So, you want to sell your business

Cash sales, we told you, are not without pitfalls. Here’s what to consider about selling with terms.

By Frank Butrick

In Part I, we covered the basics of a cash sale—plus some ideas on a ‘cosmetic treatment’, how to visualize your job after the sale, and then on pricing the business. Here now is the term sale and ideas on how to find a prospective buyer.

The term sale, with the payments stretched over a number of years and the seller being the ‘banker’, is attractive for a number of reasons. First, the price always goes up; cash-on-the-barrelhead is always the lowest price. Terms of three, five, or ten years always involve a higher price. Second, a cash price dumps money into the seller’s hands which he seldom knows how to invest profitably. Term payments spread the money out, giving him more time to find a wise place to put it—and less temptation to blow it on long-dreamed—of ‘essentials’ such as a cabin cruiser and a new home.

Third, as everybody knows who ever bought a house with a mortgage, during the life of a long-term sale the interest often equals—or exceeds—the principal. If the seller finances the buyer, the interest is likely to pay better than the best investment he can think of and essentially double the sales price. Fourth, long-term buyers are easier to find and sell to than are cash buyers. The seller who insists upon cash limits himself to a very limited number of buyers—and to those who can secure outside financing (in which case the banker makes as much as does the seller). For all these reasons, the term sale is usually to the seller’s advantage.

There are a number of ways to handle a term sale. Among these are variations based upon transfer of title, what is actually sold, tax considerations, methods to protect the seller, etc.

Generally, a term sale follows the form of a land-contract, often seen in real estate sales. Title to property, equipment, and fixed assets remains with the seller until the business has been paid for in full. Partly this is because the downpayment is often insignificant and the seller must protect himself against a dissipation of the assets.

The opposite is a mortgage sale, with a large (25% or so) downpayment, title passing to the buyer at the time of sale, and the seller holding a secured mortgage against the assets. Often the seller considers the business as inadequate security for holding the buyer to the contract and therefore demands additional security in the form of other assets the buyer may have (home, investments, etc.).

Notice that the essential difference is when the title goes from seller to buyer—at the time of sale or when the purchase is consummated, perhaps years in the future. From a practical standpoint, the distinction is a function of legal safety for the seller; legal requirements vary from state to state and this should be explored with a good attorney. If the seller is dubious of the buyer’s ability to perform, probably the contract sale is best because of its relative informality.

Another distinction is made in what is sold: stock in a corporation or the business is a proprietorship or partnership—or merely the assets.
and liabilities. The price is the same either way—the only essential difference is in the words employed. If ownership (stock) is sold, the buyer acquires the seller’s books—with current book value on all assets. Since many of these have been heavily depreciated and the selling price is generally more than the net worth, the difference between book value and sales price is called “good will”, which is difficult to depreciate and may lie in his books forever. The alternative is for the buyer to purchase only the assets and liabilities, putting them into his books at fair market value. He sets up a new depreciation schedule for each asset and starts all over.

Here, too, there may be a difference between the value and the price. It can be called good will, but a wise buyer will call it purchase of customer lists, mailing lists, or of a covenant not to compete executed by the seller—all of which are depreciable. The result here is much lower income taxes for the buyer because of the tax-shielding depreciation—and higher for the seller (recapture of depreciation, etc.), so the price is usually adjusted upward to compensate.

The Valve Gap

Since taxation plays a major part in determining the exact way to put the deal together, the gap between actual book value and the sale price should be carefully considered. The objective is to ascribe this difference to something depreciable. In most businesses, especially those doing contract or repetitive work, such as many builders, the customer list is of solid value and can be assigned a substantial price. In some other kinds of businesses, a high value can be assigned to the mailing list, which also is depreciable. Most popular, however, and readily justified to the IRS, is to purchase an already existing contract not to compete. This is a contract which the seller signs to assure the stockholders of his own business (which may be himself, but no matter) that he will not leave and go into competition. Obviously, the buyer wants to acquire that contract; in fact, the buyer would be foolhardy to buy a business without some such assurance that the seller would not bob up six months later as a competitor. Thus the popularity of the covenant not to compete; the value ascribed to it can be fully depreciated in the same period as the contract—five, ten years, etc.

The tax aspect of a sale must be considered; generally, what is good for the buyer is bad for the seller and vice-versa. As the seller, you will get out your original starting capital tax free. That amount which corresponds to recapture of depreciation and profit on the sale of inventory is ordinary income, and the rest is capital gain. It is actually more complicated than that, but this is close enough for calculation purposes. Of course, in a term sale, with payments spread over some time, there is interest to consider. If the value is $250,000, with $200,000 financed at 10% for 10 years, the interest is about $110,000. Interest is ordinary income to the seller, a deductible expense to the buyer. If the price was increased to $360,000, with $310,000 financed without interest, and the value ascribed to the covenant not to compete increased accordingly, the seller gets the increase at capital-gain rates and the buyer gets an increase in depreciable value. There are a score of ways to handle tax aspects; any sale of magnitude requires expert help.

Measuring Risk

Of course, every term sale entails a risk: Will the buyer ruin or rob the business and then desert? There are numerous ways to provide protection for the seller, based upon the ways a dishonest or incompetent buyer could damage the business. The buyer could borrow money with the assets as collateral, pocket the funds, and disappear. He could sell the equipment for cash and head for South America. He could change suppliers, shifting to buddies who charge high prices, kick back to him, and thus drain away the firm’s cash. Or provide services at sweetheart
prices to his friends, or load the payroll with relatives, give himself a big raise, etc.

To protect himself, the seller must constrain the buyer against improper use of the firm’s assets or missing payments due the seller. The easiest is supplemental collateral—the buyer’s home or other possessions. This is fine for the sale of a little business; but not much help if the price is over $100,000 or more—and few businesses sell for less than that. So most protection is built around contracts which limit the buyer’s freedom to borrow, increase his salary, change suppliers or customers, increase the payroll, buy or sell equipment, change the inventory, etc., generally requiring the seller’s written permission. This requires the seller to play God because he tries to foresee what an honest buyer would need to do with the business, what a crook would do, and how a contract can assist the one and stop the other. At stake is the buyer’s opportunity to play banker and get two or more times what the business is worth—possibly even more, because many term sales tie the price to a percentage of volume or gross profit instead of the value of assets. So it is well worth the effort required to develop the details of a term sale.

As such the term sale is no more complicated than a cash sale—but it does mean more detail work by both parties, more points to work out and agree upon. Because of this, there are an infinite number of ways to set up the deal, with few predominant models. I have bought and sold businesses for myself, and acted as a broker and consultant for many sellers and buyers; all told I have been involved in well over 200 acquisitions, ranging from a few thousand dollars to over $10 million. Most of these were term sales—and no two were alike.

Patience Pays

To put together a term sale you need not be cunning—just patient. Buyer and seller start out with widely divergent aspirations and requirements; slowly, over many meetings, these are evolved and modified until they meet. Salesmanship, persistence, patience, and mental agility are the requirements and the result is well worthwhile. Once you have familiarized yourself with the concepts, you are ready to seek out a buyer.

Finding a buyer is astonishingly easy. First consider what you have to sell and then who should be interested—and why. Logic will steer you to the thought that the best buyer (honest, experienced businessman; reasonable cash downpayment, etc.) is a growth-minded competitor! If he has two or three sons who are starting to fall over each other, he has to grow just to keep peace in the family.

Acquisition is his fastest and cheapest way to do this—which makes him your best prospect. If you have no eager competitors, look to building contractors farther away—perhaps some are interested in expanding into your market area. To find them, run ads in trade magazines and make up a list gleaned from Yellow Pages, association membership directories, supplier mailing lists, etc. Write to them. DO not be coy; say what you have to sell, why you want to sell it, that it is available for reasonable terms, and invite them to contact you. If you pull a blank, then look farther afield—geographically among other building contractors, but also to people in related lines: home builders, foundation contractors, remodelers, even bridge or road contractors. Keep at it and you will wind up with three or four interested prospects. That is enough.

From there, it is all downhill—purely a matter of applied salesmanship and negotiation.

Of necessity, I have presented a very complex process, with many financial and taxation complications, in a highly simplified manner. If the subject interests you—as buyer or seller—write to me at P.O. Box 159, Akron, Ohio 44309. We have more information available. If you have a specific question, write; all letters will receive a reply. Or call me at 216/253-1757; there is no cost or obligation; I will be happy to help if I can.