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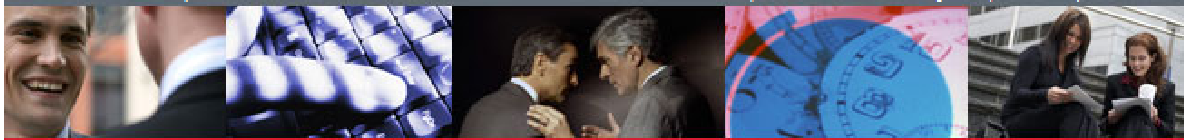

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Your Practice is a Success; Now Sell it Successfully! Part One

by David S. Rintoul

When you sell your car, with the exception of certain Corvette owners, you usually don't care what happens to it after the check clears. Whether the owner drives it into a tree, or changes the oil every 3,000 miles doesn't make a difference, so long as the check is good. But what if you are not allowed to drive another car for three years, or what you are paid for the car depends on how well the car performs after you sell it, or the car is something you have spent your entire career developing? That's what can happen when you are selling your business rather than a car. Non-competes, earn outs, sale of goodwill and intellectual property can all make what happens to your company after you sell it truly important, unlike that '94 Ford Taurus you just unloaded on Craigslist.

This article will discuss some of the basic financial issues in selling your practice, including what someone might be willing to pay, and how the payment can be structured. The second part of the article in the next issue will cover the assets sold, the purchase and contract and the process of selling your practice. These articles can only touch on some of the more important issues involved, and are not intended to be a comprehensive review of everything you need to know to sell your company. They are aimed to give a taste of the issues involved when someone sells a professional consulting practice in which they work full time.

What Will a Buyer Pay?

You may get a decent living out of your business, but that doesn't mean anyone else will be interested in buying it. A business that exists to pay you the same salary you could earn somewhere else has little real intrinsic value. No one is likely to pay you money to buy a job in which they earn the same as they could make elsewhere. To figure out what someone might pay, calculate the cash flow your practice generates **above** what you would have to pay someone to do what you do. For instance, if you earned $200,000 from the business in a year, and you would have to pay someone $190,000 to do the work you are doing, then the earnings of the business that someone else would be interested in is really only $10,000.

Other rules of thumb for valuation of a professional practice are one year's revenues, or two and a half times the owner's pre-tax income, plus net asset

- Assembling a "virtual firm,"
- Structuring your deal with partners,
- Managing intellectual property,
- Independent contractors vs. employees, and
- Taking a minority interest in a business.

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Ruth Ann Woodley, Editor
ph: 860.651.6236
ruthann@ruarkonline.com

SOA Staff:
Meg Weber, Staff Partner
ph: 847.706.9585
mweber@soa.org

values.[1] The seller usually keeps the accounts receivable and is liable for the accounts payable through the closing.

These calculations are a rough place to start in valuing a business. If you have great customer contacts and relations, otherwise known as goodwill, or some intellectual property that would cost a lot of money for someone else to develop, the right purchaser might be interested in your company. But if your business basically exists to pay you a salary, you are going to have to develop some other value to get anyone interested in paying a substantial amount for your practice.

How Will They Pay It?
When is the following equation true: $400,000 > $400,000 > $400,000? It is true when the first $400,000 is paid at the closing; the second equals $100,000 in cash at closing and a note for $300,000 secured by a mortgage on a house; and the third equals $100,000 and an earn out of $300,000 over three years, depending on the result of the acquiring company.

Cash. Payment of the full purchase price at the closing is the easiest and most certain, and the most like selling a car, but there are costs to it. Since all the risk of the business is on the purchaser, you can usually count on an all-cash offer being the lowest price available. If you have intrinsically valuable IP, such as software that would be expensive to develop, or long-term consistent cash flow from a wide base of customer that does not depend crucially on you, you can expect to get a decent all-cash price. If you are selling potential, you probably are going to get substantially more money with an earn out, discussed below.

Debt-Stock. Taking debt back can be almost like cash, or more like an earn out with limited upside depending on how any debt is collateralized. If the note you take back is well-secured, whether by real estate (such as the purchaser's house), a company of substantial size or a personal guarantee from a high–net-worth individual, there is probably not going to be a lot of credit risk. So long as you are getting a good rate of interest, there may not be much difference from an all-cash offer. In this circumstance, it is like selling a car; it's likely you'll get your money, so you don't really need to pay much attention to how your buyer runs the company after you are gone. If you do take any type of note back, cross default the note and any non-compete (discussed below) so you aren't bound by the non-compete if they have defaulted on the note.

If you don't have good security for the note, you really are sharing the risk of how the company does after the sale. If the company doesn't do well, and the buyer doesn't pay, you can get your company back. Of course, getting your company back after your purchaser has abandoned it is unlikely to be of much benefit to you, though you should get your intellectual property back. When you take back paper with inadequate security, your upside is limited (the most you are going to get is the amount of the note), and you have substantial downside (you might not get paid anything on your note). Particularly if you would not be getting back any valuable intellectual property, you might want to consider an earn out, discussed below, rather than take poorly collateralized paper. While you are sharing the downside risk in an earn out, you also have the opportunity to participate in the upside, as is discussed below.

Being paid by a grant of stock in the purchaser can provide upside that debt

Jacque Kirkwood, Staff Editor
ph: 847.706.3572
jkirkwood@soa.org

Sue Martz, Section Specialist
ph: 847.706.3558
smartz@soa.org

does not provide. Valuing a stock grant in a non-publicly traded company, especially taking into account restrictions on selling the stock, can be difficult. If you are getting stock, carefully review any applicable stockholders' agreement, particularly provisions regarding when you can be compelled to sell the stock, and at what price. Also, review my earlier article on issues when taking a minority interest in a business.

Earn Out. In most professional service businesses where the owner is an important part of the value of the company, you can expect to have an earn out. An earn out is when a portion of the purchase price is conditional on the company achieving certain financial measures after the closing. For instance, $500,000 might be paid at closing, with $250,000 due on the first anniversary of the closing if gross revenues exceed $2,000,000 for the year with a 20 percent margin, and another $250,000 after the second year if gross revenues exceed $2.5 million, with a 20 percent margin. With an earn out, you are sharing the risk of the success of the company after the closing with the buyer; if the company succeeds, you get more money. You can even have tiers of an earn out. For instance, in the earlier example, the payout could be $300,000 if the first-year gross is $2.5 million.

The structure of the earn out will be determined by what the parties want to accomplish. Is the earn out to be like a bonus in the event of extraordinary results? In that case, the intended purchase price would be paid at the closing, and the criteria for the earn out would be on the high side of probable results. Is it to make sure a seller who will continue to work for the company will keep results consistent? Then the earn out would be considered part of intended purchase price, and the criteria for the earn out would be based on the company's current results.

Structuring the terms of earn outs is complex. Will the purchased company be a subsidiary (that is, a separate entity with separate accounting), or will it be a division of a larger entity, in which case the accounting may not be separate? How much will the subsidiary or division be charged for overhead services (such as accounting, human resources or legal) that the parent provides to the subsidiary or division? By sticking your subsidiary with a high bill for overhead, the buyer can make sure you don't meet a margin criterion for payment of an earn out. If you will personally be performing services for the larger entity, aside from running the division, such as service on the Board of Directors or consulting for other divisions, will the subsidiary be credited with this? Will R&D you spend be counted as a cost, even though it is probably something the buyer wants you to do and will benefit the buyer? If your salesperson cross-sells product for another division or subsidiary, does your subsidiary get credit for the revenue, or at least get credit for the time the salesperson spends cross-selling for the parent? If you don't have a margin requirement, is there anything preventing you from selling at a discount to pump up revenue? Due to the incredible complexity of earn out formulae, you must ultimately depend on the good faith of the buyer. If you have reason to doubt that, you may want to settle for a smaller guaranteed cash payment, or cash plus well-secured paper instead of the risk and complexity of an earn out.

Depending on your business, there may be other structures for paying consideration for the purchase. You can expect some of the purchase price to be allocated as payment for the non-compete. You can enter into a long-term consulting or employment agreement. If you are depending on these amounts, make sure that conditions under which they can terminate you for cause and cease to pay under the agreement are extremely restrictive.[2] Do you own your building and lease it to the business? You either sell the building, or hold on to it and enter into a lease with the buyer to give you another revenue stream. In structuring purchase price allocations, work closely with your accountant at an early stage. Your individual tax situation, such as whether you have operating losses to use in subsequent years and how you are depreciating your equipment, can make a huge difference in how the deal should be structured to result in the smallest tax bite possible.

Conclusion

In the next issue, I will continue to discuss how to be a happy seller, covering what assets are likely to be involved in the sale, due diligence and the sale contract. By having a carefully considered and structured transaction, you will have a best chance of being the happiest of sellers: somebody pays you for your Corvette, you get to keep driving it, and the better it performs, the more you get paid.

David S. Rintoul practices with the firm of Brown, Paindiris & Scott in Glastonbury Conn., and represents many independent consultants and owners of professional practices in addressing the legal and business issues arising from a professional consulting practice. Join him for a December 9 webcast sponsored by the EA Section on "Starting Your Practice; Ready for Success." Find more information and register at the SOA Web site. And feel free to send any comments or legal or business questions that you confront in your practice to drintoul@bpslawyers.com *and they may be the subject of a future column. © David S. Rintoul 2008*

[1]Robert B. Scott, “Practice Valuation: Thumb Rules and Common Sense,” Journal of Accountancy 174.6 (1992). This article also has a longer explanation of the point made in the first section that no one is likely to buy your practice simply to buy a job.

[2]For a definition of cause strongly oriented to the employee, consider the following definition of “cause”: (i) the Executive’s willful and continued failure to substantially perform his duties under this Agreement, other than any such failure resulting from incapacity due to physical or mental illness, which failure has continued after a written demand for substantial performance, signed by a duly authorized member of the Board, is delivered to the Executive, specifying the manner in which the Executive has failed to substantially perform; or (ii) the Executive’s willful engagement in any malfeasance, fraud, dishonesty or gross misconduct, each of which must (x) be in connection with his position as the President and (y) materially damage the Company economically or otherwise.

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