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Selling Your Business: How to Bridge the Seller vs. Buyer Price Gap?

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There comes a time when a business owner wants to take advantage of his/her hard work and is ready to cash out of the business. However, even when a buyer is found there are valuation issues and a number of legal concerns to address in order to protect the owner. What can you do when a purchase price cannot be agreed upon? This story is based on a true-story client dialogue (name and details changed to protect anonymity).

Client: “Hi Marty, I am calling you because I recently listed my surf industry business for sale with a broker and I already have a potential buyer; however, we can’t seem to agree on the selling price. Can you help? Do you have any ideas?”

Marty: “Brad, I’m very glad you called because I’m sure that I can help. Outside of the pricing issue, normally I work with clients before listing the business to prepare for many of the typical issues that arise, such as non-competition restrictions, consulting arrangements, warranties about the condition of the business, and indemnities for problems that may occur after the sale. However, since you’ve already started the process we’ll handle these issues after we deal with this price problem. Can you give me some background first?”

Client: “Well, I listed the business with a sale price of $11 million, hoping to get at least $10 million, which is what I feel the business is worth.”

Marty: “That sounds very typical to me. How did you determine that your business is worth at least $10 million?”

Client: “Things have been going well recently. Each year, for the past three years, my profits have been steadily increasing. I think that the profits will continue to increase. That’s how I determined the price.”

Marty: “OK, your thought process makes sense but what about the actual numbers? What are your profit numbers for the past few years?”

Client: “Marty, I projected that my profits for the next three years would continue to increase at about $250,000 per year, resulting in net profits of $1,750,000 next year, $2,000,000 the second year, and $2,250,000 the third year. This would be an average of $2,000,000 over the next three years. If I apply the “five times” factor to this projection, I think that a net sale price of $10 million is fair.”

(continued on next page)

Marty: “That sounds reasonable and plausible but a good portion of it is based upon future performance. How does the buyer feel about that?”

Client: “The buyer doesn’t want to pay my asking price because he is not sure that my business will achieve the results that I projected.”

Marty: “Does the buyer feel comfortable that your business is worth at least $7,500,000?”

Client: “Yes, he does. But he balks at paying the extra $2,500,000 because he doesn’t feel comfortable that my business will achieve all of my projections.”

Marty: “Understood. If the buyer bought your business at $7,500,000 and the profits stayed flat at $1,500,000 per year for the next three years, would you feel that $7,500,000 would be a fair price for your business?”

Client: “Yes, I would feel comfortable with that. But, it’s not going to stay flat. The profits are going to increase each year. I’m sure of it.”

Marty: “Well, there is a way that we might be able to bridge the price gap. The technique is called a ‘contingent earn-out.’ Have you ever heard of it?”

Client: “No. Can you explain it to me?”

Marty: “Sure. We structure the deal so that you get the minimum $7,500,000 up front. Then, we add a provision to the purchase agreement that you get another $2,500,000 if the average profits over the next three years are at least $2,000,000. That way, if your business achieves the profit goals that you’ve projected, you get your full $10 million. Both sides get what they want.”

Client: “That sounds great, but what if the profits are less than the $2,000,000 average that I’ve projected? Does that mean that I don’t get any of the extra sale prices?”

Marty: “No, it doesn’t. We can structure the earn-out language so that you get five times the amount of average annual profits in excess of the minimum $1,500,000. For example, if your business produces average annual profits of only $1,800,000 over the next three years, that would mean you would get five times $300,000, or an extra $1,500,000. Likewise, if your business produces average annual profits of $2,200,000, the result would be five times the extra $700,000 of average profits. This would get you an extra $3,500,000, for a total sale price of $11 million. Does that sound good?”

Client: “It certainly does. How do we get this done?”

Marty: “Brad, I’ll call your broker and we’ll modify the offer to include the earn-out, but we still need to address those other issues that I mentioned. Let’s schedule a meeting for the three of us to cover all the issues up front so that we have a unified response to the buyer.”

Epilogue: We had the meeting with the broker, we modified the offer and term sheet, the deal was closed, and the client eventually obtained his $10 million selling price. Of course, many other issues were addressed in developing an appropriate business valuation and protecting the owner from various legal concerns. This story exemplifies the importance of seeking legal counsel prior to and during the process.

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