2 (5s):

Welcome to the Maximize Business Value podcast. This podcast is brought to you by Mastery department, where our mission is to equip business owners, to maximize business value so they can transition their business on their terms. Our mission was born from the lessons we've learned from over 100 business transactions, which fuels our desire to share our experiences and wisdom. So you can succeed. Now, here's your host, the CEO of Mastery Partners, Tom drugs.

3 (35s):

Hi folks, me again. And I need to give another quick disclaimer, before we start this podcast. If you listen to the podcast last week, you already know that David Hammer is one of the most knowledgeable attorneys and CPAs. When it comes to extracting the most value in exiting a business last week, you heard part one of my amazing interview with David. The content was so good and the conversation went so long. I decided to break this conversation up into two podcasts, and I promise you, it is worth every minute you spend listening. So just like last week, grab a pen and paper because you're going to want to take notes on this one and enjoy the second half of my conversation with David Hammer.

3 (1m 22s):

We're back with David Hammer, a business and M and A attorney and CPA, as we learned in the first half. And we're talking about business transactions. So we covered a lot of the basics before the break. Now I kind of want to turn to the actual transaction. One of my favorite sayings of yours is if you have only one buyer, then you don't have any buyers. What does that mean?

0 (1m 49s):

That's actually a saying that I borrowed from a long time client of mine, which happens to be one of his favorite sayings. And what he believes is that in order to effectively sell your business for the best price, you need to conduct a process that is designed to uncover as many possible buyers for your business as you can. Oh, and that doesn't suggest that you're trying to create a bidding war because you really can't. One of the, the fundamental pieces of any transaction is a, what they call a nonbinding letter of intent.

0 (2m 34s):

But there is a one single binding provision of a letter of intent. And that's, what's referred to as the no shop, what the no shop and effect says is buyer is not willing to spend all the money and time and attorney expense and CPA expense looking at seller's business unless seller agrees not to sell it out from under him to someone else for some defined period of. And so, while it is important to run a process, to uncover multiple buyers to pick from you will eventually have to pick one. And by virtue of the no shop, you will be prevented from playing one of them off against each other.

0 (3m 17s):

But the importance of the multiple buyers is not just from a pricing perspective, a bar perspectives, change bar desires, change. If you've put in, if you've put all of your hope and trust in a single buyer, and that buyer has something in their environment that causes them to back away, then you're back at ground zero. Whereas if you have uncovered a number of multiple buyers, you, you simply move on to the next buyer that you might want to do business with. So there's a protective element associated with that, even though you typically don't see an out and out bidding war for any particular client by virtue of the no shop.

3 (4m 5s):
Yeah. The, the whole concept of the, like in, in residential real estate where you've got multiple bidders coming after one house and, and, and you're raising the price that way, that just doesn't happen very frequently in businesses. I suppose they can, for somebody that's got some very desirable technology or, or a disruptive type of a service, but they're going to get, they're going to get a high, multiple for their business anyway. And it's going to be based probably on the technology and not risk really on the financial performance of the business. But, but that's so rare. And folks who think that they're going to get a bidding war, they aren't, but having multiple buyers and having multiple folks looking at your business, it'll give you some indication when they all, when all of their offers come in, kind of within a range.

3 (4m 56s):
Now you kind of know that, yeah, this is what my business is worth and, and it's validated. And if something happens as it frequently does after, during due diligence, then you have other interested buyers that you can always fall back on the worst possible thing that I hear over and over again. And I hear this from prospective clients. So call and schedule a meeting with me. I just got connected, or somebody just reached out to me from a private equity firm or, or a strategic buyer. And they want to buy my business. And I want to understand, you know, how it's worth. And I say, well, w it really, if you enter into an agreement there, you're probably not going to get the best price for your business.

3 (5m 43s):
And, and, but if all you want to do is sell the business and get rid of it, then fine. You can engage with one buyer. But if they're interested, there are other folks who are probably also interested in your business and just haven't reached out to you yet. And the other point is that I always make is if you're getting calls from prospective buyers and mostly that's private equity firms, the only reason that, that you get those calls is because you're breathing and you have a business, you know, they, they, they don't know. They, they may say, oh, we've been following your business for years. Really then tell me about my business, right?

3 (6m 23s):
They, they, don't, they're shopping, they're fishing, looking for opportunities to, to go out and find acquisitions. And it's very rare for somebody to reach out that has a specific interest in your business. Now it happens because there are buyers agents that are, that are engaged with specific buyers to go and look for businesses. But if out of the blue, some private equity firm calls you and I'm not against private equity. I think that they have, they are an important part of the M and a ecosystem. But if you get calls from private equity, it's probably because you appeared in some press somewhere, and suddenly you made the list that

everybody uses to call you. So doesn't mean that they're necessarily that interested in that, that you can close a transaction.

3 (7m 7s):
When you have that one buyer. I just love that. I'm glad to hear that you stole it from somebody else because I've stolen it because I've stolen it from you. This has been re gifted over and over again. And I use that with clients all the time, but

0 (7m 18s):
They call you or not calling to offer you top dollar. If they're calling you, don't talk to them. And the difference is between being proactive and being in control of the process, and you selecting the people that you talk to, or your representative selecting, the people that you talk to and being completely reactive, where you're responding to whoever it is that happens to call you on the phone. And it is not unusual for businesses to receive two or three of those calls a week. I have a number of clients that receive two or three of those calls a week. And because they didn't initiate the process, most of those clients simply choose not to talk.

3 (8m 5s):
I had a, I had a role. I, I would talk to anybody and I'll give them 30 minutes or whatever, and talk to anybody. And that certainly did that at our last company Granbury, but I would, I could predict how many calls I was going to get by how much press we were getting. So, you know, we were on the Inc 5,000, four years in a row. We were on, you know, the, the tech Titans, fast, 50 fastest growing technology companies in the area, several times in a row, we were on the Dallas 100 list. I was a finalist for the Ernst and young entrepreneur of the year award. Every time some of that press hit my phone, ran, rang off the hook with folks from private equity.

3 (8m 51s):
Why, because they saw me on a list. Right? And so, and that means if you're on a list, you're probably, there's at least a decent chance that you're a well-run company. And, and, and they're just fishing for anything that they can find. So if you're breathing, then you're probably getting those calls. I can tell you, David, after we would get some of that press at like the Inc 5,000 list, I wouldn't be surprised if I was getting five calls a day on it. And so

0 (9m 18s):
Well, and that's, that's the other point to note, those people can really consume a substantial portion of your time. And if you give them anything beyond an initial call, they really can, because if, if they express an interest and you buy it, the next thing that happens is that you sign a confidentiality agreement with them and they start asking you for information and they can consume a massive amount of a business's time, simply compiling information in response to a due diligence request. And then if they go away, you've wasted all the time. That's the reason it's so important to be proactive and run a process, prepare all your information in

advance, disclose the same information to everybody that has been identified as a prospective buyer and deal with them in your time, rather than being reactive and responding to them in their time.

3 (10m 15s):
Yes. So proactive versus reactive and being in control of the process is very, very important. A, you know, a well-run process and, and by the way, investment bankers do these processes. Some business brokers do these processes, but, but businesses can run a process on their own as well. And we did that with Granbury. We had been through enough transactions that we decided to run our own, but we ran it just like what we're describing here and a well run sale process. We'll start by kind of identifying those potential buyers, giving them just enough information to peak their interest and ultimately securing that letter of intent that David referred to earlier.

3 (10m 60s):
So why are letters of intent important and why should you pay attention to the points in the letters of intent?

0 (11m 9s):
Because letters in the tender described as non-binding with the exception of the no shop provision that I described earlier, a lot of people tend to dismiss their importance, but they're very important because they give the parties the opportunity to flesh out all of the deal, breaking and potential deal, breaking issues that stand in the way of closing a transaction. The, the well drafted letter of intent covers all of the different things that you need to be talking about whenever you sell a business. And if it does, when you get down from the five page letter of intent to the 60 to 80 page definitive agreement, you don't find these big issues that are popping up for the very first time that nobody has thought to talk about or, or consider.

0 (12m 2s):
So the letter of intent should be used as the mechanism for getting all the issues out on the table, all the business issues out on the table, and then the definitive agreement can deal with those, those business issues in a legal context. But if the business people agree and they sign their names, fortunately we live in a pretty ethical business environment. And even though it's, non-binding both parties will generally adhere to what they've signed their names to. So if you can get that letter of intent, there's a really good chance that your transaction will close

3 (12m 37s):
Well. And, and the letter of intent as you, as you say, will kind of point out the big things that you all need to agree on, right? And, and typically in a letter of intent there, they're tossing a, a, a, a grenade across your bowel, right. To just see if you're going to agree to these things, right. And, and you should negotiate that letter of intent, you know, just because someone sends you a letter of intent, don't just sign it and sit down with your attorney and review it and make sure that the letter of intent is appropriate for your business. You know, it's bitten me before, but because of a provision that I found in a letter of intent that, that we didn't

think was important, but it turned out to be way more important than we realized later on, but it review that kind of thing with your attorney to make sure that when you sign that letter of intent, that, that you're not agreeing to something that that is going to be detrimental to the outcome.

3 (13m 35s):
And so a very important, and it's bit me before

0 (13m 39s):
I have two transactions on my desk right now from very sophisticated clients where they signed the letter of intent before they ever sent it to me. And what that points out is the dangers of what Alan Greenspan described as overexuberance, it is real easy for a business owner to receive a letter of intent for millions of dollars and get excited and sign their names. And by doing so deprived themselves of the opportunity to really flesh out all of the issues that could be standing in the way of those millions of dollars coming into their bank accounts.

0 (14m 27s):
So unfortunate, but again, sophisticated people purchase price for one was 8 million and the purchase price for the other was 27 and a half million. So these are significant transactions and people got excited and they sign their names. I understand it, but they did surrender an opportunity to go a long way door down the path toward ensuring that their deal would, would close.

3 (14m 54s):
And it pays to get that legal advice beforehand. Don't, you know, we actually had a rule at Granbury, nobody signs any agreement without passing it by our attorney. David, when he was our chief counsel looked at lots and lots of agreements, you know, we actually retooled some of our agreements while he was our chief counsel. And then later when Kurt guys Dixon became our chief counsel, you know, we paid him a retainer so that he would look at all agreements. I had a rule within our business. Nobody signs a legal document without having it go by our attorney first, because you just don't, we don't understand legal language. You know, those of us who are not attorneys and it pays.

3 (15m 34s):
And so certainly when it comes to selling your business, don't sign anything without running it by your attorney. First, you can get that irrational exuberance says, as Greenspan used to say, and I recognize that that happens, but, but pump the brakes, go visit with your attorney because you're gonna uncover some things that you hadn't thought about yet. And if you have a really good M and a attorney like David Hammer, then he can help with that. You know? Well, it occurs to me that I probably should have addressed this in the first half of the, the podcast, but I wanna address it here. Anyway, one of the important things in the unfortunate outcomes is that only 17% of attempted transactions actually closed.

3 (16m 18s):

Now, these are even transactions that, that have a letter of intent and they go into due diligence and they don't reach the finish line, right? That means 83%, a full 83% of transactions never reach the finish line. And one of the biggest reasons that they fail is unrealistic expectations of enterprise value of the business. While I understand that every business and every situation is different. Can you give us some sort of rules of thumb that you use when you're advising clients on regarding valuations of a business

0 (16m 52s):

In, in a sane universe, it would be fairly easy to do that. We don't live in a sane universe right now and haven't for the last three years, but let me give you the, the sane universe response to that question. Everyone's heard of purchase price multiples, but they don't always understand exactly what purchase price multiples mean. What it typically means in the M and a area is the number of times EBITDA that a buyer is prepared to pay for your business.

0 (17m 34s):

And if you're a seller and you hear a buyer say, I'm prepared to pay you a three multiple or a six multiple, you don't always know what that means, but what it means in reality is that the buyer is looking for the business at a minimum to continue to perform after closing at, at EBITDA level, as it performed at the closing date. And they're looking for a certain rate of return or return on investment on the purchase price that they're paying. So if, if a buyer is offering you a three multiple, that buyer is saying, I'm going to continue to perform at an Eva doll level like yours after closing.

0 (18m 18s):

And I want to make 33 and a third percent on my money, because if you divide the purchase price by the EBITDA, which is what the purchase price multiple is, that's and state it and percent, that's exactly what you're getting. And so a lot of people don't think about the purchase price multiples as being indicative of the buyer's desired our ROI, but that's exactly what it is.

3 (18m 43s):

So, so what about just again, let's go back to our sane universe versus recently, what are, and by the way, let me give a side story here. When you're, when you're, when folks are talking about multiples, they're almost always talking about multiples of earnings, right? Just the way David just described it. So many times I talked to business owners who say, oh yeah, I was just told that I could get four times. So I'm a $4 million top line revenue business. My businesses were $16 million. I say, in what universe, right? Your, your $4 million top line, you're not making any money to the bottom line.

3 (19m 25s):

And what universe is going to pay $16 million for your business. I just, but it's because owners hear what they want to hear when I talk to them, when they talk about multiples, they're almost always talking about multiples of earnings. And so, so I wanted to clear that up and, and you did so nicely there, but so give us some kind of rules of thumb. What kind of expectations are there? Should there be on, on multiples of earnings

0 (19m 52s):
For a public company, you can see the multiples and the E column opposite the company's name in the wall street journal every day, private companies are different. And the reason is because buyers attach a greater degree of risk in acquisitions of private companies than they do public companies. And the, the reasons are varied accuracy of financial information, all sorts of reasons, but small privately held companies are simply riskier. They don't have process and procedure the way big public companies have and, and who are required by law to have.

0 (20m 35s):
So in the EBITDA multiple universe of a private company, they will usually range from three on the low end to eight on the high end, and three applies to a bottom line or an EBITDA earnings before interest taxes, depreciation, and amortization of 2 million or less. When you exceed 2 million and up to about two and a half million, the, the multiple will bump to a four. And for every $500,000 of EBITDA, after that, it'll bump an additional multiple, all the way up to about 4 million in EBITDA, which is an eight multiple business in a sane universe.

0 (21m 22s):
And typically then the multiples for privately held companies cap out, you have to have a massive amount of EBITDA in order to be able to demand a multiple bigger than eight. If you're running a private company,

3 (21m 41s):
I completely agree now. Cause your starting point, there was 2 million. So look, the vast majority of businesses are smaller than 10 million in revenue. And probably by definition are under that. So the expectation really for those businesses is going to be a three multiple or less, right?

0 (22m 0s):
Yes. And if, if they're a well-run business with 10 million in revenue, they're probably putting a million dollars in EBITDA every year that will probably sell for $3 million in the sane universe.

3 (22m 17s):
Right. Right. Well, and of course, private equity sometimes messes up some of these multiples because they've got a lot of dry powder and they're overpaying and boy that there's never been a better M and a time than we're in right now. It is absolutely a sellers market. And, and you might be able to get hired today. But if you're already not into a process today, you don't start one today and hope that it closes this year because it takes time to be able to do that. I mean, on average, it's 12 to 18 months to close a transaction. And so, so if

you're, if you are for sale right now, you know, congratulations you, I hope that you can take advantage.

3 (22m 60s):
Let's see, where are we here? Okay. So the, once you have a letter of intent, let's go back to the letter of intent. Once you have a letter of intent and before a transaction closes the buyer and the seller have to agree to a definitive agreement, right? So can you give us some major points of what a well-written definitive agreement should include?

0 (23m 26s):
The, the typical definitive agreement in a, a million dollar plus purchase price let's say will be between 40 and 80 pages. And it will say five, relatively simple things. It will tell the reader what the seller is selling, what the buyer is, paying, how the buyer is paying it, what the seller is telling the buyer about the seller's business. And then the last category is the give backs, the circumstances under which the seller might be required to part with a portion of the purchase price, because some of the things, or one of the things that the seller sold the buyer about the business turned out not to be born out by the facts after closing.

0 (24m 16s):
So those are the five essential things. And, and out of those 40 pages typically about 25 of those pages are what the seller is being required to tell the buyer about the seller's business. Now, why does it take 25 pages? The reason is because the buyer is asking the seller to represent that they have the perfect business. Now that's counterintuitive on its face because there is no such thing as a perfect business. And no buyer believes that its seller has the perfect business, but the representations and warranties are designed to elicit disclosure.

0 (24m 58s):
A buyer doesn't believe seller has the perfect business, but buyer wants the seller to tell the buyer about all the imperfections. And so you have 25 pages worth of representations and warranties supported by seller disclosure schedules that tell the buyer what the buyer believes. It needs to know in order to run the business effectively after the closing.

3 (25m 26s):
So that's those seller disclosures are really important. And, and why is it important then to, to really have full disclosure? Why is that absolutely essential?

0 (25m 40s):
The, the seller disclosure are basically the sellers get out of jail free card. Oh, if you tell the buyer about all of the problems in your business and your buyer closes anyway, they can't come back to you after the transaction is closed and say, you never told me I need some of my money back. And so if, if you disclose the problems you generally, and I say, generally, escape liability. Now some of those problems are so

significant that a seller will say, look, I can't deal with this problem without some specific financial guarantee from you, should it result in, in financial liability to me.

0 (26m 28s):
And in those situations, you may have a specific indemnity provisions that apply to specific circumstances, but I can tell you in 174 closed transactions that I've been personally responsible for. And I don't know how many dozen more, whenever I was at Deloitte or as a young associate in the law firm, I don't, I don't know how many years and maybe even decades it's been, since I've seen a case of specific indemnity for a particular problem. It's, it's not unusual. Sellers have nothing to fear from full disclosure and they have everything to gain by fully disclosing.

3 (27m 17s):
I love the, you call it that's the get out of jail free card, because it really is, you know, the, the it's interesting, those are the things, whatever you disclose there, or don't disclose there that they discover later or things that can come back against you. We used a little, a little known mechanism in our last transaction that I remember surprising. And our friend Jay Rogers with w we had 36 shareholders, but only five of us that controlled almost 95% of the business, 94, 90 5% of the business. And then the balance of our shareholders were very minority shareholders. And so in our, we actually had two different purchase agreements.

3 (28m 1s):
The, in the majority share purchase agreement, we were agreeing to the reps and warranties. And in the minority agreement, we excluded them meaning that those people didn't have enough gain out of this to even, and they were not involved in the business and therefore were the ones who should be held accountable. And it, and it gave us the opportunity to get a hundred percent agreement on the transaction. And so I remember when Jay Rogers called me and said, I've never seen such a thing Bronson. And I explained to him what it was. He said, well, that's brilliant. We need to start using that.

0 (28m 42s):
I've used that mechanism on another transaction myself, where there were passive investors who didn't have enough knowledge about the business to be willing to take the financial risk of liability for representations and warranties.

3 (28m 57s):
Yes. Yeah. So if there are ways to, to be able to do that with very minority and passive investors and things like that, but so, you know, it's, it's very common for sellers when they get that letter of intent and that initial offer to get those stars in their eyes and sign things without getting legal counsel, to have a look at it. But it's also equally common that after due diligence buyers come back and reduce the offer. So I thought I had a $10 million deal, and now I got an $8 million deal or worse, a $5 million deal. Why and how did they do that?

0 (29m 38s):

The, the circumstance that you're referring to is commonly referred to in the trade as a retrade, the buyer comes in and retrade the deal in a way that's always more favorable for the buyer, supposedly because of something that they have uncovered in due diligence. And when I say supposedly, occasionally a buyer will have uncovered something in due diligence that suggests that the business was not what the buyer thought it was whenever they tendered the original offer.

0 (30m 20s):

And in that situation, when a bar can demonstrate the facts that they were relying upon, usually because the facts were provided by the seller were not born out in reality, that retrade is totally justified. Now, there is another type of buyer, a more nefarious buyer who believes that no seller will risk a transaction for 10% of the purchase price. And so their standard method of operation is to make an offer. And shortly before closing come in with a retrade that reduces the price by 10%.

0 (31m 1s):

Now they will always come up with a reason why it's the sellers fault, but for that particular buyer, most of the times that reason is, is specious. And the buyer is simply looking to save 10% of what it originally agreed to pay. Fortunately, in the ethical business environment that we have in the United States, we don't see that much. And we do, however, see the situation where the facts as the buyer uncovered them were not the facts that the seller represented. And those are really the more challenging deals in, in the first case of the nefarious buyer.

0 (31m 44s):

The seller has a simple decision to make, do I want to do business with somebody that would do this because I know that the circumstance that they are citing is not right, that's a fundamental business decision. Do you want to start over with a new buyer or do you want to take a 10% reduction in your price in order to get the thing over with, in the other situation, the parties typically end up negotiating a mutually agreeable solution because they are both prepared to acknowledge that the facts as born out were different than what one or both parties thought.

3 (32m 35s):

You know, it goes almost to that, that whole no shop provision and due diligence can drag on for months and months and months. And, and the biggest thing is slows down due diligence is seller responsiveness to their requests. So that's why our whole business model is around preparing a business for transition so that you can be very responsive. You know, the old saying speed kills, right. Which was meant for, you know, slow down on the highway, speed kills deals too, when they go too slow. Right? And, and, and, but the other thing that happens, especially with these nefarious buyers that you're describing, you're in that no shop period, they drag it on the due diligence for a very long time.

3 (33m 24s):

You are mentally and physically committed to this deal. And then they punch in the face with a, with a temper 10% reduction or, or worse. And just to test and see, you know, can they get that because you're already emotionally and mentally committed to this deal. So many times you you'll just roll back and accept that deal. But there are other times when it's not nefarious that they do discover things that you didn't disclose in advance, which is why it's so important to run a good clean process in the beginning, disclose all of the wards in your initial material that you provide them before you sign a letter of intent. Let me give you an example of how that worked for us.

3 (34m 5s):

And, and with this last company that they have an IRA with. We had in our marketing process, we had management presentations before we took final letters of intent to kind of explain kind of the state of the business, what our vision was, where we were going. And in one of those presentations, we disclosed that we had just a horrible customer satisfaction rating in one of our businesses, we had recently acquired some businesses and we were working to fix it. But we knew on an NPS score, which runs from minus a hundred plus a hundred. We had a minus 27 a In this, everybody hated us pretty much.

3 (34m 48s):

Right? So, but, but we knew that. And because of that and knowing that, that if they uncovered it, that could cost us. We disclose that in advance. Now fast forward to 30 days before closing, or not even probably three weeks before closing, I get a call from the CEO of the buyer and, you know, he's making nice, nice. And we're talking about the weather and things going on. And I said, I said, you know, I, I don't suspect that this is a social call. What do you have on your mind? And he said, well, we've just finished due diligence. And there's a few things I want to talk to you about now being a savvy seller, somebody who's participated in transactions.

3 (35m 31s):

I know I'm actually happy. This is the retrade conversation, because now I know where he wants to take this. Right. So I'm to, yes, I'm ready. Tell me. And he says, well, what we've discovered in due diligence is that this one division has the absolute worst customer satisfaction rating we've ever seen. And as a result of that, we're going to have to reduce the purchase price $1.2 million, $1.2 million. And I said, wow, that is unfortunate. That, can you tell me, how did you measure the, the score in that business? Because I'm leading him. Now, I know that I've already disclosed this. And he said, well, we measured it at a minus 24.

3 (36m 12s):

I said, really a minus 24, that's pretty bad, but it's not the worst I've ever seen. He said, what do you mean? And I said, do you happen to have the presentation that we gave you? And I'm flipping through my calendar real quick on August 11th, when your team came down and we gave you our management presentation, do you happen to have that on your computer? And he said, I do. And I said, and I'm frantically opening it and flipping slides. And I said, there it is. Why don't you open it and flip to slide 76? And he said, well, what am I going to find on slide 76? I said, you're going to find that I disclosed to you that we had a minus 27 NPS score and what your, and we also disclosed on that slide, what we were doing to fix it.

3 (36m 55s):
And what you're telling me is that what we're doing is working because we've improved three points since that time. And so while I appreciate the fact that this is the call to retrade, this, it's not going to be on that. So what else do you have? And so, and so I was able to hold off that retrade because I disclosed it in advance of him providing the, the offer that we ultimately accepted. So,

0 (37m 24s):
And you also, you also demonstrated an attitude. That's very important there that I think is, is summed up by the, the business speaker, herb Cohen, Cohen always advises that in a negotiation care, but not too much. I talk about it in the context of falling in love with the deal, never fall in love with the deal, because if you're a seller and you fall in love with the deal, you are easy prey for both the nefarious buyer and even the buyer that has a good faith reason to retrade your price. Yes,

3 (38m 0s):
Yes. As I used to say, when I worked in retail, even honest, people will steal from you if you give them ample opportunity to do so. So you're right, it's it. You have to go in with that mentality. So many business owners are surprised by the retrade conversation that, oh, I thought we had a deal. Well, perhaps you didn't disclose something or perhaps you have an affair expire, but, but our clients know, I tell them this, isn't when we get a letter of intent, this isn't the last time we're having a conversation about the purchase price. We're going to get through our due diligence. And we're going to see what they find and see where that goes.

3 (38m 42s):
It's very rare, not, not completely rare. It's, it's less than 50%. I would say you might give me a better number, but less than 50% of deals actually close at the price that was given on the LOI. They're all, there's always some sort of an adjustment.

0 (39m 1s):
And, and I don't doubt the statistics, but it doesn't square with my experience on, on either the letter of intent side or on the purchase price side. I never have tried to quantify this, but if I can get a nonbinding letter of intent for a seller, it is close to guaranteed that the transaction will close. And when I say guarantee, I don't mean a hundred, but it's well into the nineties. In my experience set. Now I may have a different experience set than other people and, and would submit that I probably do given the accuracy of those statistics, but the, the more you get into that nonbinding letter of intent, the more you improve your chances of closing the deal on those terms.

0 (39m 57s):

And, and that's why it's so important to get that letter of intent done correctly and broadly as the basis for moving your transaction forward.

3 (40m 9s):

Absolutely, absolutely. It starts at the beginning. Don't try to go back at the end and, and fix those things. Get good legal advice, which is why, part of the reason you're here today. So we're going to make another point.

0 (40m 24s):

No.

3 (40m 25s):

Okay. So there are some ways that buyers saved cash at closing when buying businesses, can you comment on some of those things, notes set offs, you know, earn-outs things like that,

0 (40m 38s):

The biggest way that bars, so cash is safe. Cash is through the valuation multiple I'll. They look at your level of EBITDA and then try to convince you that your business is flawed to the point where you don't deserve the EBITDA multiple, that, you know, you should receive even a fraction of a one turn of EBITDA is significant purchase price dollars. And so that's the, that's the primary way purchasers save cash. Probably number two, on that list I would say is, is with the structure it's, as we talked earlier, very important to a buyer to be able to purchase assets of a business because of the ability to purchase price, allocated, to intangibles and Goodwill over 15 years, if they're buying assets, they will be selling or saving cash by virtue of the intangibles and the Goodwill, but the, the next, and, and that's more a function of your organization than anything else.

0 (41m 59s):

If you're a pastor entity, you don't have a whole lot to worry about in the context of the structure, because the buyer will get, it's a preferred asset purchase treatment, and you'll only get taxed. Once. If you're a C Corp selling assets, the buyer will save cash by insisting on an asset deal, and you'll pay two levels of tax and be the sadder for it. The third way is the allocation of purchase price, which we've also touched on. Don't need to revisit intangibles and Goodwill. I think we've made a point of that, but one thing that that does happen, an allocation of purchase price and an asset transaction, which as we've said, is, is the buyer's preferred method of operation.

0 (42m 47s):

A method of structure. What does happen is that the occasional buyer will not be happy with amortizing purchase price over 15 years. And they will look for ways to amortize it over a shorter period of time. The way of choice is to look at fixed assets and attempt to mark up those fixed assets above the depreciable basis for those assets. The problem with that, if you're a seller, is that you have depreciation recapture under section 1245 and section 1250, if it's a building, oh, so you pay tax at ordinary income rates on purchase prostitutes, allocated in excess of taxable basis to those two categories of fixed assets.

0 (43m 34s):
And you have to be aware that the buyer's motivation for doing that is to reduce the period of time over which that portion of the purchase process amortized or depreciated. So that becomes a real way in which buyers save cash at closing, they do it with the timing of the closing two types of closing. There's a close it's referred to as a sign and close where the parties signed a definitive agreement, some period of time elapses. So that things like buyer financing and sellers obtaining consents to transfer assets and contracts can be obtained.

0 (44m 23s):
How the, and then they close. Whenever those conditions have been satisfied. The, the second top of closing is a simple contemporaneous close, where the party signed the definitive agreement, the seller gets their cash, right? Then I'll, while you can get your cash and I sign and close, the buyer is still delaying the time that you get your cash while your business is off the market. And while they've imposed certain restrictions on your ability to operate the business in the meantime. So you don't want the, the buyer to delay your cash either by suggesting a transaction where there's a sign and close timing of the payments, how the buyer is paying the purchase price is another big area where cash to sellers can be reduced.

0 (45m 20s):
How do they do it? Buyers do it through offering a per a portion of the purchase price and a promissory note in an earn-out or a contingent payment that is tied to the occurrence or non occurrence of certain conditions. So to the extent that notes earn-outs or contingent payments are part of your deal, your cash is delayed and, and you may not get it because there's no guarantee that your buyer will perform after the closing. There's no guarantee that the milestones for an earn-out payment will be met by the business after closing.

0 (46m 1s):
And so you always have to be aware of the possibility of not receiving that portion of the purchase price that is to be delivered by a way of promissory note contingent payments, or earn outs. Those are just a few of the ways. And I, I think you, you may want to talk about some of those categories more carefully. We haven't talked about purchase, purchase money, escrows, and hold backs. We haven't talked about working capital deliverables and I, I know you've indicated an interest in those things, so,

3 (46m 42s):
Yeah. Yeah. In fact, I want to, I want to talk about those things in, in particular, the regarding kind of the, the holdback or the delayed cat, the delayed, if you're assigning a seller note, if you're, if you've got an out, I want you to comment on, on earn-outs, but I can't recall. I learned this with you in the room. It was either you

or Jay, that that taught me. And I love this. I use this with sellers all the time. If you're not happy with the amount of money that transfers on closing as if you will not receive another dollar, then don't do the deal.

0 (47m 26s):
And I think that's great advice because there's, there's just no guarantee about future payments. You've heard me talk about one case where the buyer declared bankruptcy after the closing, oh, the purchase process, the buyer had agreed to pay was $20 million, but 19 million of it was a promissory note bar declares bankruptcy. The $19 million note is worthless and the seller believes correctly that it sold a $20 million business for a million dollars. Oh. So that emphasizes the importance of getting what you have to get in order to be happy with the deal at closing in cash, because there's just no guarantee about what will happen after closing.

3 (48m 16s):
So comment, if you will, on earn-outs and what's been your experience with them. And an earn out of courses is enhancing the purchase price by the future performance. And that assumes that the seller is going to stay with the business and has any M can have an impact on future performance, but what's been kind of the success rate. And in our earn-outs in your experience, a good tool to use,

0 (48m 42s):
There are, they are a tool to bridge gaps and expectations about valuation. If a buyer in reality is buyers as valuing a business, let's say hypothetically 6 million and a seller is unwilling to sell a business, the same business for anything less than 10. You may end up in a situation where an out helps the parties bridge the gaps. And then you have to talk about what the earn-out needs to look like. The typical buyer will propose an earn-out that is based upon bottom line performance, and they will justify it by saying the bottom line is the only money that we have left on which to compute our ROI.

0 (49m 31s):
It's not anything else. Oh. And of course that characterization is accurate. But the problem with that is that the seller loses control of the financial statements of the business at closing. And the buyer is free after closing to increase any category of expense that it might choose the effective, which would be to drive down bottom line profit and to deprive a seller of an earn-out. Hence the reason why you need to be satisfied with the cash that you received at closing. Now, there are constraints that you can impose upon a buyer's ability to do things on the expense side of the income statement to deprive you of an earn-out.

0 (50m 20s):
But it's very difficult to anticipate all the ways in the universe that any buyer can exp again, increase any expense in any business.

3 (50m 34s):

And you said a mouthful there, once you, once you close, you've lost your ability to control the financial statements. As I used to say, actually in our last transaction, we had an earn-out, but, but then negotiated that at the last minute, because they did something that made me angry. And I, and so we negotiated for an earn-out. I knew I was never going to see a dollar out of that. Earn-out why, because the buyer was a very sophisticated buyer, very highly acquisitive, and they had a whole army of MBA. As I called them spreadsheet jockeys that were going to make certain that we didn't earn any earn out

0 (51m 9s):
Generally through accruals by the way, but that's a topic for another day. The other thing I would tell you to elaborate on earnouts is a flip over the coin and talk about the seller motivation and an earn-out many sellers will want to tie an earn out to top line revenue. The savvy buyer will reject that. And the reason, especially if the seller is remaining in some position of authority and the business after closing, you don't want to give that person in a position of authority, the ability to run in a whole bunch of low margin unprofitable business for the sake of increasing revenue and meeting an earn-out.

0 (51m 53s):
And so the, the buyer is totally correct. And rejecting the seller's model, the seller is totally correct, and rejecting the buyer's model. And the logical compromise is to tie an earn out to the operating margin revenue minus cost of goods sold because both parties are interested in that number being as high as possible. And for the people that are committed to pursuing an earn-out, I've strongly encouraged them to tie it to the operating margin. Also known as gross profit and gap circles in order to avoid manipulation by either party.

3 (52m 34s):
I like that, that seems like a very clean way to be able to do that. Now, as you're, as you're using these tools and we're, we're getting toward the end of my line of questioning here, I have, sorry. I feel like that I've suddenly put you on the stand here, raise your right hand. So is there a difference between escrows and hold backs?

0 (52m 57s):
There is, and the, the key differences, the location of the money in a purchase money hole or purchase money, escrow, the portion of the purchase price that's dedicated to that. Escrow is deposited with a financial institution. It's in an account it's there. And the whole back situation, the portion of the purchase price is in the hands of the buyer. Oh. And because the buyer is an interested party on its face, it would appear that it's much more difficult for a seller to get to a whole back than it would be for a seller to get to an escrow that's held by an independent financial institution.

0 (53m 42s):
You also have to remember the example of the bankruptcy. If, if you have a portion of your purchase price and a whole back in your bar, declares bankruptcy, you've lost that whole back, whatever it is. And so as a

seller, you don't have a whole lot to fear from a purchase money escrow, just because if your representations and warranties proved to be true, you'll get your money because it's held in a financial institution. You can't always say the same in a whole back environment because you just don't have any control over the buyer.

3 (54m 18s):
And I think the clearest example is that example you gave of where the, the buyer declared bankruptcy, right after closing or soon thereafter. And so that money was being held as a hold back. I'm assuming, and not an escrow. And, and they've for all intents purposes sold their a $20 million business for a million bucks. So don't, don't be that example folks. Now, I hope I'm not opening up a can of worms here, but there's one last really important thing that a lot of sellers don't understand. And that is in the area of working capital. It's very common for working capital requirements to be addressed in both the LOI and the definitive agreement.

3 (55m 2s):
Can you explain what working capital deliverables deliverables are and how to kind of, and how that impacts the, the purchase price and how a seller can potentially minimize that?

0 (55m 15s):
Well, first of all, let's, let's define working capital for the, the audience under generally accepted accounting principles. Working capital is defined as current assets minus current liabilities. The premise behind a working capital deliverable from the bar's perspective is I'm buying a going concern. And by definition, a going concern is generating enough positive cashflow to pay the bills without my having to inject additional funds into the business after closing. And so if I'm a buyer, I want to look at what working capital has been over an extended period of months out in order to adjust for seasonality, settle upon what a normalized level of working capital is for that business at that particular time of the year, in which the acquisition is taking place.

0 (56m 14s):
And then insist that the seller deliver a business to me with that level of working capital. Now, no buyer and no seller close the books and prepare financial statements contemporaneously with the closed. And so typically what happens is that buyer and seller agree on the targeted working capital that will be delivered to the buyer as part of the deal shortly before closing the seller will give the buyer its estimate of what will be there. The transaction will close based upon that estimate the estimates a little high, the buyer will pay a little more. If it's a little low, the bar will pay a little less.

0 (56m 57s):
And then after the closing occurs and the books are closed and the financial statements finalized there'll be a true up. And if the buyer paid too much, it'll get a little bit of money back. If the buyer paid too little, the seller will get a little money more. And that's the way a normalized level of working capital on a go-forward basis is

provided to a buyer so that the buyer is not in a situation where they have to come up with more money when they feel like they paid top dollar for the price.

3 (57m 34s):
So many business owners confuse that because many business owners start their business here. Well, I didn't have any working capital when I started well, but the difference is is that your buyer is buying a going concern, right? And, and the going concern that is assumed to be self-sustainable without having to inject additional capital, if you've paid top dollar for the, for the going concern. So

0 (57m 58s):
That's a, that's a gap concept that is as widely understood everywhere.

3 (58m 3s):
And, and so many small businesses don't understand that. And, and they're confused when, when there is a working capital requirement or working capital deliverable in that. So thank you for sort of clearing that up for us. I have, frankly, I think we can almost do a whole podcast on working capital and what that means and, and how it impacts a purchase price, but know that for the purposes here, that there is likely in a business transaction, there's going to be a working capital requirement and, and that can impact how much cash that you get at closing. If you're, if you're below that requirement, you may have to pony up a little bit more. If you are, if you're in good shape financially, then, then you may get a little bit more money for the business based on whatever that requirement is.

3 (58m 53s):
So

0 (58m 53s):
There's another one of the ways that buyers can reduce cash to sellers at closing.

3 (58m 58s):
Well, that's it, that's it, you know, and it's one of those things. And, and in my last transaction that they calculated the working capital requirement that they wanted. And I had to go back and argue that, that it doesn't need that much cash. Right. You know, if we could demonstrate that just because we had the cash on the balance sheet didn't mean that we needed that cash to operate the business. So we had to back with a little arm twisting to, to based on the LOI that they originally presented and, and demonstrate what we really needed in terms of working capital to operate the business. And so having a sale savvy financial person in a, in a savvy attorney help you with those things because many times they are addressed in the LOI.

3 (59m 40s):

Do you see that in LOI is frequently that working capital or working on

0 (59m 44s):
The well-crafted Los? I see it in, yes. The ones I do always has it in there.

3 (59m 51s):
Of course they do. So it's all right,

0 (59m 55s):
It's a roadblock if you don't deal with it because it will come up and you might as well get the parties in agreement on the front end. And, and sometimes on the front end, they don't have enough information that they can say the targeted working capital at the closing will be X, but you want to have the concept in there so that when it shows up in the definitive agreement and X's agreed upon, there's not an issue.

3 (1h 0m 19s):
Yes, yes, totally agree with that. And, and it's one of those things that many times is a surprise. And that it's one of those things that knocks the, the train off the rails and, and kills deals. You know, fortunately when you've got a BA a much higher close rate than, than most do than the average in the business. And so I guess my admonition to here to our listeners is make sure that you have good solid counsel when you're, when you're going into this. And David is among the best, look, this one last business question here. This podcast is all about maximizing business value. Now, you know, lots and lots. And we have taken a long walk down down a lot of different things here today.

3 (1h 1m 3s):
But if I could boil down your advice to what is the one thing, one most important thing that you would recommend business owners do to build value in their business? What would that be?

0 (1h 1m 21s):
Start with the end in mind in terms of your organization of you need to, you need to decide on how you will exit the business before you ever start the business. Oh, are you going to run it forever and pass it down to your children? Are you going to sell it or are you going to take it all the way to IPO? Oh, IPO of course is the best way to maximize wealth. Always has been, always will be because you can sell a portion of your business for a higher multiple that you would ever get in a private transaction. And at the same time, maintain some ownership, often controlling ownership at the time of closing.

0 (1h 2m 8s):
However, in 2019, which was the last year on tainted by COVID statistically, oh, there were 219. IPO's the United States of America. If you are building a business to IPO, you're probably making the wrong bed because the odds are overwhelmingly against you. So you need to start with the end in mind, the end in

mind will be the exit of the business and everything from organization to process and procedure to drive earnings flows from that one decision.

3 (1h 2m 48s):
Ah, I love that. And just so you know, this is not a set of folks, you know, as the name of my book, Maximize Business Value, Begin with The Exit in Mind. So I love that advice. That's the best advice I've heard all day.

0 (1h 3m 2s):
And that wasn't a setup. I had not seen your book until just now,

3 (1h 3m 7s):
But you have a copy of it. It's on your bookshelf. I see that. You've read it. So

0 (1h 3m 13s):
Obviously,

3 (1h 3m 16s):
All right. So our avid listeners who listened through our podcast and have been with us for a long time, always know that I ask a bonus question. So I hope to hit your called with this. If you haven't listened to the podcast is what personality trait has gotten you into the most trouble through the years. David,

0 (1h 3m 37s):
What I would say in response to that and I'll offer a supporting example after I explained is my shyness. I, I do not like to be the center of attention. Many of my clients are big, a personalities who thrive on attention and being the center of attention. And those types of clients often question whether I will handle their legal issues with the level of assertiveness and timeliness and directness that they would require that has been, that's been a handicap and a weakness for as long as I've been in business.

0 (1h 4m 25s):
And I'll illustrate it with one example. My longest and oldest client interviewed me way back in 1989, as he was preparing to sell his business, he had undertaken a process to identify an M and a attorney to represent him. And a friend had referred him to me. We have lunch and he immediately crosses me off his list. And the reason was he is the enormous, a personality I'm essentially shy of. I don't try to make myself the center of attention in any setting, whether it's lunch with him or speaking in front of a group like biz owners, ed, which is terrifying because I don't like being the center of attention, but he crosses me off the list.

0 (1h 5m 17s):
And a couple of months later, I get a call from him and he told me that he had three people coming in from Houston for a Saturday morning meeting in his office. And they were intending to discuss starting a business

together, the four of them. And he asked if I would come out and talk with them. And I said, sure. And it was the only time I'd ever been with him since I'd had that one launch never heard from him since. And I get out there and we start talking to three, these three guys, and it was just a delightful conversation. And by 10 minutes into this thing, he and I were finishing each other's sentences.

0 (1h 5m 57s):
And we'd been finishing each other's sentences. Now for 33 years, what he figured out is what he interpreted as a lack of directness or a lack of resolve, or however you characterize someone that's shy had obscured. The fact that I can really think, and he locked the fact that I could really think to the point where he was willing to overlook the fact that I'm not this enormous, a personality that he likes to surround himself with and make me a part of his team. And we've been together ever since

3 (1h 6m 41s):
I know who you're talking about. And, and that is a surprising story. I didn't know that the beginning of it

0 (1h 6m 48s):
Probably hadn't heard that

3 (1h 6m 49s):
I had not heard the Bennett at the beginning story, but it's interesting that the person you're talking about while he does like to surround himself with a players, he does it, he is always the biggest a in the room.

0 (1h 7m 0s):
Yes. And that's actually documented through a tool called culture index, which is a conversation for another day.

3 (1h 7m 8s):
Yes, exactly. We've actually had the culture index folks on this podcast. So for sure. And it's funny that, that his culture index and mine, if you hold them up to the light, they're almost identical. Right. And, and yours and Kim, my sidekick are, are almost identical and that's why we work so well together, Kim and I, why you and I worked so well together cause you are the perfect compliment to, to my drive and, and extrovertedness okay.

0 (1h 7m 45s):
Well, and that's, that's the way it worked with him. And, you know, we have, we've reflected over those two initial meetings, the launch in the Saturday morning, at his office, way back in 1989 over the years. And it always causes each of us to question why we've been able to work together so effectively for so long, we closed 14 transactions together. And 14, even for a serial entrepreneur is, is a pretty significant number. But it wasn't until we both took the culture index survey that we really figured it out. Because if, if you look at his

he's this enormous a like seven standard deviation units to the right of the 50 percentile, you look at his B, which is social ability.

0 (1h 8m 38s):
He doesn't have any of you look at his C he's one of the most impatient people on the planet. And you look at his D and attention to detail. And it's a little bit, yeah, it's, it's deficient, it's a little bit less than normal and you lay his down next to mine and you look at mine. And my a because of the, the shyness is less than the 50 percentile. My social ability just looks just like he is. I don't have any of I'm as impatient as he is, but my attention to detail is seven standard deviation units to the right of 50%.

0 (1h 9m 20s):
And so his big, a vision strategy, assertiveness ambition, coupled with my attention to detail as produced 14 deals and a fair number of millionaires, which is the way he chooses to measure his performance in business these days.

3 (1h 9m 40s):
I love that. I love that. Yeah. That's well, I'll have to share with you my culture index. I'll bring it next time. I see.

0 (1h 9m 47s):
Like to see it so that

3 (1h 9m 48s):
You can see that. So before we go, how can you know, I I'd be willing to bet that some folks who are contemplating deals or need some good, strong legal business advisor, M and a advice with an ear toward a tax consequences might want to get in touch with you. How can they do that?

0 (1h 10m 7s):
Email is the best way of getting in touch with me. Thanks to caller ID. I typically don't answer the telemarketing calls that I get from numbers. I don't recognize, but I am obsessive about responding to email. So I think you have my email addresses that you can share. I have to WW or DW hammer, DW hammer, co.com, and then David dub or DDW hammer at David W Hammer pc.com.

3 (1h 10m 40s):
Yep. Yeah, those things work. So David, thank you for spending so much time with us today and being just a wonderful guest. Thank you for being with us.

0 (1h 10m 49s):
It's been a pleasure, Tom. I've enjoyed it very much.

3 (1h 10m 53s):

You can find David Hammer at DW hammer co DW hammer, like a hammer and nail ceo.com or on LinkedIn. Or of course you can always reach out to me and I'll be happy to make a warm introduction to my good friend David Hammer. This is the Maximize Business Value podcast, where we give practical advice to business owners on how to build long-term sustainable value in your business. Be sure to tune in each week and follow us wherever you found this podcast so that you'll never miss another episode. So until next time I'm Tom Bronson reminding you that it's never too early to work on your exit strategy.

3 (1h 11m 34s):

Remember what David said, Begin with The Exit in Mind while you Maximize Business Value.

2 (1h 11m 44s):

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3 (1h 12m 29s):

That was perfect. I wouldn't make any changes.