by Dyanne Ross-Hanson

Upsize Minnesota

Seller financing not to be feared when planning firm's sale

SIZE DOES MATTER when it comes to designing an exit strategy for your business.

Buyer demographics, valuation multiples, completed transactions, financing structure and available debt are just some of the variables that differentiate "Main Street" companies, defined as those with a value up to $2 million, from "Lower Middle Market" companies, defined as those with a value between $2 million and $50 million.

According to the International Business Brokers Association (IBBA) and M&A Source, in partnership with the Pepperdine University, their latest Market Pulse Survey Report indicated a number of obvious, and not so obvious, conclusions. They included:

- Typical buyers for companies valued at $1 million or lower were dominated by individual, many first-time, buyers. Strategic buyers and private equity groups, typically well-funded, represented the vast majority of buyers for companies valued at $5 million or higher.
- The smaller the deal, the more likely it terminated without successful completion. Only 26 percent of companies valued at $500,000 or less successfully closed. This increased to almost 99 percent successfully closing, once the company reached $5 million or greater in market value.
- While lenders have increased their appetite for lending, they are far less likely to finance acquisition loans for businesses with less than $1M in annual revenue.
- For companies valued between $500,000 and $2 million, nearly one out of five buyers required the seller to accept some portion of their payment in the form of a seller's note receivable.

While seller financing comes with many pros and cons, understanding the most common design, terms and protective measures is the focus of this article.

Skin in the game

In today's marketplace, most small-business sales are financed, either through third-party financing or seller financing or some combination of the two. Most institutional lenders have two basic requirements before proving to be

tips

1. Once a price has been agreed upon, the first step is typically to require the buyer to provide some sort of skin in the game in the form of an out-of-pocket down payment.
2. This often represents a range of 10 to 25 percent of the purchase price.
3. The balance of the purchase price is then structured as an interest-bearing note, for a certain period of time.
4. While terms can be flexible, it is typically suggested that the interest rate be based upon your buyer's credit history, financial health and/or commercial market rates.

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a viable financing option. One, they need confidence in the borrower's ability to repay the loan. And two, they need collateral to sell, if the borrower does not or cannot pay back the loan.

If your buyer is internal, such as family members, co-owners or key employees, their leadership experience and qualified collateral is typically limited. If a seller is motivated to close a deal and has confidence in his/her successor's ability to run the business and credit history, he/she often facilitates the transaction by agreeing to finance some portion of the sales price.

What percentage of the price is typically seller financed? Much depends upon the strength of the business's cash flow, finances, operational efficiencies, customer diversity, forecasts, seller dependence, etc. The more attractive and self-sufficient the business, the less likely the seller will need to finance the majority of the deal. Some transaction intermediaries cite 60 to 70 percent of the sales price as typical in their seller financed deals.

Once a price has been agreed upon, the first step is typically to require the buyer to provide some sort of skin in the game in the form of an out-of-pocket down payment. This often represents a range of 10 to 25 percent of the purchase price. The balance of the purchase price is then structured as an interest- bearing note, for a certain period of time. While terms can be flexible, it is typically suggested that the interest rate be based upon your buyer's credit history, financial health and/or commercial market rates. Duration is typically 5 to 7 years, but with amortization calculated over a much longer period, such as 20+ years to make payments manageable.

At the end of the loan period, it is expected the buyer will make a balloon payment equal to the outstanding principal amount owed. The idea is, at that point, the business should be on solid ground and bank financing should be easier to secure.

It is also important to note, however, that the terms of the note should reflect the buyer's ability to make payments based upon realistic business cash flow projections. After all, if the new owner cannot manage note payments, plus extract a livable wage, the sellers are likely to find themselves unintentionally back in the driver's seat.

Safeguards to consider

What about protective measures for seller financed deals? There are a number to consider. First is incorporating provisions so if note payments are missed for 60 to 90 days, as an example, the seller has the right to take back control of the business. The seller might also restrict the buyer's sale of assets, acquisitions and expansions until the note is paid off.

Some sellers require the buyer to make a personal guarantee on the loan, or require the buyer to put up a personal residence as additional collateral (assuming there is significant equity in the home). Some buyers have other commercial real estate or investments that can provide more security. Lastly, the seller could require the buyer to secure a life insurance policy naming the seller as beneficiary. That way, should the buyer meet an untimely demise, the loan will be paid off in full.

Finally, it is important for the buyer and seller to avoid the tendency to do it themselves when designing and documenting this arrangement or any other exit strategy for that matter. Buyers and sellers should each involve their independent legal and accounting advisers, at minimum, when ironing out the details.

Accountants are needed to offer valuation opinion, review/recast financials, and review tax implications of the deal structure. Attorneys will draft the legal documents necessary to formalize the arrangement including a purchase agreement (the terms of the business sale), a promissory note (the loan document) and a securities agreement (which describes what and how the lender can access collateral).

Yes, the size of your business, be it Main Street or Lower Middle Market, often does dictate feasible exit strategies to consider, and may involve seller financing as part of the deal structure.

Don't be afraid of it, but do be aware of it, when contemplating exit plan options.

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