The Offer to Buy a Business Depends on the Many Characteristics

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In our Merger and Acquisition practice we try to prepare our business sellers for the multitude of different deal structures that they should expect from various buyers. We go through elements like cash at close, seller notes, earn outs, non-competes, escrow accounts, etc. More often than not our first time seller will actually put out his or her hand in a stop gesture and reply, "I only want the full price in cash at close." This article will discuss some of the selling company characteristics that directly effect both the selling price and the terms.

Selling Company Revenue Composition – This is a very important factor in determining how much a buyer will pay for your business and how much will be in cash at closing. If 80% of your annual revenue is a result of contractually recurring revenue, you can command both a premium price and a deal heavily weighted in cash at close. On the other hand, if you have little or no contractually recurring revenue and are heavily dependent on net new sales from new clients, your sale price will be far less and you will be expected to receive a significant portion based on a future performance earn out. Companies that can demonstrate historically repeatable revenue with long term clients will fall between the two extremes mentioned above.

Selling Company Management Depth – If every aspect of the company's business funnels through the two key partners who are close to retirement age and there is a huge gap in management depth and capabilities, this is risky to buyers. They are not inclined to write a big check to the owners only to have them walk out the door with their relationships and knowledge six months later. The more decentralized the customer and supplier relationships are and the more widely dispersed the intellectual property is, the higher the sale price and the higher the percentage of transaction value is at close. If it is all concentrated, the buyer will want the insurance of a transaction structure that pays over time based on future company performance.

Selling Company Customer Concentration – You can absolutely correlate purchase price and cash at close to this element. Let's say, for discussion purposes, that you had two identical companies in revenues, profits, profit margins, and EBITDA. Company A has no more than 5% of their revenue coming from a single customer. Company B has 40% of its revenues coming from four large blue chip accounts. Company A will sell for a 15-25% premium to Company B. Also Company B will command only 60 to 70 % of the cash at close that Company A commands. Customer Concentration is a big risk factor for a buyer that can not assume that the relationship dynamics will be the same once the principals leave.

Main Street versus B2B Company - Typically the issue of seller notes comes up with an individual buyer that has limited resources and is attempting to buy a main street type business with as much leverage as possible. Corporate buyers seldom utilize this vehicle.

Escrow Account Requirement – This is a portion of the purchase that is held by a third party Escrow Agent with instructions on how the funds can be released to the seller. These are typically required by a buyer where they perceive the risk of a future event such as product liability, a pollution issue, or an outstanding law suit. The funds are held for a period that could extend for several years if there are unresolved issues of this nature.

Professional Services type firm – Your company literally walks out the front door each evening. These may be consulting firms, accounting firms, executive recruiting firms, ad agencies, etc. Your producers have developed their book of business and their loyal account relationships. Your clients are customers of the company, but may be more loyal customers of their professional contact person. Sales transactions for this type of firm can involve a very heavy earn out component to protect the buyer from a mass exodus of clients because the professionals leave the firm post acquisition and take their clients with them.

Non Compete Agreements – these are pretty much standard for prudent buyers buying a company and not wanting to defend themselves against the former owner who gets bored with retirement and decides to start a similar business. The seller should get some compensation for the agreement and the more restrictive the agreement, the higher the compensation.

Stock Sale versus Asset Sale – Most large corporations "have a policy" that they will only do asset acquisitions as opposed to buying the stock of a target company. There are some very good reasons to do this. When you do a stock purchase you get all the assets and all the liabilities both known and unknown. If you look at the reasons buyers have escrow accounts, many of the same reasons apply for wanting to do an asset acquisition. They simply are buying identified assets and the remaining corporate shell is still owned by the previous owner with all the liabilities not specifically identified in the asset purchase agreement.

If the seller is a C-Corp, however, it is a major negative from a tax perspective to do an asset sale because the sale of assets is taxed as ordinary income at the corporate tax rate. The proceeds are taxed again at the owner's long term capital gain rate when the funds are distributed to him. For companies that do not have the escrow type potential liabilities, a stock sale may work. A buyer could successfully offer a significantly lower price with a stock purchase than a competitor requiring an asset purchase. The seller should analyze the two transactions from an after tax proceeds perspective to determine the superior offer.

If you are a business owner contemplating a business sale and you want the highest purchase price and the most cash at close, analyze your company based on the factors above. If you can implement changes that correct some of these risk factors you improve your odds of your best exit.

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