Selling the Small Manufacturing Company:

Primary Considerations for the Entrepreneur

Chapman Associates

Mergers & Acquisitions

Overview

The business you've worked hard to develop may be your most valuable asset. Someday it may be sold due to retirement, relocation, disability, or investment cash out. You'll want to maximize the return on your investment of time and personal funds. The sales price you ultimately receive is your final dividend.

Divestiture of a manufacturing business poses serious challenges given the technical issues and complexities of converting raw materials and distributing products in a global market. Compared to the service sector, your workforce is better skilled, you maintain a more significant investment in capital equipment, and you face a higher level of business risk.

Furthermore, many domestic manufacturing companies' value has been adversely affected by cheaper imports from Mexico and China. Unlike service companies and retailers who compete locally, you're competing with the world.

Most small manufacturers serve niche markets. It's to your advantage to be able to document your strengths in protecting your market share. The price you'll receive for your business is influenced in one way or another by what you do better than your competitors.

Selling any business is like selling a house: *you must prepare it for the market.* But selling a manufacturing business involves more than just a fresh coat of paint. Buyers don't want your problems or surprises. They want a definable quantity, assurance of a going concern, and financial justification of their investment. Any risks and unknowns are discounted out of the purchase price.

Fixing problems requires time and money. If you believe your business may be up for sale soon, the time to start addressing issues is *now*. You're taking a risk by waiting for the last minute to get your house in order.

Anticipated future earnings drive the market value of your company. A projected upturn of profits can often be justified by efficiency improvements, new products, and market expansions. The reasons for poor historical earnings need to be addressed in your sales presentation.

Distressed businesses can be challenging to sell. Prospective buyers will inevitably ask, "If you can't make a profit, how can I?" The strategy here is to honestly identify the problematic issues and provide a plan for corrective actions. A buyer with prior experience in the industry sector is more likely to accept turnaround challenges.

How long will it take to sell your business once it's placed on the market? Three to six months is a reasonable estimate.

Other considerations for the business owner preparing to sell are discussed in the following pages.

Buyers

Your business buyer can be an employee, a family member, a competitor, a corporate investor, or an individual investor. The negotiation process will be affected accordingly. You may be more flexible when selling to an employee or family member. If you're dealing with a competitor, you'll be disclosing sensitive information that may be used to your detriment if the deal falls through. It's a good idea to start thinking early about your options for locating a buyer.

Valuation

Business valuation is a subjective process. The actual value of a business is what a buyer is willing to pay. Given the unique nature of production operations, the appraisal process is more challenging and should be performed by someone with a manufacturing finance background. The actual worth of a manufacturing business is often hidden in the numbers. Market-based valuation methods that establish value using industry sector criteria are frequently used. The aggregate value includes three primary components: fixed assets (real estate and equipment), inventory, and goodwill. The relatively high level of operational assets can create complex valuation issues.

Goodwill

Goodwill is that portion of the sales price that exceeds the net assets' fair market value and is the value attributable to earnings. Goodwill is where you earn real money on the sale. Without goodwill, you're essentially selling the company for what you put into it, excluding asset appreciation, in any.

Recast Earnings

Historical reported earnings must be "recast" to eliminate extraordinary and discretionary transactions and adjust for excess owner compensation. The objective here is to identify the enterprise's normalized earnings versus the paper earnings reported to the IRS. Recast historical earnings is the basis for establishing a projection of future earnings.

Due Diligence

Due diligence is the analytic review and verification of business operations that a buyer performs to substantiate valuation. The worst thing you can do is place a business on the market without performing internal due diligence. It's always to your advantage to identify problems and implement corrective actions *before* the buyer brings them to your attention and discounts your asking price. It would be best if you also were prepared to discuss and provide explanations for any open issues.

Deal Structure

You can divest a business by selling either the corporate stock or the business assets. Each method has advantages and disadvantages for the buyer and seller. Selling stock is easier to execute and avoids reincorporating but exposes the buyer to past acts' potential liabilities. If you sell only the assets, you're still responsible for existing liabilities and any future corporate transactions, and your workforce ends up with a new employer. Be careful with interstate transactions because securities laws may create transfer issues.

Financing

The buyer may expect you to finance a portion of the deal. You should establish your terms before placing the business on the market, keeping in mind that the installment payments will be coming from future earnings. If the buyer is a corporation, you'll most likely be offered stock as part of the deal. Be aware that the minority stock of a privately owned company has no ready market, and you're essentially trading the ownership of your company for another. If you agree to accept stock, you must perform due diligence on the buyer.

Tax Consequences

The profits you earn on the sale are subject to federal and state income taxes. Your tax exposure is affected by various factors such as type of organization, deal structure, and the carry forward of prior operating losses. A "C" corporation that sells only its assets may be subject to double taxation. You must complete your tax planning *before* executing the deal because the resulting tax consequences cannot be reversed.

Confidentiality

Selling a business can create problems with day-to-day operations. The resulting uncertainty may cause your employees to jump ship, your customers to find other sources, and your suppliers to stop offering credit. This is why you don't see "For Sale" signs hanging on factories. Your search for buyers and your eventual negotiation with them should be discreet. If possible, plan for off-site negotiations and due diligence work and be prepared for the buyer who insists on interviewing your key personnel.

Product Documentation

Will the new owner be able to manufacture products after you and other key personnel leave? Product documentation is a critical component of the business sale and includes bills of material, routing sheets, process sheets, prints, and similar data incorporating the latest engineering revisions. Such documentation will be scrutinized during due diligence, so it's wise to get it all in order.

Inventories and Fixed Assets

The issues here are 1) Do they exist? 2) How much are they worth? And 3) will they contribute to future operations? These are the questions a buyer will ask during due diligence. Small companies are often lax in conducting periodic physical inventories and may be carrying bogus assets on the balance sheet. Also, keep in mind that a fully depreciated asset may have significant market value. A buyer may request a supervised physical count and may ask you to match raw material stocks to a bill of material requirements. Get a head start by doing housekeeping, confirming asset existence, and disposing of obsolete items.

Productivity

The productivity of the business will be factored into the sales price. A buyer will be willing to pay more if the company is already using Lean techniques and does not require additional investment to move away from classic batch processing and its related inefficiencies. Some of the critical areas to address are redundant and complex setups, indirect workers, non-value-added activities, rework, delays, and long lead times.

Operating Systems

Your internal systems for accounting, performance reporting, order entry, internal control, and the like will also be reviewed during due diligence. Problems in these areas should be addressed as soon as possible to avoid credibility issues. If the buyer concludes that operating systems are inadequate, the replacement cost will likely be discounted from the sales price.

Strategic Planning

When you decide to sell, you should refocus your operations to maximize short-term cash flow. This approach will allow you to realize the highest sales price. Avoid discretionary transactions that drain cash without providing an immediate gain to your bottom line. These include new white-collar positions, major equipment purchases, research and development projects, and marketing campaigns.

Management Transition

If you're actively involved in managing the business, you may be required as part of the deal to provide your services as an employee for a specified period after the company is sold. The buyer may want you to remain close by to provide training and to ensure a smooth transition. Such a relationship can be a severe imposition if your objective is to retire or start another business, and you may be uncomfortable reporting to a boss. You should decide early about your post-sale availability as this issue may be raised during negotiations.

Business Prospectus

The prospectus is your marketing document presented to prospective buyers. It's your "packaging." A well-written prospectus will portray the business favorably but honestly and lay the groundwork for subsequent due diligence. After reading it, prospective buyers will decide whether to follow up on your offering or walk away. Be prepared to assemble a large amount of detail. A prospectus is typically 10–40 pages in length and is best prepared by a professional, given its technical nature. The sections usually consist of an executive summary, company description, product descriptions, ownership structure, historical financial performance, personnel, market assessment, sales overview, sale terms, and appendix.

Chapman Associates is an Illinois licensed business broker registered with the Securities Department of the Secretary of State. We provide a range of intermediary services for sellers and buyers, including valuations, prospect searches, due diligence, and market packaging.

Chapman is one of the most respected middle-market mergers & acquisitions firms in the country. Buyers and sellers have trusted Chapman Associates® since 1954. During that time, we have successfully sold over 2,300 middle-market companies worth billions of dollars.

We provide professional guidance so you can make intelligent decisions.

Contact us to arrange a free consultation:

1100 East Woodfield Road, Suite 434
Schaumburg, IL 60173
847.884.0010
www.chapman-usa.com

Mark L. Mroczkowski, CPA
Managing Director
mark@chapman-usa.com
407-580-5317
www.chapman-mlm.com

Manufacturing Company Due Diligence Checklist

Entity
___ Articles of Incorporation/Organization
___ Bylaws
___ Organization status
___ Ownership
___ Financing
___ UCC filings
___ Board minutes
___ Delegation of authority
___ Industry statutory law compliance
___ Contracts
___ Leases
___ Disaster recovery planning
___ Litigation and claims
___ Government audits

Historical financial performance
___ Five-year tax revenue and earnings
___ Five-year product line revenue and earnings
___ Extraordinary transactions

Products
___ Technology
___ Current products
___ Planned products
___ Services
___ Industry trends

Assets
___ Real estate
___ Inventory
___ Machinery and equipment
___ Construction-in-progress
___ Receivables
___ Other assets
___ Security

Accounting
___ Independent accountants' reports
___ Financial statement integrity and relevance
___ Software
___ Budget variances
___ Account detail and analysis
___ Cash flow
___ Records retention

Information Technology
___ Software licenses
___ Network configuration
___ Security
___ Backup

Government Filings
___Annual reports
___Income taxes
___Sales and use taxes
___Employment taxes
___1099's
___SEC filings

Human Resources
___Employment agreements
___Confidentiality agreements
___Union agreements
___Job descriptions
___Undocumented employees
___Uncompensated employees
___ Independent contractors

Risk Management
___General business
___Business interruption
___ Product liability
___Workers' compensation
___Errors and omissions

Production
___Bills of material
___Routing and process sheets
___ Procurement
___Lean practices
___Workplace safety
___Environmental protection

Engineering
___Patents and trademarks
___Research and development
___Sustaining

Sales and Marketing
___Customer base
___Competitors
___Web site
___Marketing plan
___Credit practices
___Order entry
___Pricing
___ Quotations and proposals
___Outside sales reps

Customer Service and Product Support
___Warranty policy
___Resources