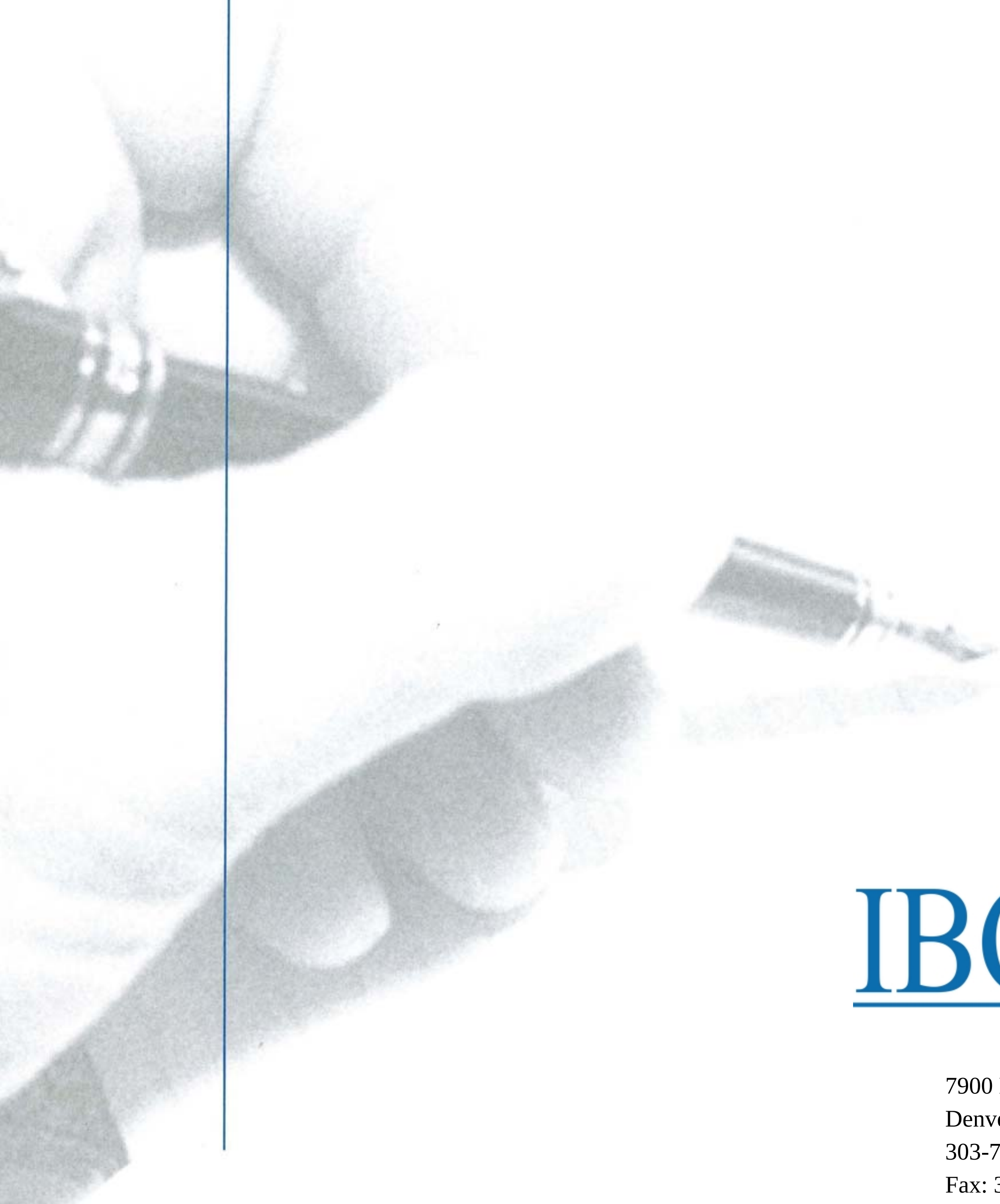
Building Your Company's True Value:

How to Sell Your Business for More Than It's Worth.



A White Paper
by

IBG International Business Group LIMITED

7900 E. Union Avenue, Suite 900
Denver, CO 80237
303-758-4000
Fax: 303-758-6300
www.IBGBusiness.com

Building Your Company's True Value:
How to Sell Your Business for More Than It's Worth

> "Selling your company may be the biggest decision you'll ever make. It's critical that you have resources and know-how behind you, not only to effect the sale more quickly, but also to achieve maximum profit. Capitalizing on the opportunity of a lifetime requires the experience to recognize it and the skill to do what is needed."
>
> – John Zayac, CEO
> IBG Business Services

Since 1986, IBG has been providing merger and acquisition services to middle-market business owners in a variety of industries nationwide. Our record of success has made IBG one of the leading merger and acquisition advisory firms in the nation.

We provide a wide range of services, including customized selling strategies, business valuation analysis, strategic planning, sell / hold timing review, transaction structuring, targeted industry research and marketing, due diligence guidance, and expert witness testimony. IBG advisors are experts, highly trained in the intricacies of selling a business, and are more than prepared to handle the unexpected challenges of such momentous transactions. Many are former entrepreneurs or senior management, and so are uniquely positioned to understand your concerns as a business owner.

About The Author

John Zayac founded IBG in 1986 to provide middle-market business sellers with the same high-quality resources and sophisticated service traditionally reserved for firms valued over $100 million. His concept for IBG evolved from his personal experiences buying and selling businesses; he has owned and operated a variety of businesses, including a printing company, an automobile importing agency and a chain of car washes. As a Certified Business Intermediary (CBI), John has completed hundreds of transactions representing both buyers and sellers. A native of Binghamton, New York, he graduated with distinction from Cornell University, and has resided in Colorado since 1982. John is actively involved in a number of industry associations and civic organizations, and is a competitive race pilot in the T-6 Racing Association.

To receive a portfolio of information about IBG and our services at no cost or obligation, telephone us at 303-758-4000 or visit our website at www.IBGBusiness.com.

Why Spend the Time and Resources to Prepare Your Business for Sale?

The sale of your business is potentially the single most important decision you'll ever make.

That's a strong statement – but if you're like most business owners, you may have 75% or more of your net worth tied up in your company. The typical owner has sacrificed countless hours and risked his or her family's financial security by starting or purchasing a company. And, chances are, you'll sell a business only once in your lifetime.

The typical buyer, on the other hand, is a professional who will acquire and sell, on average, five companies during his or her career. Yours may be the fourth or fifth he acquires – and he will have the benefit of all that experience going into the transaction. A professional buyer's job is to get the best deal possible when acquiring a business, and they generally have the knowledge to do so.

It's no wonder that, according to a Small Business Administration survey, about 80% of business owners sell their companies for 20% to 50% less than full value!

There's only one way to get the price you deserve when it comes time to sell – and that's by taking advantage of professional expertise to prepare your company for market, years in advance, if possible.

The purpose of this white paper, *Building Your Company's True Value*, is to give you the tools to help you prepare your company for sale, when the time comes, so that you obtain maximum value for your company. The guidelines in this paper are the result of over 26 years of personal experience in selling over 780 companies in 40 different states around the country.

If you have further questions or would like additional information, please telephone us at 303-758-4000 or email us at info@IBGBusiness.com.

Guidelines for Building Your Company's Value

Build Middle Management

As many as 200 buyers a day contact IBG about buying companies. Surprisingly, one of the first questions we receive isn't about the company financials or its markets; it's "How strong is the middle management team?"

Buyers don't want to purchase a business that is dependent upon a single employee or owner; it's too risky. The creation of a strong middle management team **creates value for acquirors** by eliminating reliance on a single individual, lessening risk.

After all, if the owner is responsible for all key customer contact and all operational decisions, what is going to happen after the company has been sold? Buyers want to see a strong management team that has been delegated both the ability to make decisions and the authority to implement them. The development of a management team and the delegation of management decisions greatly contribute to the company's value in the eyes of a purchaser.

Guideline #1:
Build a strong middle management team. Don't be indispensable to your business.

Environmental Risk

It should be no surprise to you when I say that litigation is on the rise. People are more concerned than ever about environmental contamination and potential health issues. Therefore, any professional buyer (and his or her lender) is going to demand a Phase One or Two Environmental Site Assessment.

Be prepared for it. The worst possible time to discover an environmental problem is the week before your company is to be sold. You've spent maybe 20 years running your business, you'll spend six months working with buyers, and planning your retirement – so imagine what it would be like at that point to find out that you must start the process all over due to some contamination, for which you were not even responsible, being identified on company property.

That's why at IBG we recommend that all our clients consider having a Phase One Environmental Site Assessment performed before going to market – this allows the owner enough time to correct defects before they become deal killers.

Think you're immune just because your business doesn't deal in potentially hazardous products? Then listen to this true story and think again: One of our clients discovered that a local dry cleaner (over four miles away) had contaminated the groundwater under his facility. By discovering this issue early, we were able to take the necessary time (almost two years!) to get local and federal agencies to assess who the true responsible party was and give the company a clean bill of health. If our client had discovered the problem at the last moment after he already had a buyer lined up, do you think that buyer would have waited two years? In some transactions, sellers are forced to purchase environmental insurance or escrow large amounts of money – a very costly expense for something that could have been prevented.

Guideline #2:
Don't be surprised. Perform a Phase One Environmental Site Assessment before you put your company on the market.

Recast Your Historic Financial Data

Why do 80% of business owners sell for less than full value?

The answer may surprise you: It's usually because most business owners try to sell based on their company's historic financial data.

This guideline may seem somewhat counter-intuitive, so let me explain. What do you suppose the buyer is purchasing when he acquires your business? You have already enjoyed the profits from past years, so the buyer is actually buying your company's *future* financial income. Chances are that your historic financials don't really create an accurate picture of what the buyer may expect in the future under his management.

There are a number of reasons why; the most common reason is that most owners of private companies suppress earnings in an attempt to reduce taxable income.

Public companies, on the other hand, do just the opposite. By showing growth in earnings in their financials, they fuel optimism in the marketplace for their stock. So, to fairly represent the profitability of your company, you must take the past three to five years of historic financial statements and recast them as if your company was public.

That means removing expenses for discretionary or non-recurring items from your income statement (by footnote). These items may include your personal life insurance, over-compensation to family members, excess over-payment of executive salaries, personal aircraft and boats, country club dues, dinners and travel that you may be able to "defend" as business expenses to the IRS but which were not absolutely necessary for the operation of your company.

Non-recurring or one-time expenses need to be "recast" out of your financial statement to put your company in its best light and show the company's true earnings capacity. Non-recurring expenses can include bad business decisions or failed marketing programs, installation of new machinery or software, excess labor or interruption of the business that occurred when the company was relocated, and excess depreciation above economic cost.

IBG utilizes a checklist of items to analyze each business and to identify and recast expenditures from the financial statements to show the company's true profitability (a copy of this list follows). Do not expect the buyer to identify all the one-time or discretionary expenses, or to accept everything you identify in the recast.

Guideline #3:
Buyers buy the future, not the past. Using recast financial data better projects what your company can do.

Items for Financial Recast

- Excess or unnecessary compensation, including bonuses, salaries, wages, etc.
- Portions of Officers' salaries in excess of market rate
- Unnecessary or personal travel and/or entertainment
- Discretionary contributions to retirement or insurance programs
- Unnecessary vehicle expenses, including insurance related to the vehicle
- Depreciation
- Amortization
- Interest
- Life insurance premiums for benefit of owners
- One-time advertising or marketing expenses proven non-productive
- Research and development costs expensed instead of capitalized
- Capital expenditures expensed instead of capitalized
- Inventory write-offs
- Excess rent or occupancy expenses
- Moving and premises renovation expenses
- Excess or non-recurring legal, consulting or other professional services
- Cash shortages or missing funds
- Uncollectible customer accounts receivable
- Discretionary charitable donations
- Discretionary dues/subscriptions
- Any other extraordinary or non-recurring expenses, including one-time business events

Financial Projections

Buyers purchase your company's future ability to produce income. The value of the business will be based on the buyer's projections of future profits, not your own. They may have resources that are unavailable to you that could substantially change the company's future profitability picture. That is why you see a large national company willing to pay 10 to 20 times a company's after-tax earnings.

Here's an example: Our client, a large lumber business in the Rocky Mountain region, generated $20,000,000 in revenues but had a recast profit of only $750,000. A national accounting firm appraised the company at $4,000,000 – an estimated value that was confirmed by an investment banker.

IBG sold the company for $11,500,000 in cash. How did this happen?

We identified potential strategic buyers that had resources our client didn't have. One of the many buyer prospects was Hope Lumber Company, selling over a half a billion dollars in lumber a year. With this level of purchasing power, the buyer was already purchasing entire trainloads of lumber at substantially higher discounts than our client (no surprise). When we prepared pro-forma financial projections on the seller for Hope Lumber, we used Hope Lumber's cost to purchase materials, thus showing a substantially higher projected profit. The result: Hope Lumber knew that this higher figure was accurate, and did not have a problem paying the higher price due to the increased future profits that they expected to generate.

Guideline #4:
Look at the transaction from the buyer's point of view. Sell the future, not the past.

Tangible and Intangible Assets

The book value of your company has probably been minimized to legally accelerate tax deductible expenses. Most good accountants accelerate depreciation or amortization expense and thus reduce company taxes. So, to show the true value of the company's assets, you must also recast your balance sheet.

Assets should be recast to show current fair market values. Equipment in manufacturing companies has often actually appreciated in value since being purchased. Such equipment should be valued as "operating in place" and should include the cost of installation and tooling.

Overlooked intangible or "phantom" assets are also very valuable to a purchaser, and so need to be identified and documented. These assets include patents, proprietary processes, trade secrets, employee knowledge, trade name, reputation, procedures, systems, customer lists and vendor lists. All of these items should be considered when determining the real value of your company.

The following checklist will assist you in identifying phantom assets and creating more value in your business for prospective acquirors.

Guideline #5:
Identify and document your phantom assets – and keep this valuation current.

Selling Full Value: Phantom Assets

Phantom assets are those which may not be specifically stated on a company's balance sheet and can often be overlooked as key elements of value in a transaction. The following list suggests phantom assets which can add significant value to the sale of your company:

- Local Economy
- Industry Ratios
- Custom-Built Factory
- Management
- Loyal Customer Base
- Supplier List
- Distributorships
- Reputation
- Delivery Systems
- Experienced Design Staff
- Growing Industry
- Recession Resistant Industry
- Low Employee Turnover
- Technologically Advanced Equipment
- Computer Databases
- Computer Designs
- Employee Manual
- Name Recognition
- Skilled Employees
- Advertising Campaigns
- Advertising Materials
- Engineering Drawings
- Favorable Financing
- Royalty Agreements
- Government Programs
- Systems and Procedures
- Training Procedures
- Proprietary Designs
- Tooling
- Backlog
- Location
- Contracts
- Franchises
- Mailing Lists
- Location
- Trade Secrets
- Licenses
- Trademarks
- Know-How
- Credit Files
- Copyrights

Documenting the Opportunity

Buyers today come from all corners of the world, and you need to educate potential acquirors on all aspects of your company. In order to communicate with buyers, we recommend that you create a Confidential Business Report (CBR), a comprehensive description of your company. A CBR typically includes the following chapters:

- Confidentiality disclosure and limit of representations
- Executive summary of the business opportunity
- History of the company, including any major milestones
- Operational overview and analysis
- Organizational chart and background information of key employees (another intangible asset)
- Market analysis and marketing plans
- SWOT analysis: your company's strengths, weaknesses, opportunities and threats
- Historic and Recast Balance Sheet
- Historic and Recast Income Statement
- Projections of future earnings and detailed assumptions used to create these projections
- Company brochure, product lines and other ancillary materials

Our research and buyer surveys have discovered that pictures truly are worth a thousand words. Pictures let the buyer get a feel of the business environment that cannot be communicated by the written word. We have seen instances in which buyers have created a mental picture of what the business should look like, but then were disappointed when they finally saw it for themselves. Pictures can promote your company's appeal and avoid buyer disappointment.

Guideline #6:
Create a Confidential Business Report to educate buyers – and include pictures!

Procedures, Policies, and Manuals

Buyers will pay more for companies that are professionally organized and documented because they perceive the risk factor to be lower. Well-written procedure manuals and policies avoid confusion, prevent litigation and add value for buyers. Documented procedures take the guesswork out of a process and ensure consistency in products and service. Among other things, policy manuals should include your company's specific benefit plans, sexual harassment procedures and injury reporting requirements.

Guideline #7:
If you don't already have written policies and procedures manuals, prepare them immediately!

The Pitfalls

There are a number of traps, snares and landmines that can derail a sale; here are some of the biggest ones to avoid:

Pitfall #1: Customer and/or vendor dependency

Company value is directly correlated with its ability to generate profit for the purchaser at an acceptable level of risk. The lower the risk, the higher the value and thus the more the buyer will be willing to pay. Buyers see companies that are dependent on a few large customers as highly risky. If your company is in that situation, *now* is the time to start diversifying your customer base.

Equally important is that your business does not rely upon a single source for services or materials. Diversifying your suppliers and maintaining alternative resources for critical materials reduces the risk to an acquiring entity and subsequently increases your company's value.

Pitfall #2: Failure to make full disclosure

This is, unsurprisingly, a litigious world. When you sell your business, the last thing that you want to worry about is costly litigation. There are two keys to avoiding litigation: (1) Have a professional advisory team made up of an experienced transaction attorney, accountant, and merger and acquisition advisor; and (2) *always* disclose all defects or weaknesses upfront.

Paradoxically, weaknesses can even be seen as positives! In the past 20 years, I have not met a single buyer who doesn't think that he or she can run the company they acquire better than the previous owner did. By disclosing your company's weaknesses upfront, you can actually position them as <u>opportunities</u>. The purchaser will probably see weak marketing or outdated equipment as areas that can be easily corrected to improve profitability (have you read *Barbarians at the Gate*?). Timely full disclosure both avoids litigation and creates value.

Pitfall #3: Non-specialist professional advisors

When choosing an advisor, attorney or tax accountant, remember to look for firms that specialize in the sale of companies.

Selecting your professional advisors is similar to selecting a doctor; you may have seen the same internist for years – but you don't want to be his first brain surgery patient.

Identify an attorney, a tax accountant and a merger/acquisition advisor who specialize in selling businesses similar to yours. It's true that there are many talented generalists – but you sell your company only once in a lifetime. Don't take unnecessary risks to save a little money. In the long run, the "savings" could cost you dearly. Remember that *you* are the captain of your business and the role of your advisors is to explain the available choices and provide advice. You make the ultimate decision of what is reasonable or not.

Pitfall #4: Failure to convert to accrual accounting

Buyers will demand that you supply financial statements that are based upon the accrual method, because it typically represents your company's ability to generate a profit more accurately than cash-based accounting. Our experience has also shown that reviewed or audited financial statements are a substantial value-builder. Larger companies are required to audit the financials of a targeted acquisition. Leave nothing to chance in a sale and have your financials audited prior to going to market; this could substantially increase your company's value as well as help you to avoid costly litigation.

Pitfall #5: No employment agreements in place

The following cautionary tale is a true story. A business owner in Texas had successfully operated his company for 35 years. He eventually hired a young individual who he trained to assist with managing the company; although this person had no formal education, the owner took a chance and invested in him for ten years. The young manager was very talented, and was not only trusted by the owner but paid handsomely for his service. On the day the owner's company was to be sold, the manager announced to the purchaser that he was going to quit immediately after the sale to start his own competing company. The young manager was honest enough to explain that he was also taking the top five customers with him, as well as three other key employees of the company. Do you think that this business sold that afternoon?

The manager technically did nothing wrong – but if the owner had had a written management agreement that contained a non-compete covenant, the transaction would have closed and the owner would have retired happily. Any manager or key employee should have a formal employment agreement that protects both the employee and the company. (To protect our clients' confidentiality at IBG, we even require our receptionist to sign an employment agreement.) Avoid being blackmailed or derailed at the last minute; invest in a well-written employment agreement.

For more information about any topic covered in this White Paper – or any other issues regarding building your company's value – please telephone us at 303-758-4000 or visit our website at www.IBGBusiness.com.