Insider Tips on Selling a Business in Canada

Based on the “At the Broker’s Table” article series

Greg Kells

Insider Tips on Selling a Business in Canada
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About the Author

Greg Kells is President of Sunbelt Business Brokers, Inc., the Canadian offices of the world's largest and most successful network of business brokers.

Over the many years Greg has been in business, he has helped hundreds achieve their dreams.

Greg is a Mergers & Acquisitions Master Intermediary, Certified Business Intermediary, Certified Senior Business Analyst, Certified Machinery & Equipment Appraiser, Life Member of the Institute of Business Appraisers, Real Estate and Business Broker and an instructor for the International Business Brokers Association, the National Equipment & Business Brokers Institute and the Society of Business Analysts.

In addition to his management and training responsibilities, Greg continues to assist clients with the purchase or sale of businesses.

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Sunbelt Business Brokers Canada Core Values

If we can help enough other people to achieve their goals we will achieve ours.

We cannot be successful until we have made the people around us successful.

How we treat people in business is how we treat people in life—with caring and respect. We revere honesty and welcome disagreement. We treat others as we want to be treated.

We continually strive to improve our skills, our systems, our policies, our technology, our knowledge, our focus, and our support to be the very best at what we do.

We develop and implement strategies to effectively deliver services that enable our clients, our peers, and us to achieve our goals.

We set goals and measure performance against them individually, as a team, and corporately. We take responsibility for the outcomes.

We modify our plans, strategies, and activities based upon measured performance and expanding knowledge.

We value the role and contribution of each person.

Making money is the reward and the catalyst for being the best in the industry.

Acknowledgments

The concept behind the series that spawned this book—"At the Broker's Table"—was to sit together with a group of experts in various disciplines and, as a group, to provide advice to business owners preparing to sell their business.

Having sold more than 400 businesses and trained hundreds of business brokers over the past 12 years, I brought the expertise in business brokerage.

I am most fortunate to have had two great mentors in my business brokerage career: Ed Pendarvis and Tom West.

Ed Pendarvis, who founded Sunbelt Business Brokers and built it into the world's largest and most successful business brokerage network, has been a kind and generous mentor. Ed has shared his experience, time and energy to build our industry and to help many hundreds of business brokers to launch their careers. His humility and care for others along with a keen understanding of the small business mindset enabled him to understand how to help business sellers and buyers achieve their goals and win/win outcomes. I was one of the many students fortunate enough to benefit from Ed's tutoring. Ed has written two books of note and continues to help business buyers and sellers through BusinessBuyersUniversity.com and his brokerage in Charleston, S.C.

Tom West is the grandfather of business brokerage in North America. He shares with Ed a very generous spirit, which manifest itself in launching and nurturing the International Business Brokers Association (IBBA), which provides training, mentoring and resources to our industry. A Fellow of the IBBA, I have benefited greatly. I have also gained from Tom's personal tutoring and from reading the many helpful publications and training materials issued through his firm, Business Brokerage Press.

The third person I wish to thank for their help is Karen Runtz. Karen kindly and expertly edited each article and kept me working in a timely manner to meet the newspaper deadlines. She has helped with our web site www.sunbeltcanada.com, my blog "The Real Deal", our monthly newsletter, social media and with the editing and formatting of this publication. This book would not have happened without her.

The team assembled to provide advice for business buyers and sellers included: Adrian Spitzer and Glenn McLeish, Valpak (Marketing); Dianna Larkin, McCay Duff (Accountants); Jay Humphrey (Lawyer); Randy Harrison, Advanced Planning Group (Wealth Planning and Life Insurance); Rob Tanner, Tanner Insurance (Property and Liability Insurance); Ray Joseph, Connor Clark & Lunn (Investment Managers); Grant Mellow, ActionCOACH (Business Coaching); Jeffrey Edwards, *The Inner Circle* (Peer Mentoring); and the staff of the Sunbelt Ottawa office—Chris Skowronski, Olga Nadjakova, Khaled Bitar, James Luck, Mitch Murphy, Patrick Ryan, Gavin McLintock, Chris Strang, Jason Kells, Amy Kells, Susan Langmack, Amin Karimi, Mark Cullen, Heman Hui, Francois McDonald and Robert Benell. Each has made a valuable contribution.

Our many clients have kept us in business and each has increased our understanding as have their lawyers, accountants and professional advisers, and for this I am grateful. I am also grateful for the sharing of experiences and knowledge among the many Sunbelt office owners throughout the world. Without their help I would not have survived the first few years.

Most of all I would like to thank my wife, Gayle, who has put up with the evenings and weekends devoted to building Sunbelt, to increasing the professionalism in our industry, to educating business buyers, sellers, and brokers, and to this project.

Introduction

The decision to buy or sell a business is among the most important you'll ever make. Friends and family will give advice, but do they really understand the rules and issues at stake?

Business brokers provide professional expertise, advocating and guiding both buyers and sellers through the challenges of the transaction. It's the broker's job to understand and match opportunities with needs, resources, skills, lifestyle goals, energy and passion. They manage the transaction and control the process, respecting timelines and channeling the flow of information required to bring the deal to a close that works for both parties.

Lawyers, accountants, bookkeepers, bankers, wealth advisers, marketing specialists, insurance professionals and business coaches also have valuable expertise and services to inform the decisions you will be asked to make along the way.

Insider Tips on Selling a Business in Canada explains the processes and the sequencing of steps and responsibilities in selling a business, so you'll understand who should be doing what and when. You'll be able to pick up proven tips whether you're buying or selling.

The goal is a fair deal, with price, terms and conditions that work for both sides.

A desire to help others achieve these goals was, in fact, the force behind *At the Broker's Table*, an article series we launched in 2010 in the *Ottawa Business Journal*, and on which this publication is based.

A good broker focuses on finding the right business for the buyer. Starting the transaction with a buyer that has the necessary experience, skills, ethics, financial resources, risk tolerance and passion is more likely to lead both parties to a successful outcome.

Likewise, the seller's expectations need to be in line with the market reality. The business broker starts by formally assessing the value of the business to determine the most probable selling price (MPSP). This represents a reasonable price, factoring the true earnings, the state of the business, the risks, and what the market is willing to pay. The seller can then negotiate on an informed basis.

In Canada, business brokers often represent the interests of both seller and buyer. The broker commits to confidentiality, loyalty and full disclosure to both parties simultaneously.

It's the broker's job to be fair, to get the right questions asked and answered, and to help both parties achieve their goals.

Business owners want to maximize value while minimizing risk and taxes when they sell. But achieving this result requires planning and effort. *Insider Tips on Selling a Business in Canada* will help you get there.

Greg Kells; President
Sunbelt Business Brokers Inc.

Understanding what buyers are looking for

So what *are* buyers looking for?

Whether it's their first purchase of a business or their 10th, buyers are looking for an ongoing income.

Not surprisingly then, they'll be attracted by businesses with a proven track record of consistent financial performance with solid, growing revenue and earnings.

Will the buyer be able to see himself in the business?

Let's follow a prospective buyer; we'll call him Tom. Tom meets with a business broker to assess his skills, interests, financial resources and experience as well as his personal and financial goals. This process equips the broker to pre-screen businesses for the ideal fit. If the right business is not there now, it may be in the near future.

Tom is quite taken with one business in particular — an automotive parts store. Tom's been tinkering with his own and his friend's vehicles since his teens so a somewhat-related business is appealing. He currently manages a call centre so he has a skill set that's transferable.

The store's cash flow looks good. It might be enough to give him a decent salary and cover financing payments. But the purchase price is higher than Tom thought it would be. He knows the seller is willing to take back a note for part of the cost, but is concerned that the down payment will be too high. He can't overspend as he needs working capital after the purchase.

He really wants to see the business though. His broker can set that up, maybe sending him as a mystery shopper.

Preparing for the walk down the business aisle

So now this potential buyer is about to make his first visit to the business. He has signed a confidentiality agreement and he is serious.

Are the premises clean? Is the equipment well-maintained? Is the inventory current? How will he be treated? First impressions matter.

Tom will want to know more about operations and opportunities:

- Does the business have a wide range of clients/customers or is there a concentration of accounts in any one area? A concentration is a risk.
- What about suppliers? Does the business depend on a select few? How long are their contracts for?
- How involved is the existing owner? If involved in most every aspect of daily operations, then how will the business function with a new owner?
- Is there a good operations manual and staff training program?
- Is the intellectual property protected?
- Will staff and clients stay?

Buyers need assurances; sellers need to find ways to provide them. Having the seller stay on a few months after the sale to assist with transition or training will alleviate concerns and help a new owner get acquainted with staff, clients and suppliers.

Back to Tom. He's still nervous, but wants to make an offer, with the understanding he can retract it for any reason up to the last day of due diligence.

A business is only worth what a buyer will pay and what a seller will accept

Both parties need to be comfortable with the other's ability to deliver what is promised. The detailed work of verifying financial and legal matters happens at due diligence—that's when the lawyers and accountants play key roles. But getting to that point requires give and take on both sides.

In negotiating a business deal there are many things that are important, but none more so than price and terms.

Tom understands that we'll need concessions from both sides to arrive at a deal that works for both parties. He may not get the price down by much, given the value the business represents in the market and his own need to secure financing for the purchase.

In most cases a buyer needs the seller to take back a note for a portion of the purchase price, paid off over time. This "vendor take back" bridges more than financing—it reassures a buyer that the seller is confident the business will pay for itself, mitigates potential unknown future liabilities and provides assurance that the seller believes this buyer will be successful.

Another part of the price and terms is the all-important *down payment*. Tom can't let the down payment deplete his cash. Even with an immediate cash flow, working capital is needed to keep the business going. He must also keep something aside for the unexpected.

With the broker's help, Tom and the seller work out the deal. Tom is satisfied he's getting a good business that will meet his current and future needs. And the seller continues preparing for the future, knowing the business will be in good hands.

Provided nothing takes the deal off course at due diligence, we'll be toasting their success at closing!

Why confidentiality counts

Realtors want to get the word out as quickly and widely as possible that a particular house or building is for sale. Selling a business is a confidential process—you do not want *anyone* to know your business is for sale.

Broadcasting that your business is for sale introduces risk.

Employees will have questions you can't fully answer. Insecure about their future, they may look elsewhere for a job. Losing key employees could affect the sale of your business. Buyers count on taking over a business with skilled staff.

Customers might go elsewhere, reducing sales and profit, making your business less attractive to a buyer.

Thinking you're having financial difficulties, suppliers may take steps to protect themselves, demanding cash rather than credit and transferring your exclusive agreement to a competitor.

Competitors may take advantage of what can be a period of uncertainty to chip at your business base.

All these are risks that could leave you with less money in your pocket *while* you sell and *at* the sale. And what if the deal collapses at the 11th hour? The impact on those with an emotional investment in the deal can be damaging.

Signing an NDA

So how do you get the word out to prospective buyers without setting off any alarms? To whom *can* you talk? To whom do you *need* to talk? How much information do you release and when?

Business brokers have established systems to protect the confidentiality of a business. A broker with a well-established firm can expose the opportunity to hundreds of prospective buyers without employees,

customers or a competitor knowing the business is for sale. Advertising won't specifically identify the business.

A broker will also screen prospects to confirm their resources and potential for assuming your business, so you don't waste time with "tire-kickers."

A more detailed business prospectus is only provided to qualified prospective buyers after a strict and detailed, legally enforceable non-disclosure agreement (NDA) has been signed. An NDA creates a confidential relationship between the parties to protect any type of confidential and proprietary information or trade secrets. It also prohibits the potential buyer from letting anyone know you are selling.

Meetings are facilitated between the business owner and buyers that are serious. Then, if the seller agrees, the buyer is given proprietary financial and operating information, including strengths, weaknesses, opportunities and threats facing the business, to make an informed decision about proceeding with an offer.

Discretion is the word

Confidentiality ensures that information is accessible only to those authorized. Until a deal is complete, it's best to tell only your trusted professional advisers; even then you have to ensure they keep the transaction confidential. Some are already bound by professional provisions—lawyers are obligated to protect client confidences as are accountants. You will need tax, financial, legal and perhaps investment advice prior to going to market.

There are some circumstances where early disclosure is advisable or even required:

- Never assume that the landlord will approve the transfer or assignment of a lease to the buyer. A business broker will speak to the landlord as early as possible, but only with a signed NDA in hand.
- With a franchise, you can only sell the rights to the business and franchise with the agreement of the franchisor. You need to determine the conditions and costs involved in obtaining their approval.
- Any business with multiple shareholders must ensure that all are on the same page when it comes to selling the business. Never assume all will agree.

Problems can also arise when selling a business operating as a partnership without a formal agreement. One partner may feel they've put more into the business than the other, deserving a bigger share. You don't want dissension after an offer has been accepted.

Some buyers will approach a commercial lender for a loan. This step introduces risk—the bigger the organization, the higher the risk. The lender too should sign a confidentiality agreement.

The buyer and seller are themselves sometimes responsible for confidentiality breaches—they want to share the news with their family and close friends.

When *should* a seller tell their employees? When the deal is done! It's the same for key customers. You'll want to introduce the buyer and give both staff and clients confidence about the changes to the business after closing the deal. There are exceptions: occasionally an in-house accountant or other key staff members are necessary to a close and need to be brought into the seller's confidence. Ensure they understand the need for confidentiality.

The shorter the time frame to sell a business, the less chance of word slipping out.

Building value: top financial factors

Does your accountant dread your visit? Bad record keeping is, in fact, the biggest roadblock to selling a business.

Buyers want a business with a proven track record of consistent financial performance with solid, growing revenue and earnings.

Yet, most businesses are rather flabby when it comes to fiscal fitness. Spending some time with a trainer/coach can boost your strength and health.

Let's start with some top financial drivers of business value. Focusing on these will make it easier to sell your business and get you more money—*then* as well as *now*. Assess your own business, determine which factors affect your business the most and prioritize what you want to work on.

Keeping (in the) good books

A correct set of books prepared with proper accounting software is a necessity. Documents need to be current and correct, demonstrating timely remittances and filings.

Compliance is essential: issues with the Canadian Revenue Agency (CRA) or others can freeze your accounts and destroy your business. Continuity is also important. Are you dependent on a single employee who could leave?

Outsourced bookkeeping provides efficiencies that can benefit small businesses as you pay for work that's being done, not standby hours. Clean and compliant books will contribute to a good relationship with your accountant and save you dollars there, too.

A good bookkeeper will also help you understand your numbers, providing forecasting, financial analysis and identifying cash flow risks.

Keeping good records and communicating any changes is a necessity. Owners often dispose of assets or sign a new lease and forget to advise the person doing their books.

Financial Value Drivers

Clean up the Balance Sheet. A Balance Sheet provides a snapshot of the business's health. Use it to pinpoint and remove obsolete and slow-moving inventory or excess cash. Resolve potential liabilities and lawsuits, ensure that assets are properly recorded and that expensed R&D investments are noted.

The top reason businesses fail is not poor profit but dry cash flow held hostage in accounts receivable or inventory.

Increase revenues and profits. All else being equal, a better bottom line leads to a higher business valuation: a) sell more to existing customers, b) sell to new customers or c) a combination of the above.

How efficient are you at turning revenue (sales) into profit, i.e. controlling expenses?

Keep in mind that it takes six times as much money to attract new customers to businesses than up-selling, on-selling and generally over-servicing existing customers. You'll want to keep your customers coming back and bringing their friends with them.

Review and reduce or eliminate discretionary expenses. A $25,000 increase in your bottom line might add $100,000 to your selling price. Phone bills, office supplies and insurance expenditures are areas that should be reviewed by outside agencies annually. Be careful with insurances, though. Your coverage needs to be adequate and the right kind. Having a proper insurance policy with up-to-date coverage assures a purchaser that what they're buying is protected.

Maintain steady revenue or aim for growth. Steady sustainable revenue beats one that's erratic.

The greater the market share, the better. Market share can be more important than revenue. A business with a 50% share in a defensible position is attractive to buyers.

Resolve and diversity customer concentration. It's risky to have any one customer representing any more than 10% of your business.

Resolve and diversify supplier concentration. A dependency on any given supplier is also a risk. Line up alternatives.

Prepare reasonable future business projections. Set goals with detailed steps to meet them. Show the earning capacity of your business. Base your plan on existing records, the market and technology; document the steps that will take you there.

Get a business valuation. A valuation tells you where you are now versus where you want to be *x* years from now. A valuation also helps pinpoint changes that can boost the business value.

Research tax implications upon selling the business, including "vendor take back" and earn-outs. Who doesn't want to minimize the tax consequences when selling? Some of the options: share sale, family trusts and deferred payments.

Building value: top organizational factors

Can a potential buyer see himself in your business or are you blocking the way?

When preparing to sell or build value in a business, you need to step back and become dispensable so your business works without you.

Many businesses are dependent on the contribution of the owner for success. If you want to add value, be sure you have systems running the business and a great team running those systems. A business that lacks systems and relies on you has less value.

Working ON the business, not IN the business can be especially hard for those whose business has been their means of self-employment.

The greater value comes when the business is making money without the owner's day-to-day involvement, giving the owner the option of "retiring on the job" with income and flexibility.

Make yourself dispensable

An owner's role is to focus on the future—expanding operations, improving revenues and profits—while bringing in the money today. If you're still working IN the business, make yourself unnecessary. Pay for the help you need. Hire someone else for administrative duties.

Learn to delegate and empower your employees. Challenge them to improve their skills. Set goals and expectations then let them follow through. Hold them accountable for their actions and specific jobs.

Ensure you have an organizational chart with defined positions, reporting lines and duties and the right people for the right positions (financial, management, sales). Groom a competent management team.

If people are in the wrong jobs, move them now—a buyer won't know your people like you do. Settle them in their new jobs before the buyer takes over. Document duties, responsibilities and expectations. Ensure you have:

- a current business plan with reasonable future projections;
- an honest analysis of your business's strengths, weaknesses, opportunities and threats (SWOT);

Show prospective buyers the earning capacity of your business. Keep up your business plan as a living guide. Base it on your existing records, market and technology and document the steps that will take you there. Invite staff to contribute and keep it current.

Lack of full disclosure destroys trust. People must trust you to do business with you. Never try to hide deficiencies. Buyers need to understand what they can do with the business. Profits are being generated with weaknesses present; fixing them will increase the profits.

Retain key employees

Buyers count on taking over a business with experienced and knowledgeable staff. Losing key employees can affect the sale and value of your business.

Find ways of retaining your key personnel such as an incentive program with bonuses paid after the seller leaves or a special payment giving "consideration" for signing a non-compete agreement that extends two or three years beyond the planned sale.

Some businesses are more prone to staff turnover than others. There is always a concern that key employees will leave to set up their own business in direct competition.

Sellers are advised to secure non-compete agreements well in advance and structure them so that if there is a change in control, the agreement stays in place.

How long a term is reasonable? An agreement that specifies five years is unlikely to be supported by the court. The scope of expertise and defined geographic area in question are factors. What it comes down to is *you can't prevent someone from earning a living*.

Even with an agreement that's "enforceable", you'll want to weigh the cost and impact of litigation to keep your position in the marketplace. You may find it better to "give to get". Negotiated solutions can benefit all. The terms and conditions can be anything that is agreeable to both parties.

Building value: top operational factors

If a hidden camera recorded private comments of potential buyers touring your business, what would it reveal?

Like homebuyers, prospective business buyers spot what's worn, cluttered and dated. Like moths to a flame, they're drawn to defects, totaling up renewal and revitalizing costs.

Some may see the business as an opportunity; *all* will see it as worth less money. Like financial and organizational factors, operational factors can add or take away value.

Clean up the shop, warehouse, office, store.

- Dirt and dust say you don't care. Show customers and staff that you do. Clean and freshen up all store, work and rest areas.
- Do assets need repair or replacement? Deal with it.
- What about inventory? Do you have more than needed to sustain average levels of sales? Sell off the excess. Take the same approach to eliminate unneeded files, equipment and programs.

Tighten up operations: non-performing or unsatisfactory employees, non-performing or unsatisfactory suppliers, slow or non-moving products or services.

- If an employee isn't working out, tell them. Give them a chance to improve. Provide coaching, an improvement plan and feedback. If they're unwilling or unable to improve, start progressive disciplinary action. The steps that you take when you prepare to terminate employment matter; you do not want to

end up paying out for unlawful dismissal. A lawyer can help you understand your options.

- Are family members who work in the business competent in their assignments? Are they held to the same performance standards as other employees? They should be.
- Are your suppliers punctual; do supplies arrive in good condition? If not, take it up with them. If they're at fault, review the penalties. Can you go elsewhere? If the contract isn't exclusive, you may be able to dual-source. If you terminate early, there may be penalties. Again, legal advice may be in order.
- Do you set and monitor profit margins for each product? You may need to keep some slow-moving items in your inventory if they're high profit or critical to the operation. Consider discounting and selling the balance.

Our next set of operational factors relates to systems used to run the business—the collection of processes or rules that govern our attitudes and actions in support of customers and staff.

Document, communicate and apply Vision, Mission, Goals, Values and Principles.

- A *Vision Statement* defines what the business will be like in five years; a *Mission Statement* defines the benefits customers can expect from the business. *Goal setting* involves establishing specific, measurable and time-targeted objectives. A business plan sets out how you will achieve these goals. These documents aren't just for large companies; by being closer to where the rubber hits the road, smaller businesses can often respond faster and better to needs.
- While these documents provide common purpose and direction—who you are, why you're in business, what you sell, what you want to achieve—the *values and principles* define *how* you do business.
- Have you an identity or brand? Is it recognized by your target customers and reflected by your employees? Carry it through every point of contact.
- Practice your elevator pitch. Can you explain your business in 30 seconds? Try using three points—the name of the business, what it does, what defines it and makes it successful.

Keep the Operations Manual current and complete.

- An Operations Manual pulls together the processes and procedures needed to run a business. One that's current and accurate will be worth its weight in gold to a new owner.
- Standardizing activities across your business also makes your operation more efficient and effective, incenting employees to follow the "rules".
- A typical Operations Manual has general company information as well as position-specific information (job description, duties, results expected, etc.). It should also reference any legislated requirements.

Maintain clean documentation, records, minutes and financials.

- Always know where you stand as a business. Are all contracts and licenses documented, current, and readily available? Is the minute book up to date? Are all required filings done? Meet with your lawyer at least once a year to review your corporate records—buyers lose confidence in a business when the legal due diligence turns up a long list of outstanding issues.
- Does your reported revenue adequately represent what your business is doing? Is your accounting supervised by experienced professionals and performed by competent bookkeepers?
- Keep in mind that buyers need three to five years of financial statements. An accountant's Notice to Reader Statement is the quickest and cheapest type of financial review; a Review Engagement Report is more thorough and reliable. An Audit is the most comprehensive but costs more than most small businesses can afford.
- Look beyond financials: ensure Health and Safety records, licenses and/or permits are up to date; hold regular staff/management meetings and document their minutes.

What is your business worth

If beauty is in the eye of the beholder, then the worth of a business lies in the eye of the market.

For the market is really what decides how much an owner will get for their business when they go to sell.

Determining that value, the most probably selling price (MPSP), is an art that goes beyond straight valuation. You'll benefit by engaging an accredited business broker with expertise in both.

Obtaining a formal business appraisal before you are ready to sell can help build a roadmap for increasing value and minimizing taxes. The end result is more money in your pocket.

A formal business appraisal can also provide the necessary valuation to buy out a partner or split assets in a divorce, for estate planning, an asset freeze for tax planning or roll over into a family trust.

At Sunbelt, we start by formally appraising the value of the business to determine Fair Market Value (FMV), using methodology of the International Business Brokers Association (IBBA), the Institute of Business Appraisers (IBA) and the National Equipment and Business Brokers Institute (NEBB).

From the FMV, we determine the MPSP. This calculation represents a reasonable price, factoring the true (recast) earnings past and future, what the market is willing to pay, and the seller's motivation. With this knowledge in hand, the seller can then negotiate on an informed basis.

Value is: seen in current dollars; risk-adjusted; not negotiated, but arrived at *objectively* based on determined value.

Price is: not time-sensitive and not risk-adjusted; derived from value and may be negotiated.

Deriving the MPSP: recasting financial statements

The seller's expectations of price need to be in line with market reality.

Often though, financial statements of small businesses *do not* reflect the business operations. They are often prepared to minimize the tax burden for the company and its owners. A first step in valuing the business is to recast, or normalize, line by line, the most recent balance sheet and three to five years income (profit and loss) statements.

Recasting the financials provides a realistic value of the assets and liabilities and shows the true earning capacity of the business.

For an owner-operated small- to medium-sized business, metrics based on income—seller discretionary earnings (SDE) and Earnings Before Interest Taxes Depreciation and Amortization (EBITDA)—are important factors in determining value.

Benchmarking

Valuations also weigh the fair market value of tangible and intangible assets and comparable ratios of sold businesses. Working with a business broker who has access to specialized databases and brokerage archives is of great advantage in benchmarking a business against the industry, marketplace and other like businesses.

Business patterns, systems, competition, markets, quality of service or product, staff and operational factors are all predictors of future earnings and need to be taken into account. But first, we need to normalize the company's earnings starting with the true cash flow from operations, "adding back" expenses considered discretionary, extraordinary, non-recurring or non-cash.

Discretionary means not necessary to support the revenue of the business; extraordinary means excessive, above normal levels; non-recurring means a one-time expense; and non-cash is usually tied to depreciation.

We also add back interest expense as this is the cost of capital and may be different for the new owner. We do the same with income tax.

Recasting requires rethinking

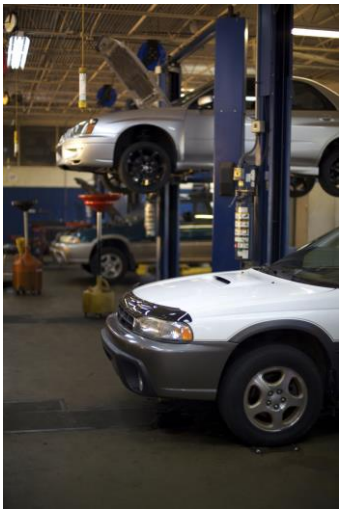
Although recasting is a standard practice in business valuation, it can take buyer and seller a while to adjust to the concept. A fair representation of the business is essential to both parties.

Sellers need to understand that these are valuation, not tax-deriving documents, and that all things being equal, a better bottom line will lead to a higher business valuation. Without recasting, an owner may understate cash flow from operations, arriving at an asking price that is too low.

A buyer needs confirmation that the adjustments to earnings are real and validation that the cash flow is sufficient to pay their salary, service the debt incurred to buy the business, build or reinvest in the business and provide a reasonable return on their invested capital.

All must be substantiated to the satisfaction of both parties, their lawyers and accountants at due diligence.

What is your business worth Part 2



As you read previously, a seller's price expectation needs to be in line with market reality. Most financial statements of small businesses are prepared to minimize the tax burden for the company and its owners. To reflect the company's true earnings, we need to recast/normalize the balance sheet and income (profit and loss) statement.

Recasting income statements

Owner's compensation can include pension plans, profit sharing, health and life insurance, auto travel, entertainment, meals, memberships, dues, fees, subscriptions, salary, wages, bonus and payroll taxes, family and relatives on payroll.

In a small- to medium-sized business, owner's compensation is often based on what the business can afford. It also tends to be the area of biggest adjustment in an income statement, where we "add back" expenses considered discretionary, extraordinary, non-recurring or non-cash. We also add back interest as the new owner may have a different capital structure.

In recasting, you need to ask: Will the new owner incur this expense to obtain these earnings?

This process can take some time and the business broker/appraiser can assist with the right questions.

Let's look at an example of an auto service centre—Andy's Auto Service—recast to uncover true earnings (Sellers Discretionary Earnings/SDE*). The company's income statement shows gross profit is $300,000, based on revenues of $750,000 and cost of sales of $450,000. After subtracting operating expenses of $298,000 the company's pre-tax profit is $2,000. Would that interest a buyer?

With recasting, operating expenses were normalized to $107,500. It's *not* that certain expenses aren't legitimate—it's whether or not they're essential for the next owner.

Sometimes, we need to add back discretionary expenses that an owner *hasn't* included—a family member who works for no pay, an owner who uses his own tools, unrecognized expenses, or where a business is uninsured or underinsured.

In our example, the true earnings were determined to be $109,500, proportionately more in line with the 15 to 25 percent of gross sales that SDE typically represents in a small (four- to six-bay) auto service centre.

The Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) in this example is $59,500, as we would have to add back the cost of a replacement for the owner at a fair market wage estimated at $60,000.

Recasting the balance sheet

We also need to normalize assets and liabilities.

The recast balance sheet should reflect the Fair Market Value (FMV) of the assets and liabilities being transferred. While net book value is used for tax purposes, their value as is, in use, in place, is more relevant here for *tangible assets* such as furniture, leasehold improvements, vehicles, machinery, and so on. *Intangible assets*—goodwill, patents, trademarks, database/mailing lists, licenses, permits, franchise agreements—should also be recast to FMV.

Only after recasting can we 1) look at industry benchmarks to analyze performance against similar businesses; 2) identify the value drivers; and 3) begin the process of valuing Andy's business.

For recasting, we need the financial statements as prepared and filed for the past three to five years. We also need the owner's time and input for our adjustments, which we document with source, rationale and supporting paperwork. All will be required at due diligence.

Back to our Auto Service Centre—after recasting we have a business with SDE of $109,500 and equipment worth $148,000 rather than the book value of $73,000 and inventory worth $43,000. We now have a saleable business operating with the industry norms for its type and size.

Many more factors

There is much more to take into account. Does the year-end represent the normal level of inventory? The value of the inventory is a topic on its own—the method of accounting used and its proper application affects the cost of sales and of course, the earnings.

The operating and accounting systems, employee training and loyalty programs, marketing collateral and programs, customer retention, applicable gross margins and pricing systems, mix of commercial and consumer work, location and factors affecting future market growth, availability of good employees, competition and differentiators, niche focus of the service centre, etc., all affect the value and saleability of the business.

The structure of the sale and the willingness of the owner to finance some of the purchase price are other major factors.

Having the valuation done early will give the owner time to work on tax planning and increasing the value of the business before sale.

*SDE is net income less: interest; taxes; depreciation and amortization; owner's compensation (including salary and discretionary expenditures).

Minimizing taxes when you sell

Although our one-cent coin has been retired, the premise "a penny saved is a penny earned" still holds true for those in business. We don't want to pay out any more than we have to in taxes.

To capitalize on the best tax strategies when selling their business, an owner needs the professional guidance of accountants, lawyers and financial advisers.

We have drawn on such expertise for this overview of the two main tax structures in the sale of a business: 1) the shares of a corporation and 2) the assets of the business. Tax considerations and lead times are different for each option.

Share sale

The difference between the cost of the shares and the sale proceeds is a capital gain. By taking advantage of the lifetime capital gain exemption of up to $750,000* **(see Note page 33)**, share owners can potentially receive the capital gain tax-free. Advance planning is usually required to ensure:

- shares are of a Canadian-controlled small business corporation;
- shareholder(s) have owned the shares during the 24 months preceding the sale;
- substantially all (at least 90%) of the company's assets are used in an active business in Canada at the time of sale;
- a minimum of 50% of the company's assets have been used in active business in the prior 24 months.

Potentially significant tax could be saved by removing any excess cash, portfolio investments and investment properties not being used

in the active business. Many of our clients have achieved this through insurance vehicles. Another option is to multiply the capital gain exemption by having your spouse and/or children own shares (through a trust), so each can use *their* lifetime capital gain exemption. This can be set up through an estate freeze two years prior to the sale of the business. We highly recommend working with your accountant and a tax lawyer as part of your exit planning team.

Negotiating the structure of the purchase can be difficult as the buyer and seller have conflicting goals. Sellers want to sell shares for tax-free capital gains; buyers want to buy assets to get the stepped-up asset values and to avoid liabilities for past business activities. The purchase price is often discounted in a shares sale because the purchaser is losing the tax shield against future earnings.

If you own shares of a small business corporation, set an annual review with your accountant and tax lawyer to continue meeting capital gain exemption requirements. Keep in mind that as shares are deemed to be sold at fair market value on death, appropriate planning may avoid placing a tax burden on your estate.

Asset sale

Purchasers often prefer buying assets, which are recorded at fair market value and amortized over time, accelerating tax savings. The remaining value relates to goodwill, also amortized over time. When the seller receives proceeds in excess of the "tax cost" (UCC) of the asset, tax will be due. The proceeds need to be allocated to the various assets being sold; some may need to be appraised.

The purchaser may agree to buy some of the assets at the end of December and some at the start of January, splitting the taxable income and capital gains between two years, helping to minimize taxes for the vendor. Your accountant and tax lawyer can help you determine if this is of advantage.

The existence of significant eligible capital property (goodwill) can benefit both the seller and purchaser in an asset sale. The purchaser, who can amortize the goodwill, will generally be willing to pay more for assets to offset increased tax costs to the seller.

The seller may enjoy a small tax savings or a small tax cost and a significant tax deferral or a moderate tax deferral depending on whether or not the sale of eligible capital results in income eligible for the small business deduction.

Financing the sale of a business

There is a general misconception about the availability of financing for the purchase or sale of a small business, especially where the purchase price includes significant goodwill. Banks do not want to finance these transactions.

Your banker may play golf with you and suggest that their bank would be happy to provide financing for you at any time.

A good client for many years, you assume that when you are buying a business for $100,000 or $3 million, you could structure the deal with 30% cash, a 20% loan from the seller and 50% from your bank.

Think again. Your bank was willing to lend you money while you had a steady income, but in lending for the purchase of a business, the bank fears its security is insufficient. If the business fails, you have no income to service the debt and the assets of a failed business have questionable value to the bank. They do not know how to and do not intend to run the business. In a bankruptcy sale, the assets can go for 10 cents on the dollar.

Your bank *may* be willing to give you a home equity loan or a loan against other assets to cover part of the down payment. It *may* agree to process a Canada Small Business Loan (CSBL), but it will be limited to 75% to 90% of the value of Furniture Fixtures and Equipment with an upper limit of $350,000.

If real estate is part of the transaction, the upper limit is $500,000 and you must provide a Certified Appraisal of the assets. The catch—the loan must be for the purchase of assets, not shares. However, the tangible assets may represent a small part of the purchase price and the seller will likely end up paying more tax.

There will typically be a recapture of depreciation, which is taxable as corporate income, and a taxable capital gain on the sale. As a result, the seller ends up with less money.

There are two ways to offset this. While the simplest is for the buyer to pay a higher price to compensate for the additional taxes on an asset sale, most buyers do not want to pay more.

An alternative is to structure a two-part sale where the seller can use their lifetime capital gains exemption. The purchaser of shares, at closing, incorporates a new corporation to buy the assets and uses a CSBL loan to finance 75% to 90% of that purchase while using such funds to pay the seller for the shares. The buyer then amalgamates the two companies.

There are some additional costs in the equipment appraisal and legal fees. Sometimes this is the only way the sale can be financed. The seller may have to reduce the price to compensate for the corporate tax payable by the purchaser but will net more than if the whole deal was an asset sale.

A share sale without bank financing

The better approach is a share sale without bank financing, where the seller finances 50% of the deal and the buyer pays 50% in cash. The banks may provide working capital secured by receivables and inventory; they will generally agree to this as they will have security for the components they are financing.

The seller should treat their loan to the buyer the same as a financial institution would, by:

- insisting on life and critical illness insurance on the purchaser.
- insisting on quarterly financial statements so you can monitor the loan.
- obtaining as much security as possible, including general security agreements, share pledges and personal guarantees.

The big difference is that you, the seller, have security because you know how to run the business, so the assets have value to you. If the purchaser defaults on their loan, you can take back the business and operate it while a new purchaser is found.

Our experience is that seller-provided financing is repaid in the vast majority of cases. This structure also provides comfort for the buyer, as the note to the seller helps protect the buyer against misrepresentation and undeclared or unknown liabilities.

Financing the sale of a business Part 2

In part one of "Financing the sale of a business," we talked about financing a business through a bank loan (unlikely), through a Canada Small Business Loan (CSBL), a hybrid structure using a CSBL, and a seller note (preferred choice). In part two, we'll explore other approaches.

Business Development Canada (BDC) provides a lending facility—albeit expensive—for business acquisitions. There is a bureaucracy to work through, but BDC *does* finance *some* sales.

They generally require the seller to finance some of the transaction *behind* their loan, and the seller doesn't usually receive principle payments on his/her note until the BDC debt is repaid.

Most sellers aren't willing to wait that long to get paid out, and being behind the bank as a creditor adds to their risk.

A seller can sometimes get additional cash by selling assets of the business to a leasing company then leasing them back.

Partnerships where the purchaser has an option to acquire the rest of the business in time are sometimes used, but these can be fraught with problems.

Earn-outs can be rewarding for sellers

A seller and purchaser may disagree over projected earnings or other factors affecting the value of the business. Historical financial information may not be enough to offset the perceived risk to a purchaser determining a purchase price.

A deferred payment or earn-out that bases a portion of the valuation on actual future performance can soften the risk of speculative projections to the purchaser *and* put more money in the seller's pocket.

Often, service businesses with long lead times can only realize true value if their current management remains with the business. An earn-

out induces the seller to remain in management to maximize profit for the purchaser *and* for himself.

An earn-out can be structured to bridge the value gap and/or provide an incentive for the seller to hit predefined targets after the transaction closes.

Be clear about what you are trying to accomplish with an earn-out because that intention will shape the discussions and negotiations.

Example: A purchaser had one perception of value and a seller had another. Resolving the issue, the purchaser committed to pay the seller, in addition to the purchase price, 10% of all sales in excess of $500,000 during each of the first three years after the sale. Current revenues were $450,000 and gross margin was 30%.

If sales grew as the seller forecast, the seller would receive more for the business and the purchaser would make more; if they did not grow, the purchaser would be paying what they perceived to be fair market value based upon the current revenues.

Protecting the seller

Both parties need to have an alternative dispute resolution process or binding arbitration in place; otherwise, costly lawsuits can arise in interpreting and enforcing the earn-out.

Protections for the seller need to be balanced with the purchaser's need for flexibility to operate the business post-closing without restrictive covenants. Otherwise, the earn-out protections are likely to limit the purchaser's ability to modify, expand or contract the business' operations or capital structure.

The seller should insist that the purchaser maintain separate books and records for the business. The purchaser must agree that these financial records will be made available for review upon reasonable notice.

The parties should incorporate into the acquisition agreement a detailed description of the accounting principles that will be used to calculate whether the thresholds have been met. In an earn-out, the ability to manipulate results is often of great concern to the seller.

Particular care should be used if the threshold is profits, where more data is introduced into the calculations determining the earn-out.

For many reasons, we like to see the calculation kept as simple as possible by tying the calculation close to the top line (sales), thereby avoiding or reducing the potential for disputes.

Summary

The economic downturn in 2009, 2010, 2011 and 2012 has prompted more sellers to consider and accept earn-outs as part of pricing the sale of their companies.

Sellers today may believe that their company's flat or declining performance will turn around quickly as the economy improves, yet purchasers are concerned about paying for future projections in uncertain times. An earn-out can bridge the disputed valuation gap *and* get a higher payout for the seller. It also provides great incentive for the seller to make sure the purchaser has success.

How insurance reduces risk

It's dead winter. You wouldn't head out on a road trip without checking your car and local weather forecast would you?

Likewise, there are many ways to reduce the risks when embarking on the buying or selling of a business. Adequate protection through insurance is high on our checklist.

Most of our deals involve the seller financing a good portion of the purchase price. Most also involve a training program to equip the new owner to operate the business successfully and ensure a smooth transition. We build these into the agreement. But what if the buyer or seller were to get ill or die? Insurance can mitigate such risks to the business.

Protecting the loan—the seller

If you are the seller, meet with a wealth planner who is a licensed insurance broker; insist as a condition of sale that the buyer put in place adequate protection for the loan you're making to them. An experienced broker can find the most cost-effective plan to meet the needs and obligations of the buyer AND protect you, the seller.

Let's backtrack slightly to mention another precaution. A seller who is financing the buyer would be prudent to apply the same diligence as any financial institution lending money. This can include checking references—former employers, employees, clients, suppliers, bankers and so on. Verifying the skills, competence, integrity and reliability of the purchaser is important. Credit checks, Personal Property Security Act (PPSA) searches and criminal history checks through the Canadian Police Information Centre (CPIC) are, of course, essential.

Back to the need for insurance. Our seller should insist upon a critical illness policy on the buyer with sufficient benefits to cover the payments on the loan they're providing.

Insurance policies can also be an effective means of removing excess cash from the business prior to the sale and saving on taxes.

Protecting the loan—the buyer

A judicious buyer will want more protection than this as the seller is not their only obligation.

The plan should continue in place to protect the buyer and their family; the buyer should be meeting with a knowledgeable broker to establish requirements. Adding sufficient life insurance to pay off the outstanding debt obligations, with the seller as a named beneficiary, can cover off the risk of the purchaser getting ill or dying. Setting up this type of policy is much cheaper than the loan insurance provided by banks, is more flexible, and may provide significant tax benefits to the purchaser.

We mentioned earlier that most of our transactions include a training/transition program. Sellers should obtain insurance to make sure that the buyer receives sufficient proceeds to enable them to survive in the business if the seller can't deliver on the program.

It is important to meet with a wealth planner who is a licensed insurance broker before selling your business and you should be insisting as a condition of sale that the buyer also meet with them to put in place adequate protection for your loan to the buyer.

Protecting against liability and business interruption

The security for the loan that the seller provides to the buyer includes a personal guarantee. While it *may* include the shares of the business being held in escrow until the loan is paid, it *almost always* includes the assets of the business being used to secure the loan.

A prudent seller will put a commercial insurance policy in place to protect these assets against fire, flood, theft and other losses. Experienced insurance brokers can help you determine what's most cost-effective. Sellers should do this before selling the business and insist as a condition of the sale that the insurance be maintained and that they be a named beneficiary of the policy.

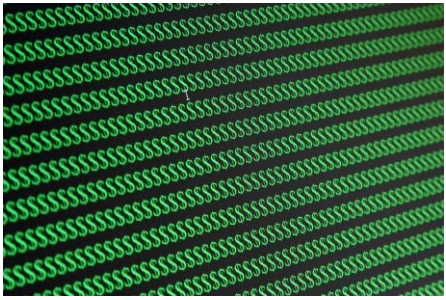
Business interruption insurance should also be part of the basic protection.

Most of us put an insurance policy in place and then forget about it. Revisit the policy with an experienced commercial broker each year as your needs, risks and assets change.

Liability coverage is also essential. As a lender, you do not want the business wiped out because the purchaser failed to put in place adequate liability insurance. Put the coverage in place prior to the sale and insist that it be maintained as a condition of the loan.

As a prudent business owner, you should have these protections in place whether you are selling the business or not.

Tax planning prior to sale



In preparing to sell your business, the earlier the better applies. Some planning is best done years before:

- Start with an appraisal to determine the most probable selling price (MPSP);
- Identify drivers to increase the business's value; and
- Get advice from a tax lawyer or accountant to minimize the tax you will need to pay.

We have asked Jay Humphrey of Jay C. Humphrey Professional Corporation (jay@humphreylaw.ca) to comment upon one of the meaningful tax benefits available to owners of small businesses—the lifetime $750,000***(see Note)** capital gains exemption on the sale of shares of a qualifying small business corporation.

Qualifying for lifetime capital gains exemption

While the tests for determining whether a sale of shares does or does not qualify for the exemption are technical, a rule of thumb is that the corporation must be operating an active, rather than passive, business and the assets owned by the corporation at the time of sale must all or substantially be assets used in the active business.

A corporation's stock portfolio acquired with retained earnings would typically be seen as "passive" assets, while inventory and equipment would be considered to be "active" assets.

It is possible to clean up a non-qualifying corporation prior to the sale so that the seller can nonetheless qualify for the capital gains exemption.

"It is key to remember that only individuals (including as beneficiaries of certain trusts) can qualify for the exemption," notes Humphrey.

"If there is a holding company between the operating company and the ultimate owner, the sale could only qualify if the individual sold shares of the holding company that in turn owns the operating corporation.

"The problem is that holding companies often hold passive or other assets that the business owner does not want to sell and that the buyers do not want to buy.

"There are structures that may allow an owner to obtain the $750,000* **(see Note)** exemption and also enjoy the benefits of a holding corporation, including creditor-proofing and the payment of tax-deferred corporate dividends out of the operating corporation," adds Humphrey. "Business owners should speak with their advisors to see if such a structure is appropriate in their particular circumstances".

Further requirements

There is usually a 24-month hold rule to claim the capital gains exemption, with a notable exception. An entrepreneur selling an unincorporated business may claim the lifetime $750,000* **(see note)** capital gains exemption on the sale of shares of a qualifying small business corporation by first transferring their business to a corporation then selling their shares of that corporation.

A seller who accepts a promissory note for a portion of the purchase price payable over a number of years should be able to claim a capital gains reserve so that the timing of the obligation to pay income tax on the portion of proceeds not yet received is matched with the actual receipt of cash.

The capital gains reserve rules require a minimum of 20% of the capital gain to be recognized in the year of sale and the four following years. Keep in mind that the test in the reserve rules is not that an amount has not actually been received, but that it is not yet *payable*.

If the note that a vendor takes back is payable on demand without restrictions, no reserve would be available as the Canadian Revenue Association (CRA) would argue the whole amount is immediately payable.

The new owner

From a buyer's perspective, give careful consideration to using a newly incorporated corporation to acquire the shares of a target corporation. If you buy the founder's shares that had an initial subscription cost of one hundred dollars, as is often the case, only that amount will be allowed to be repaid to you tax-free from the target corporation even though your cost to purchase the shares was their current market value.

"Using a new corporation to acquire the target should allow the tax-free removal of retained earnings of the target in amounts up to the purchase price through inter-corporate dividends to the new corporation and then a return of capital or debt to the owner of the new corporation," says Humphrey.

Ensuring interest deductibility on debt borrowed by an acquisition company to acquire shares is also an issue that requires analysis before proceeding. Proper planning may ensure the holding corporation will not incur interest expense in circumstances where it has no income against which to offset the expense.

Note:** *Under proposed changes, for dispositions* ***after 2013 *of qualified small business corporation shares, the lifetime capital gains exemption limit will increase to $800,000.*

Making the most of business property

When real estate is owned by the business or business owner

You own a business. You or the business also own the real estate used by the business. You do not have to include this real estate when selling your business. *Retaining or selling the real estate separate from the business has its advantages*.

Often the business itself is sold and a lease then put in place at market rent. This reduces the amount of capital that a potential purchaser requires and creates a wider market for the business. The owner can then sell the building with the lease in place and the purchaser does not have to be someone who wants to run or own the business that it houses.

As a result, there is a larger group of prospective buyers and the building sells for a higher price than could have been realized if sold along with the business. The goal is to sell the business *before* selling the real estate, or if it is listed in combination with the business, at the same time.

Using real estate for capital

A business owner who wants to extract some of the capital or equity from their real estate to invest in the growth of their business can:

- mortgage the building to its maximum—usually some 70 to 75% of appraised value—and use the funds in the business;
- sell the building and lease it back at market rent, giving them more capital to invest in their business; they will typically get 100% of the building's value.

We generally do not recommend the sell and lease option, as the business owner will no longer be participating in the equity growth resulting from increased real estate values.

Retaining real estate as an investment

In many cases, the seller will be looking for an investment for the proceeds of the sale of their business and retaining the real estate may be the best investment they can make.

In today's market, commercial/industrial real estate increases in value at an average of 4% to 8% per year and in some locations, more. Interest rates are currently averaging 4% to 5%, leaving a spread of 1% to 4%. If the market rent is sufficient to cover the mortgage payments and the business is increasing in value by 8% per year with the mortgage 75% of the building value, then the return on equity would be 32%.

Given that real estate is a relatively low-risk investment, this is as good as it gets—no cash flow but great return on investment (ROI). In a more conservative calculation, the spread might be at low as 2% and the mortgage as low as 66% of value, resulting in an ROI of 6%—still better than most secure investments but, again, no cash flow.

Protecting intellectual property

Business owners also need to protect their intellectual property (IP). Too often we find that our clients do not own their name or logo and have not protected their web presence or other intellectual property they own.

The cost of protection is generally not high, but the cost of not owning it when you are selling the business can be much greater. It may result in making the business unsalable.

Whether patents, copyrights, trademarks, or trade secrets, your company's intellectual property may be the most valuable asset you have. Intellectual property can be any proprietary information—anything from a particular manufacturing or sales process to plans for a product launch, a trade secret like a recipe or formula, or a list of the countries in which your patents are registered.

The formal definition is "creations of the mind — inventions, literary and artistic works, symbols, names, images, and designs used in commerce. IP includes, but is not limited to, proprietary formulas and ideas, inventions (products and processes), industrial designs, and geographic indications of source, as well as literary and artistic works such as novels, films, music..."

Taking your business from good to great

GOOD to GREAT

I recently read *Good to Great*, by Jim Collins. Although this book was written a decade ago, its concepts remain relevant and stand the test of time.

Criteria for moving from good to great

1. Combine personal humility and professional will to build a company that can run without you. Have ambition for the company and what it stands for. Your sense of purpose goes beyond your own success—build a company that can tick along without you. Focus relentlessly on tangible results and achievement.

2. First Who then What. Start by getting the right people on the bus and the wrong ones off. Then get your team's input on where to drive the bus. Select top performers who share your company's core values and purpose. This will provide a basis for promoting from within and further reinforcing core values.

3. Confront the brutal facts of your current reality. Sustain faith that you will prevail in the end. Create a climate where truth is heard, particularly at the top. Clarify what must be done to stimulate progress. A master mind group or council like *The Inner Circle*, where other business owners provide peer mentoring, can help you clarify your vision and take appropriate actions.

4. Develop a simple, clear concept (a Big Hairy Audacious Goal, a BHAG*) and consistently make improvements in systems and processes that enhance performance. Determine what you can be the very best at (even if you are not already in that business). Equally important, determine at what can you *not* be best.

Determine what drives your economic engine—what is the single denominator with the greatest impact on your results**?** What are you passionate about**?** Use your Inner Circle group to help you crystallize your vision and hold you accountable to make your vision reality.

5. Develop a culture of discipline built around commitments, giving staff freedom about how to meet those promises. A culture of discipline removes those who do not share the values or standards of your organization.

6. Carefully select technology to accelerate momentum towards achieving your company's goals. Technology is subservient to core values.

7. Consistent, repeated actions and behaviours will achieve revolutionary, dramatic results over time i.e. achievement of a BHAG.* A company builds momentum from evolutionary, incremental efforts towards what it wants to become. The momentum keeps increasing at an ever faster pace until it hits breakthrough. Eventually momentum takes over.

I hope these concepts encourage you to start making the changes that can take your business and your life from good to great, or, as *The Inner Circle* says, "*A Better Business and a Richer Life*".

*A term coined by James Collins and Jerry Porras in the book *Built to Last*. "A BHAG… is tangible, energizing, highly focused. People 'get it' right away; it takes little or no explanation."

Improving the odds with *The Inner Circle*

INNER CIRCLE
Better business. Richer life.

How many of you remember Victor Kiam, the businessman who liked his Remington shaver so much he bought the company?

Well, the three *Inner Circle* meetings I experienced in the U.S. impressed me so much that I bought the company—at least the Canadian Master Franchise.

Membership in an *Inner Circle* group can substantially improve the odds for entrepreneurs rolling the dice. In a recent member survey, 97% reported better decision-making ability; 75% reported higher revenues AND profits; 71% reported better work/life balance.

So what is *The Inner Circle* and its life- and business-changing power?

A dual process for success

The Inner Circle is a private master mind group or council that enables business owners to achieve A *Better Business and a Richer Life*, based on Napoleon Hill's first two universal principles of success—Definiteness of Purpose and the Master Mind Principle.

Business writers Jim Collins (*Good to Great*), Donald Trump and many others have suggested that these principles have been the key to success for entrepreneurs.

Hill's works examined the power of personal beliefs and the role they play in personal success. *Think and Grow Rich* remains one of the bestselling books of all time.

In 1985, Minnesota entrepreneur Norman Stoehr founded the Entrepreneurs Network to enable business owners to implement Hill's two universal principles. A dual process for members to achieve both

a better business and a richer life evolved. Renamed *The Inner Circle* and franchised, the business spread to many cities across the country.

Inner Circles are groups of eight to 12 non-competing business owners/CEOs who meet once a month for three hours, usually over breakfast, to work on their business and personal visions. Each *Inner Circle* serves as an interactive think tank, a place where entrepreneurs come to challenge one another and to be challenged. Members use a proprietary process to get clear on their goals and how to achieve them. By tapping into the wisdom and objectivity of the group, members find they are able to overcome obstacles faster and with greater confidence.

An *Inner Circle* provides an experience that is personal and encompassing. The result for each member is the creation of a game plan for the life they truly want to live. In my case, I was astounded at how quickly the bonding between members enabled us to share with one another and how quickly the process improved my business and my life.

First Canadian Inner Circle in Ottawa

We are fortunate to have the first Canadian *Inner Circle* in Ottawa. With two outstanding facilitators on board (Arnold Campbell, Ph.D. and Jeffrey Edwards, M. Ed., M.B.A.) both with significant business experience, I am confident that *The Inner Circle* will improve the businesses and the lives of many local entrepreneurs.

The Inner Circle is *not* a social club or a networking group. To become a member, you have to be willing to listen, to contribute and to be held accountable. I have signed up to be a charter member. I recommend that you also consider signing up if you are a business owner who has any of the following characteristics:

- seven or more employees
- does not have a board of directors
- feels isolated
- seeks better clarity
- desires change in their business/life
- wants a better business/life balance

Taking off weight with *The Inner Circle*

INNER CIRCLE
Better business. Richer life.

The load most business owners carry on their shoulders is a heavy one. Immersed in daily operations, it can be hard to see avenues for a better business and life beyond immediate responsibilities.

Inner Circle peer advisory groups have helped many business owners drop some of that weight and achieve "A B*etter Business and a Richer Life*."By tapping into the wisdom and objectivity of the group, members find they are able to overcome obstacles faster and with greater confidence.

I mentioned earlier how impressed I am with the three *Inner Circles* I experienced in the U.S. and how quickly their process improved my business and life. In a recent member survey, 97% reported better decision-making ability; 75% reported higher revenues AND profits and 71% reported better work/life balance.

A testimonial from a long-time member explains:

I started my business as a young teen, fixing and reselling bikes I bought with money from my paper route. When I joined the *Inner Circle* I had only one store, now I have 14. I'm proud of that growth and I credit *Inner Circle* with helping me achieve it while maintaining a life I love to live. *Erik Saltvold, President and Founder of Erik's Bike Shop*

Seeing the way to the right decisions

All companies have blind spots that only outsiders can see. It helps to get candid feedback from other business owners. *Inner Circle* groups ensure it is in the context of peers from diverse and non-competing industries. That climate encourages members to share their experiences and best practices. Each group of eight to 12 business owners-

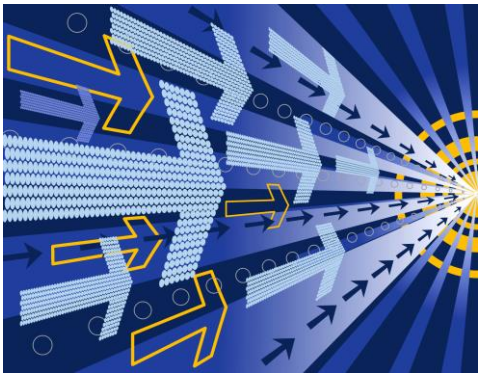
/CEOs meet monthly for three hours, usually over breakfast, to work on their business and personal vision. During this roundtable, each member presents an issue that is top-of-mind, the one it would feel best to resolve, and gets feedback from the group. The issues that come up are diverse—sometimes pragmatic, sometimes strategic, sometimes complex, sometimes simplistic. Some examples:

- A member who was unhappy working in his family's business decided to buy one division of the company and run it on his own. The group was shocked by how much he had paid—the parents' accountant had set the price. The members pushed him to renegotiate. After bringing in a third party to value the company, he renegotiated the purchase price to half the original cost, saving $350,000 and solving the cash flow problem that had prompted him to raise the subject in the first place.
- One member had a large client who had fallen behind on payments and rumours were spreading about them closing plants. The group warned the member to take the red flags seriously and get aggressive on collection issues right away to protect his company. It took effort but he got their balance down to zero and put them on a cash-before-delivery basis. The push to action helped him avoid a huge financial hit as months later the client filed for bankruptcy and his competitors, who hadn't taken action, had six-figure losses.
- One member sought feedback on how to re-brand and re-position her professional services so that potential clients would better understand the full scope of what she was capable of doing. The group helped her come up with a fresh company name, one that didn't pigeon-hole her, and helped her identify which of her services were most marketable.

Once every year, each member uses a proprietary process to get clear on their goals and how to achieve them.

- One member realized he no longer wanted to run one part of the business his father started. He was worried about the family's reaction to his "abandoning" the business. The group encouraged him to talk to others of the family still involved in the family enterprises. To his surprise, his family supported his decision. As a result, he sold that part of the business and went on to start another very successful one.

Marketing to increase value before you sell



Singular focus can achieve transformational results in our businesses if it is based on an understanding and channeling of who we are, what we have a passion for, what we can be the very best at, and what drives our economic engine.

That focus has to apply to all activities, including marketing.

Marketing is that which causes clients to come to you and keeps them coming back.

Be the best in a niche market

In *The Guerrilla Marketing Handbook*, Jay Conrad Levinson states: "In order to sell a product or a service, a company must establish a relationship with the customer. It must build trust and support. It must understand the customer's needs, and it must provide a product that delivers the promised benefits."

The goal is to dominate a niche market by being the very best supplier in that niche. You may have to narrow the niche again and again to get it down to the one you can dominate. The starting point and qualifier for identifying what you will provide and to whom, is the selective focus we referenced above.

Bill Davidow, former Marketing VP at Intel, does a great job of describing the process of market segmentation and product development in his book, *Marketing High Technology*. As he says and shows, while "devices are invented in the laboratory, great products are invented in the Marketing Department."

Building trust requires consistency

Ensure that the corporate image you have chosen is consistent with your values and the target clients' needs. Good design shops work with business owners to understand their values, vision, image requirements and prospective clients before they start any work. An image and a vision you can stay true to is required throughout the life of your business.

Image begins with your name and extends to everything and every way a prospective client is influenced to think about or react to you. Think about every way you touch your prospects and clients: how you answer the phone, what your business, staff, products and invoices look like, how you treat complaints.

Building trust requires consistency in image, quality and all channels of service: web site, logo, letterhead, phone system and manners, business cards, advertisements, signage and so on. Such things set clients' expectations and are vital to winning them. Keep them by staying consistent and exceeding their expectations by just a bit.

In that vein, Ken Blanchard's *Raving Fans* is a short but wonderful read about how to turn your clients into raving fans who not only keep coming back, but encourage others to become clients as well.

Remember—it starts with figuring out who you are and who you *want* to be, then staying true to that vision. You cannot serve everyone. You must narrow your niche to one you can dominate and ensure that the products and services you deliver are the very best and what that market segment wants. And that could be the product or service that is the least expensive, the most convenient to access, the most user-friendly, the easiest to learn or the most reliable.

Add value before you sell

Momentum builds steadily with every little improvement, provided each is consistent with your singular vision. If you are considering selling your business and have 18 months to three years to work on it before the sale, then rethinking who you are and why you are in business, and taking the journey to make your vision a reality is worth doing. Not only will the results (revenue and profit) look better when selling your business, but the fact that you have a vision and a plan to make it a reality will also add value. Discussing your exit strategy with professionals some 18 months to three years in advance will allow them to recommend the assistance you may need in developing your plan. Of course, the more lead time that you have, the better.

Marketing to increase value before you sell, part two

We have talked about finding and dominating your market niche with focus and consistency of image in product or service delivery.

I want to expand on how you touch your prospects and how a consistent image results in a better business.

Use prospect and client education

Use prospect and client education to position your business as the very best supplier to your market segment and confirm their perception that you are the best at what you do. This takes determined effort and resources—a web site, social media, e-newsletters, radio and print media, TV, direct mail, and public speaking can all spread your message. So can the publishing of articles and books.

Control your budget and investment—the material developed for one media can be re-purposed in others. The information and education being delivered must be useful and meaningful to your audience.

Make the most of peer or client recognition

Nothing imprints as well as third-party accolades. Publish client testimonials or success stories. Tell the public about awards and recognition you have won in your industry or community—Sunbelt Business Brokers has for the fifth year in a row won the Consumers Choice Award for Business Excellence and the Ottawa office has again been awarded the prestigious Sunbelt Leadership Award. We were also a finalist for Professional Services Company of the Year.

Find out how you are truly perceived

The best way to find out what your prospects and clients think of you is to ask them. We often run telephone surveys asking clients of a business we're selling how the business might improve.

Smart businesses poll clients shortly after the delivery of a product or service to get their perspective about how they were treated or about the product or service they received and how it might be improved. There are many online services that allow you to develop and send questionnaires. You also need to know why a prospect did not select you, keeping in mind that you are after a highly segmented set of clients for whom your product or service is the very best.

Business owners often overlook the value of testing to understand prospect and client perceptions. Large companies regularly engage services to perform such collecting, analyzing and reporting, but small- and medium-sized businesses often ignore this or make assumptions that are wrong.

Know your clients

I was approached by a client some years ago to sell a number of his locations. They were not doing well. After visiting some, I asked the client what business he thought he was in. He was in the business of selling bagels, he said. But really, he was in the business of making his clients feel a bit better about themselves because they had patronized his location.

I then described how this could be achieved: better control of the music and noise; setting up areas to be cozy, warm and relaxed; recognizing and greeting people in a warm and friendly manner; using lighting that was soft and plants and colours that were relaxing.

His signage and decor needed to make people feel good about being there. Service that went just a bit beyond his customers' expectations would result in a dramatic improvement in business. He replied that all of this was unnecessary—his clients came because he had good bagels and coffee at very competitive prices. He is no longer in business. His bagels and coffee *were* good and his price *was* competitive **but he did not understand what his clients wanted**.

A warm upbeat welcome and real offer of help puts clients in a good mindset and produces measurably better results in person, on the phone or in your media. Appealing music or business-related news can help to reduce the frustration of being on hold.

Marketing to increase value before you sell, part three

In parts one and two we covered **three marketing musts**: understanding what you are or want to be as a business; identifying your target market; and ensuring that everything you do is consistent with the image you are trying to create in order to be the very best supplier to that target market.

Let's now look at ways to communicate to prospects. Most business owners are familiar with standard advertising media— direct mail, telemarketing, newspapers, magazines, radio, television, coupons, flyers, billboards and signage. Such paid media can be effective *if* you have properly identified the audience you are trying to reach, the message you are trying to project *and* if you commit to the time it takes to achieve results.

Determine who you are trying to reach and with what message, in order to choose the media that will be the most effective for your purposes.

You should also be looking at the potential return on your advertising investment. All else being equal, higher revenue and higher profits will result in a higher selling price for your business. I strongly recommend getting expert advice about your advertising investment.

Some simple rules such as *including a call to action* apply—if your spending does not result in a prospect taking some action towards becoming a client then what is it accomplishing? Knowledgeable media sales people will help you make appropriate decisions about your advertising mix. Advertising firms that help with your creative materials are also a good source of such information.

Creating value with electronic and social media

In today's technology-driven world you need to take advantage of electronic and social media.

- An effective, well-designed web site will give visitors a positive impression of your business. But the site needs to be directed to your target market and search-engine-optimized to be easy to find. And if your visitors can easily find what they need, good content makes them want to come back for more. We overhauled our national site at sunbeltcanada.com, adding many more resources for *our* target audience—*people interested in buying, building or selling a business.* You'll find our ongoing "Real Deal" blog posts and "At the broker's table" topics there.
- Every business should be capturing email addresses and permissions to building databases for use in e-marketing—I am surprised by how many are not. Such databases add value to your business—use them to build loyalty and to educate both clients and prospects. Those on the mailing list for our Sunbelt Canada newsletter benefit from monthly tips, links to relevant topics and a client success story.
- Business pages on the Internet and participation on social media channels can build awareness, influence and relationships at very little cost. We include our networking options on our web site and other media.
- Do it well or don't do it at all. A poor web site, newsletter or social media presence can harm rather than help. Each must be consistent with the image you want to convey—the business that you are or will be—as well as current and relevant to the audience, speaking to their issues. Follow up to requests should be helpful and timely.

Other avenues for reaching your target audience

Take advantage of networking opportunities: host seminars to educate prospects about your product or service; piggyback with the seminars and mailings of strategic partners; speak at events or appear as a guest expert on TV and radio; participate in groups that include members of your target market.

Distribute free educational materials/articles of interest to your prospects through public media. Again, do it well or don't do it at all.

I encourage you to review your marketing budget and strategies to ensure you are maximizing your return—creating the right image and sending the right message by way of the right media to reach the right audience. Above all, have some way to monitor what is and isn't working. Without measuring your marketing effectiveness, you will not know what changes will improve it.

A wise business owner once commented that he knew he was wasting half the money he spent on marketing; sadly, he did not know which half! Do not fall into that trap.

Taking your business to market

The time has arrived. You are now ready to take your business to market! You know what you want *from* your business and *in* your life and are making those a reality.

With the help of experienced professsionals—our team of small business experts—you have:

- addressed the actions that add value;
- determined the most probable selling price;
- completed the structuring and tax planning to minimize taxes when we sell;
- addressed risk mitigation, insurance and future financial and investment issues;
- joined a peer counseling group and are building a better business and a richer life.

It is time to put together a marketing package and plan, ensuring confidentiality is maintained and that all materials are accurate. So while our professionals have expertise in marketing, it is your responsibility as the business owner to review their work in detail.

Strategic marketing and buyer screening

A business broker will produce three documents: A Blind Profile, a Confidential Business Overview and a Confidential Business Profile.

A ***Blind Profile (BP)*** will provide sufficient information for a prospective purchaser to determine if they are interested, but not enough for them to identify which business it is. Read this document carefully to ensure it doesn't reveal anything that will allow a competitor to recognize the business.

The ***Confidential Business Overview (CBO)*** will give prospective purchasers a sufficiently specific understanding of the business so they can direct appropriate questions about it when we meet with them. This document will provide detailed information about the history, market, services and products, structure, staff, clients, suppliers, physical plant and equipment, tools, systems, processes—just about everything a prospective purchaser would want to know about our business, including its strengths, weaknesses, threats and opportunities. *It will, however, contain only summary information about financials*.

The CBO will be released *after* a prospective purchaser has verified that they have interest, ability and financial resources to purchase and successfully operate the business and *after* they have signed a confidentiality agreement, having been interviewed and educated by a business broker so they understand the process and the steps involved.

The ***Confidential Business Profile (CBP)*** will contain everything that's in the CBO plus a detailed financial analysis of the history and future projections. It will include financials as reported, as well as normalized or recast financials illustrating the ability of the business to a) provide an income for the purchaser, b) do the debt servicing to pay for the business, and c) provide a reasonable return on their invested capital.

The CBP will be provided to the prospective purchaser *only after* they have met with us *and only if* after that meeting they have a real desire to acquire the business and we have decided they would be a suitable purchaser.

Positioning your business

Properly positioning your business in the mind of a prospective buyer is critical. Providing a buyer with detailed financials before he or she has fallen in love with the idea of owning the business will put them into an analytical state of mind that is predisposed to disqualify our business as a suitable acquisition.

But once a prospective buyer has fallen in love with the vision of owning our business, they will be scrutinizing the detailed recast financials and projections to rationalize their decision to purchase to their peers, friends and family.

Our business broker will use radio, newspapers, social media, email, web sites, seminars and other marketing channels to attract buyers for the business.

Prospects are then put through a detailed intake process to determine what businesses would work best for them given their interests, skills, lifestyle goals, financial resources, passions, values, experience, energy, and so on. This weeds out "tire-kickers" and ensures that the buyers they bring to meet us are serious candidates.

Our focus needs to be on running our businesses to keep them in top shape while our broker is selling them for us. We have already cleaned up our documentation and financials and are ready for scrutiny.

The buyer-seller meeting

Your business is ready to meet prospective buyers but are you? Where do you meet and when? What questions will be asked? How much information do you share—what do you *not* talk about? What questions should you ask *them*? How many buyers will you have to meet to get an offer?

The first meeting with the prospective buyer should be at the business after hours, without staff, where you will show them the business and explain how you operate.

The goal is to enable the buyer to fully understand your business—its finances, staff, suppliers, market, legislation governing your operation, and all other aspects, such that after the meeting and after reviewing the Confidential Business Profile prepared by your broker, the buyer will be able to make a highly conditional offer.

To get there, he or she must fall in love with the idea of owning your business and its ability to fulfill their personal objectives and lifestyle aspirations.

The buyer needs to understand the strengths and weaknesses of your business and its possibilities for growth. He or she needs to understand its history, why things are the way they are, why you are selling and your plans for the future.

The meeting is structured to enable you and the buyer to get to know one another.

The buyer needs to determine if you are someone they trust and would enjoy being trained by.

You need to determine if the buyer is competent, with training, to run your business and if they are someone to whom 1) you would entrust your business and 2) you would be willing to lend money.

Evaluating the buyers and offers

Accomplishing all this may require further meetings. The one thing you will *not* discuss is price and terms. These are not negotiating sessions – leave that to your broker.

You need to answer all the buyer's questions honestly and fully. They have already signed a confidentiality agreement and provided their goals and objectives, financial information, work history, experience, skills and their family situation, interests and passions. Your broker will brief you on these before the meeting.

Your broker will have also provided the Confidential Business Overview to the buyer and may have assisted them in preparing their questions. You should personally confirm with the buyer all that the broker has told and given you. Ask questions to understand their values and ethics and their plans if they purchase your business.

You will, on average, have to meet with four buyers before getting the right one. You may receive competing offers. You will need to evaluate not only the offers but the buyers as well. You will be expected to sign a non-compete agreement at closing.

You may want to stay on in the business in a different role after it is sold. At the minimum, you will have to stay on long enough to train the buyer. Will you and your staff enjoy working with them? How much training will they need? Are you confident they will succeed?

Your business broker will leave with the buyer at the end of the meeting. You need to give them the nod if you find the buyer acceptable. If so, they will present the buyer with the Confidential Business Profile and walk them through a sample offer. Your broker will get back to you the following day to discuss the meeting and the buyer's impressions.

Buyers want reassurance

I once had a seller who was very proud of the mechanical systems he had built into his business. He told a buyer how it took him years to become highly skilled at their operation. I pointed out that his son had learned to operate the systems in six months, but it was too late. The buyer walked away. He did not want to spend years learning how to operate the business.

Buyers want to know that they can learn to run your business in a reasonable time and that you are prepared to teach them. They want reassurance that you have confidence in their future as the owner of your business, with sufficient cash flow for them to live, support their family and pay for the business over a reasonable time.

How long is reasonable? For a business with significant investment in plant, equipment and inventory, it might be eight years—for a service business with little capital investment, perhaps three years. In any case, the purchase must work for the buyer and it must work for you as well.

Making the offer

We have readied our business for sale, done the structuring and tax planning, addressed insurance issues, planned our life after the sale, developed a personal financial plan with our wealth planners and investment advisers, packaged and marketed the business and met with prospective buyers.

And now we have an offer to purchase the business. The offer is a complex document but your business broker will help you understand it.

Whichever its form—an Offer to Purchase, a Letter of Intent or a Memorandum of Understanding—the offer will be dated and signed, provide a time frame for response and commit both parties to confidentiality. The offer will:

- lay out the price and terms the purchaser is prepared to offer;
- set a date for closing, with conditions to be met before closing (and perhaps some for after closing);
- specify how and when the purchase price is to be paid and under what conditions;
- set out expectations for the seller's responsibilities after closing, such as training of the purchaser or continuing employment.

The offer may establish a time frame for due diligence and it may request exclusivity in negotiation for a period of time.

The offer should identify what is being purchased and what is excluded. Assuming the business is being sold as a going concern, it will identify whether the offer is for the shares of the company that owns the business or for the assets, including intellectual property.

The offer may outline requirements for retaining or dispensing with key staff members, the amount, if any, of working capital to be included in the sale and the treatment of receivables and payables.

The offer is usually non-binding excepting confidentiality and perhaps the specified exclusivity. Drafting these offers to be non-binding on either party right up to closing prevents anyone from being trapped.

The deposit

The offer frequently comes with a deposit, held by the business broker in trust until the deal is consummated or terminated. In Ontario, business brokers must be licensed realtors and the trust fund is guaranteed by the province. This is true in other provinces as well.

Where this is not the case, or if the broker is unlicensed, the deposit is generally held by a notary or lawyer acting on the transaction. In such case the deposit needs to be accompanied by an escrow agreement stipulating that the deposit will be repaid to the purchaser if the transaction does not close and specifying any conditions associated with such repayment.

Our practice is to make the deposit refundable if for any reason the transaction does not close. This encourages a purchaser to take that big step.

Negotiating through the business broker

The offer is just that—an offer. As the seller, you must assess the offer and its terms—your business broker will provide advice and suggestions.

We recommend that offers always contain a clause *making the offer conditional upon structuring of the transaction and drafting of an agreement of purchase and sale being acceptable to both parties and their legal advisers*. This allows the parties to negotiate through their business broker to reach a set of terms acceptable to both parties without spending money on legal advisors until due diligence and closing.

The negotiations should always be through the business broker, as the buyer and seller need to remain on good terms. They will have to work together after the deal is done to provide for smooth training and transition.

The buyer is usually purchasing based upon non-audited financials and the seller is typically lending part of the purchase price to the buyer. They need to trust and respect and like one another—this will not be the case if they are negotiating directly.

Keep in mind that acceptance of a negotiated offer is not a sale. Deals can fall apart during due diligence or the subsequent negotiations around structuring. Sometimes the landlord, franchisor or banker kills the deal; sometimes lawyers focus on the risks and problems, not the solutions.

The receipt of an acceptable offer means you are halfway to getting the deal done.

Rely on your business broker to get you safely to the close. They will work with your financial and professional advisers and those on the buyer's side to find solutions to the problems that will develop. It takes some perseverance and the deal may still collapse. That is why your business broker continued marketing the business throughout this process. If the deal at hand collapses, other buyers with other offers may be around the corner.

Negotiating the offer

Generally, the first offer you receive from a potential purchaser is not their best— it is their *first*. Price, terms, closing dates, diligence timelines, inclusions and exclusions are all negotiable.

It is important that you let your business broker do the negotiating—when the sale is closed you need to be friends with the buyer.

You are probably going to train them. You will probably be lending them part of the purchase price. You may even be staying on with them for a period of time. The purchaser is buying without audited statements, and although they have done some diligence, they are buying largely on trust—trust that you have developed with them during the investigation stage.

You have opposing objectives during negotiation, though, and emotions can run high: your business may be your biggest asset and the buyer may be risking everything they have.

Your business broker has training and experience in negotiating that you probably don't. They will help you reach a deal that achieves your goals *and* the buyer's goals—they understand both. If the deal does not work for either of you it will not work at all.

This does not mean you shouldn't provide input into the development of a counter offer. You should, however, keep in mind that it has to work for both of you.

Know your goals and best alternative

One of your goals in the transaction is to minimize risk; another is to minimize tax. Many sellers forget to have the buyer put in place life and critical illness insurance to protect against the buyer becoming ill

or dying and being unable to repay the financing they are providing. Include such a condition in your counter offer.

Include specifics about structuring issues to minimize your taxes on the sale and specifics about security for the loan you are providing. If there is no bank involved in the transaction, it is reasonable to expect a first-position security on the assets of the business and perhaps, requirements for minimum inventory levels to be maintained.

If it is a share sale, expect the shares to be held in escrow until the loan has been fully repaid. Regular financial statements should be provided and you should insist upon a personal guarantee from the buyer. It is unreasonable to expect the buyer to provide a mortgage on their house or tangible assets outside the business they are purchasing.

You are safer lending 50% of the purchase price to the buyer and being in first position on everything than lending 30% and being in second position behind a bank. A general security agreement and registration under the Personal Property Securities Act should be part of the loan security.

Even when both parties finally get to the point of agreement, you are not done. Do not start making commitments that are based upon the sale closing. You still have to get through diligence and the cheque still has to clear. Many sales fall apart in diligence—a landlord is unreasonable or an adviser provides negative advice, a franchisor does not approve the buyer, the third-party financing falls apart—or one of you changes your mind. Remember, the offer is non-binding.

As you work through the negotiations, keep in mind your Best Alternative to a Negotiated Agreement (BATNA). You need to determine this before you start the negotiating process. It may be that you keep the business or you hope that another buyer will be presented. We sometimes run auctions with multiple buyers to achieve the highest offer.

You need to assess the likelihood that the buyer will actually close if you do achieve an agreement acceptable to both of you. If you turn down an offer you have in fact purchased your own business for that amount and on those terms.

Rely on your business broker's help and advice to help you through the negotiating process, but in the end, *you* must make the decisions, not your accountant or your lawyer or your family and friends. You must decide based upon what works for you.

What is due diligence

We have accepted an offer. Both parties now need to do reasonable investigation to make sure everything is as it was portrayed.

You have already worked with your business broker to prepare most of the material that the buyer will want to verify. Some items will need updating to reflect recent changes.

Verifying the details: the buyer

The buyer will want to review operational processes and the policies and systems you use to run your business. They will want to review payroll, job descriptions, training programs and procedures, safety policies and procedures, workflow and processes, systems and manuals and your policies and programs for both HR and operations. They will want to know about your staff—their tenure, skills, responsibilities, work history, rates of pay and so on.

They or their financial advisers will want to review your financials, including source documentation such as bank statements and reconciliations, invoices, the cheque register, purchases, monthly and yearly revenues. If it is a share sale, they will want to review the tax returns.

They will look at HST filings and payroll deductions and remittances. They will probably want to meet with your accountants to understand your accounting systems and policies and financial history.

They may want to do market research to substantiate the customer loyalty they have been told about. This may involve client surveys and meeting key clients who represent a substantial portion of your revenue.

They may want to meet the landlord to ensure that the lease and expectations are what they were told or they may want to check out the building to rule out structural or legal issues related to the building or zoning.

They may want to bring in experts to assess your machinery and equipment.

All of the above can be time consuming and tedious. But stand in the buyer's shoes—they are investing their life savings and their family's future. They do not want to make a mistake. They are torn between the fear of making a grievous error and the excitement of their new career as the owner of your business.

Verifying the details: the seller

You, on the other hand, may have some trepidation about selling. You may have issues about your future plans. Will you have enough for whatever is next—purchasing a larger business, retiring, travelling, looking after your family, or staying on with fewer responsibilities?

You want assurances that the buyer will do a good job running your business and that they'll look after staff and clients. You want to be sure they will repay the financing you are providing, so you need to check out the buyer just as they are checking out your business. You are lending money and should do the same diligence as a bank. Do a credit check, examine their references and talk with people who know the buyer and their history. If they have purchased other businesses, talk with the former owners.

Too often, diligence seems to be about the buyer authenticating what they're told about the company. The diligence should be both ways.

Make the best use of advisers

Your business broker will help you and the buyer determine the diligence required, then set up a meeting to confirm the roles of the advisers and the materials each will be providing and when.

I recommend that the seller's accountant and the buyer's financial adviser also attend as they will be involved in structuring the transaction and in delivering the diligence materials.

Once the details of financial, operational, market and HR diligence have been satisfied, the tax and transaction lawyers will begin their legal diligence, seeking a structure that works for both parties. These lawyers will draft the documentation to implement the agreement. They will also undertake the appropriate searches for undisclosed liabilities and ensure that corporate filings and the minute book are up-to-date.

We highly recommend using a specialist for this work, not a lawyer who normally deals with real estate transactions, litigation, criminal law, corporate or commercial law. Lawyers who specialize in tax and business transfers have the templates, they understand the most appropriate structures and they have been through this many times before.

We generally recommend specialists from smaller firms as most of our clients are cost conscious and fees from larger firms can be prohibitive. We also recommend that you ask your accountant and lawyer for an estimate of fees before embarking upon due diligence and the closing process.

Due diligence Part 2

We sell 70% of the businesses we take on at Sunbelt. This percentage is much higher than what is typically reported in the industry.

Why such a difference? A key factor is how we approach due diligence.

Start compiling material early

For the seller, this process starts well before you have an accepted offer. It starts when you realize that one way or another you will eventually exit from your business, and as this will involve diligence on the buyer's part, you need to prepare for it now. Central to these preparations are actions to get documentation in order, and that means everything from workplace safety manuals, to operating systems documentation, hiring process, training manuals, termination procedures and so on.

It also means getting financials in order so a buyer can have confidence in the financial control systems and reporting. Your accountants can help you with this. It means taking action on tax planning and structuring *now*, not when you receive an offer you would like to accept. Early planning is a must for a tax-effective sale.

A Shareholders' or Partnership Agreement should also be in place so there are set rules among owners governing how a share or asset sale can proceed. Not all shareholders or partners will agree about whether and when to sell and at what price.

It is also important to protect your intellectual property.

Achieving results

We educate the business owner about due diligence at the beginning of the marketing process and start compiling the diligence material early. We can then work with the seller and their advisers to put the material in good shape long before it is needed. This substantially

reduces the odds where 50% of accepted offers fall apart during diligence and contributes to our much higher close ratio.

Be prepared. Buyers are deathly afraid of the hidden flaw. If *some* things are not current and correct then they will believe that *nothing* is to be trusted.

Having your business broker compile and review the diligence material early in the process will identify fatal flaws in time to correct them. Working with your accountant, lawyer and any other required professionals early in the process will save you money as there will not be a critical state of urgency to correct inadequacies.

A business coach can also help you through this process to make the business saleable. There is an added bonus: the same items that make your business more saleable down the road also make it more productive now and can create a longer history of strong results.

Validate the buyer

In part one of due diligence, I recommended that your professional advisers help you conduct due diligence on the buyer prior to closing a sale. Background checks, verification of financial resources, contacting references from previous employment and previous acquisitions, verification of asset holdings, legal status (criminal records check as well as checking for previous lawsuits) and an assessment of management intentions and style are all important.

You will be financing part of the sale. You want to ensure that your business continues to prosper and you want to ensure that your employees, clients and suppliers are treated well. You will probably have to work with the buyer for some time after the sale—is this someone with whom you and your staff will be comfortable working?

Your business broker can help you to make informed and wise decisions. He or she will warn you about the risk of the buyer using something learned in due diligence as rationale to modify the deal (lower the price, stretch the terms, and so on).

You must still be prepared to walk away from the deal, so do not make any commitments predicated on the sale of your business until after the sale has closed and after the cheque for the sale has cleared.

Closing the transaction

You have made it through diligence, the purchaser is satisfied with what they have reviewed and we are at last ready to close the sale of our business.

Next is the drafting of the documents to bring about the sale that we and the buyer have agreed upon.

Your accountant and tax lawyer helped structure the business and tax planning to reduce, defer, or eliminate tax on the sale of the business.

You now need a transaction lawyer to prepare:

- non-compete, training, and transition agreements;
- a promissory note for the financing as well as a security agreement to protect that financing;
- an agreement of purchase and sale reflecting the deal and the structuring.

If it is a share sale, you may also require an agreement to hold the shares in escrow until fully paid for by the purchaser. If an asset sale, register security against the assets of the business.

Money matters

The purchaser will likely need an operating line of credit for working capital, placing you in second position behind a bank re your security, but you will limit the postponement to an agreed-upon amount.

Ensure that the buyer puts in place adequate protection for the financing you're providing. Life and critical illness insurance, and property, casualty and liability insurance should be conditions of the sale. The buyer should secure insurance coverage on you during the training and transition period as well.

You'll find that when you and your business broker meet with your lawyer to provide the accepted offer and clarify the terms of the transaction, a lawyer who specializes in such activities will do a better, faster job at less cost. Your business broker can refer you to one.

Typically the seller's lawyer will draft the security documentation and the buyer's lawyer will draft the agreement of sale, the training and transition agreement and the non-compete agreement. Each then reviews the other's documents on behalf of their clients.

The business broker understands the thinking, goals and issues on each side of the transaction and, in my experience, if you insist that the lawyers run the documents by the broker you will save time, reduce conflict and get the deal closed. Your lawyer will not talk directly to the purchaser and the purchaser's lawyer will not talk directly to you. Your business broker will talk directly to everyone involved and can get clarity and agreement.

You also need to involve your accountant in the closing process. In an asset sale they will assist with determining the appropriate allocation of the purchase price. Make sure your business broker is involved in these discussions as they will have to negotiate an acceptable compromise.

Expect adjustments

In the case of a share sale, year-end financial statements and tax returns will need to be completed as a result of the change of ownership. There will also be adjustments after closing. At the time of closing you will not have all of the bills for services used during the last month or two before closing. You should do all of your billing for completed work and sales right up to the closing date.

You will also need to do an inventory at closing to finalize what is being transferred to the purchaser. Issues relating to the currency or saleability of inventory can kill deals so ensure your business broker and buyer join you in taking inventory—the broker can mediate and find acceptable solutions.

The post-closing adjustments can be sorted out in the 60 days following the closing. As you are lending part of the purchase price to the buyer, they will not require funds to be held in escrow to support the adjustments.

You need to pay attention to employee issues. In the case of a share purchase where the buyer is retaining all staff, you need only make adjustments for items like vacation pay. But if some employees are being released, who is responsible for providing notice? An asset sale requires that staff receive notice in accordance with the labour laws. Quite often they are presented with a termination letter and an offer of rehire at the same time.

Work with the buyer

You do not, however, want to alert staff to the sale until all conditions have been met. After closing you will probably want to hold a staff meeting to introduce the new owner and give them an opportunity to reassure the employees and to set the values and culture under which the business will operate.

You will be working with the buyer for a specified period of time to train them and assist with the transition. Do the very best you can to get them off to a good start. Their success is the best insurance for paying out your note.

Most sales take place HST-free, but you must file the appropriate documents post sale. Your lawyer and accountant can assist. Given that you are a business owner, long before closing the sale you will have sorted out what you are going to do with the proceeds!

Two final points. First, do not commit your time or money until the sale is closed—deals can fall apart at the last minute. Second, *do* get advice from a wealth or financial planner early in the process. You should, in fact, have a personal financial plan in place before you decide to sell.

Congratulations!

And now, having sold your business, it's time to implement that welcomed, final part of the plan. It is also time to celebrate—it took a great deal of planning, effort and perseverance to get to this close and you've succeeded!

Glossary

Asset sale:
An asset sale is a transaction where the buyer purchases the operating assets of the business, both tangible and intangible. The purchase price must be allocated among the assets purchased including goodwill. Allocating fair market value to the assets will often result in the seller having to record a recapture of depreciation with this amount being taxable as income to the seller.

BATNA or Best Alternative to a Negotiated Agreement:
The action you will take if an agreement can't be reached, determined before you start the negotiating process.

BP or Blind Profile:
A document that highlights the key attributes of the business without identifying the business name or location.

Business Broker:
Business brokers are intermediaries who assist buyers and sellers of privately held small business in the buying and selling process. They typically estimate the value of the business; advertise it for sale without disclosing its identity; handle the initial potential buyer interviews, discussions, and negotiations with prospective buyers; facilitate the progress of the due diligence investigation and generally assist with the business sale. (WIKIPEDIA)

CBO or Confidential Business Overview:
A document with detailed information about the business but only summary information about financials. Released only after signing of a confidentiality agreement.

CBP or Confidential Business Profile:
A document that includes detailed financial analysis of the business history and future projections. Provided only with the agreement of the seller after the buyer, seller and business broker meet.

CSBL:
Canada Small Business Loan. Provides financing for the purchase of assets, limited to a percentage of the value of Furniture, Fixtures and Equipment.

Discretionary Expense:
Expense that is not necessary to support the revenue of the business.

Due Diligence:
Review/Investigation to ensure everything is as it was originally portrayed. Verifying the details. Financial, operational, market, HR and legal.

Earn-Out:
In the purchase of a business, a deferred payment that bases a portion of the valuation on actual future performance. Often requires the seller to remain with the business.

EBITDA or Earnings before interest, taxes, depreciation and amortization:
An important metric in determining the value of the business.

Exit Strategy/Exit Planning:
Preparing for the day an owner will leave their business. An exit plan will incorporate valuation, tax and estate planning, risk mitigation, stakeholder communications, due diligence and much more.

Extraordinary Expense:
Expense that is excessive, above normal levels.

FMV or Fair Market Value:
A current and objective value, risk-adjusted.

Intangible Assets:
Include goodwill, patents, trademarks, database/mailing lists, licenses, permits, franchise agreements.

Intellectual Property:
Includes patents, copyrights, trademarks, trade secrets, and other proprietary information used in commerce.

Lifetime Capital Gains Exemption:
A tax benefit on the sale of shares of a qualifying small business corporation. The current lifetime limit is $750,000 per person (shareholder).***(See Note page 72)**

Mission Statement:
Defines the benefits customers can expect from the business.

MPSP or Most Probable Selling Price:
The most likely selling price. Factors the true (recast) earnings past and future, risk, what the market and the seller are willing to pay.

NDA or Non-Disclosure Agreement:
An agreement that creates a legally enforceable confidential relationship between the parties to protect any type of confidential and proprietary information or trade secrets.

Non-cash expense:
Usually tied to depreciation.

Non-Compete Agreement:
A legal document to prevent key employees from setting up their own business in direct competition.

Non-recurring expense:
A one-time expense.

Offer to Purchase, Letter of Intent, Memorandum of Understanding:
A formal proposal to purchase. Documents that serve as a dated and signed offer to purchase the business with a timeframe for response. Usually non-binding excepting confidentiality and perhaps exclusivity. Frequently includes a deposit.

Recasting:
Normalizing the financial statements of the business to provide a realistic value of the assets and liabilities and the true earning capacity of the business. Adds back expenses considered discretionary, extraordinary, non-recurring or non-cash.

SDE or Sellers Discretionary Earnings:
True earnings. Net income less interest, taxes, depreciation and amortization, owner's compensation (including salary and discretionary expenditures). Benchmarked as a percentage of gross sales.

Share Sale:
In a share sale, the buyer purchases the shares of the corporation. For the seller, the difference between the cost of the shares and sale proceeds is a capital gain.

SWOT or Strengths, Weaknesses, Opportunities and Threats:
A way of assessing the viability of a business. Included in the Confidential Business Overview of the business for sale.

Tangible Assets:
Include furniture, leasehold improvements, vehicles, machinery etc.

Vendor Take Back:
Seller-provided financing where the seller takes back a portion of the purchase price, paid off over time. Also called a seller's note.

Vision Statement:
Defines what the business will be like in five years.

***Note:** Under proposed changes, for dispositions **after 2013** of qualified small business corporation shares, the lifetime capital gains exemption limit will increase to $800,000.

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"Most business owners have spent many years pouring passion and hard work into building their business and it is likely the largest asset they own. While many count on the sale of their business as part of their retirement planning, they do not have a solid understanding of how to prepare for its sale or what is involved. This book is a great source of practical information for business owners to understand what they need to do to make their business sellable and maximize after-tax proceeds from the sale."

—Dianna Larkin BBA, CA, senior manager, McCay Duff LLP, Chartered Accountants

"Greg has seen small business from every angle – as entrepreneur, partner, consultant, business broker and valuator. Working with many of Greg's clients, I have seen first-hand how he has helped them navigate the challenging process of buying or selling a business. Greg's in-depth experience helping hundreds of clients across industries buy or sell a business places him in a unique position to share his insights with readers."

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"This book outlines the steps and considerations involved in the complex process of extracting maximum value for the sale of a business while minimizing taxes and risk and making sure your staff and clients are looked after in the process. This is a must read for business owners."

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—Randy Harrison, president, Advanced Planning Insurance Group, Dundee Wealth