal charges involved? How seriously are these cases regarded?
- What, if any, civil rights discrimination or violation cases have been, or are being, alleged on the part of the firm and any of its employees? What is their status?
- Are there title disputes or mortgage provisions affecting any property that might complicate its sale?
- Are there any liens outstanding against any property that might delay transfer of title?
- Are there any contracts or formal agreements and "understandings" among those having interest in the firm that could be the basis for lawsuits seeking to block a sale? If such exist, what are they and what is the prospect that any action might be undertaken?

Asset Sale Closing Checklist

Most of the items below need to be addressed by one or both of the parties when selling the assets of the business. A responsible party and a completion date need to be established for every applicable line item.

Item	When?	Who?
Pre Closing		
Inspect inventory		
Review receivables		
Inspect real property		
Inspect equipment		
Obtain appraisals		
Review liabilities to be assumed		
Inspect books, records, tax returns		
Review customer relationships and contracts		
Review supplier relationships and contracts		
Negotiate key employee agreements		
Arrange third party financing		
Search for liens		
Research litigation or claims		
Research patents, trademarks, & other intellectual property		
Arrange business insurance		
Negotiate real property lease		
Investigate environmental issues		
Form buyer corporation		
Obtain federal ID #		
Obtain sales tax vendors license		
Set up bank account(s)		

Item	When?	Who?
Documents		
Purchase agreement		
List of assets purchased		
List of liabilities assumed		
Note and security agreement		
Guarantees		
Collateral list		
Financing statements		
Bill of sale		
Titled vehicle transfer documents		
Non-compete agreement		
Earn-out agreement		
Consulting agreement		
Allocation of purchase price		
IRS form 8594		
Other: Initial or assignment of existing -		
Employment agreements		
Labor agreements		
Employee benefit plans		
Pension & profit sharing plans		
Notes, mortgages		
Real property lease		
Equipment leases		
Supplier contracts		
Licenses		
Permits		
Customer contracts		
Patents		

Item	Who?	When?
Closing:		
Attorney's opinion		
Resolution to purchase		
Attorney's opinion		
Certificate of good standing		
Resolution to sell assets		
Escrow agreement		
Lien holder payoff statement		
Lien holder releases		
Sales tax release		
Closing statement		
Pro-rations:		
Personal property taxes		
Real property taxes		
Payroll & payroll taxes		
Workmen's compensation		
Insurance		
Real estate lease and related charges		
Down payment or payment		
Earnest money		
Broker commission		
Post Closing:		
Change corporate name		
Transfer utilities & telephone		
Hire employees		
Announce sale to employees		
Notify vendors, customers, and media		

About Becker & Beggs

Becker & Beggs, Ltd. are business brokers and appraisers, concentrating on sales and appraisals of closely-held, businesses with revenues from \$500,000 to \$25,000,000. The two principals, James D. Beggs and Walter M. Becker have a combined forty-one years' experience in the field.

James D. Beggs - After an early career in sales and marketing for Alcoa and Burlington Industries, Mr. Beggs focused on business lending. From the early 70's through 1992, he was involved in secured lending, financing small and mid-sized firms in this region. During that period he developed an expertise in tax leveraged leasing and direct ownership investments. In 1992, he formed Van Gaard & Company, concentrating on business brokerage and valuations. Three years later, he and Walter Becker formed Becker & Beggs, Ltd.

Walter M. Becker - With over 35 years in various consulting, planning, financial, and general management positions, Mr. Becker's background includes exposure to nearly every type of business. Prior to founding Prime Strategies in 1983, a business brokerage and consulting firm, he was CFO of Central Bancorporation in Cincinnati and Central Fidelity Bank in Virginia, and was President of a computer services and data entry processing firm. Previously, he managed the business consulting department of Ernst & Young in Baltimore. He has been in business brokerage in Cincinnati for twenty-four years.



MOBILE EQUIPMENT DEALER

#2521

The owner of this greater Cincinnati firm grew it to \$4.2M in sales in 13 years and is ready to retire. The business has two equal business segments:

- Sales and service of industry leading stock units in an exclusive Ohio and Kentucky territory.
- Sales of custom units to governments and businesses through-out the country. This segment has only been in place for 2+ years, has higher gross margins, is recession-resistant, and has the potential to be a \$5M business line within three years.

The purchase price is (1) \$500,000 for the equipment and goodwill and (2) the value of the new, used, and parts inventory at closing (in the \$1,000,000) range.

Income before owner's compensation and perks, interest and depreciation was \$285,000 for 2010. Qualified buyers should have at least \$250,000 in equity to purchase and capitalize the business.

To receive a comprehensive description of this business, please sign and fax or mail the Prospective Buyer Confidentiality Agreement.

Jim Beggs

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Walt Becker

PROSPECTIVE BUYER CONFIDENTIALITY AGREEMENT

Becker & Beggs, Ltd., an Ohio limited liability company, ("Consultants") will be providing _____ ("Buyer") with financial statements, projections, data, and other information ("Evaluation Materials") concerning a Mobile Equipment Dealer #2521 ("Company"). Buyer understands that the Evaluation Materials and the fact that the Company is for sale (collectively "Information") are confidential and sensitive and that disclosure by Buyer of all or part of the Information to others or the misuse of the Information by Buyer may damage the Company and/or Consultants' relationship with the Company. Buyer agrees that it is liable for any damages to the Company or to Consultants resulting from Buyer's misuse of the Information. In consideration of Consultants providing this Information, Buyer agrees that:

Its use of the Evaluation Materials is solely for the purpose of determining whether it makes a proposal for the acquisition of the Company.

It will not disclose any Information to any party other than its representatives directly participating in the review of the Evaluation Materials such as its accountants, attorneys or bankers ("Representatives") and Buyer agrees that it is liable for any damages to the Company or to Consultants that results from the misuse of the Information by the Representatives.

It will not copy the Evaluation Materials except those required by the Representatives and upon request, will return the Evaluation Materials and authorized copies to Consultants.

Buyer will not contact the Company, its owners, employees, customers, or suppliers directly. Further, it agrees that all contact, correspondence, inquiries, offers to purchase and negotiations will be through Consultants. Buyer understands that Consultants have an agreement for the sale of the Company providing for a fee to be paid to Consultants upon the sale of the Company and Buyer agrees not to circumvent the agreement in any way. Consultants' fee is solely the responsibility of the Company.

Buyer understands the Evaluation Materials were compiled by Consultants from materials and information generally provided by the Company and that Consultants are relying on the Company for their accuracy and for disclosure of all material facts. Consultants do not guarantee the accuracy of the Evaluation Materials or that all the material facts concerning the Company have been disclosed. Buyer agrees to look only to the Company and to its own independent investigation to verify the accuracy of any information concerning the Company and to hold Consultants harmless from any claims or damages that may result from its use.

BUYER: _____ Date _____
Company or Individual - Print

By _____ Authorized Agent
Signature

Mail or fax to Jim Beggs Becker & Beggs 2055 Reading Road Cincinnati OH 45202