SELLING THE SMALL MANUFACTURING BUSINESS

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Often the business an entrepreneur has strived to build and grow is their most valuable asset. In many cases the owner's "exit strategy" will be to sell the business, and they will want the maximum return from this "final dividend."

A manufacturing business is far more complex than a retail or services business, involving technology, machinery, raw materials sourcing and purchasing, production and operations management, distribution and marketing to a national and global marketplace, among other factors. The employees have specialized skills, the capital equipment is expensive, the logistics are intricate, and both the risks and potential can be greater.

The worldwide competition for a United States manufacturing company can impact its value, both positively and negatively. Demonstrating advantages over competitors is a key element of the value proposition.

Like any business, the manufacturing company must be prepped for the market—like "staging" a house for sale. The preparation for selling a manufacturer, however, is anything but superficial. One of the key values is sustainable, enduring business, from a diverse spectrum of steady reliable secure customers buying products experiencing continuing demand.

It takes time, effort, and expertise to properly position a manufacturing company for the maximum return on investment. A business broker with hands-on experience in owning and managing a manufacturing company is a priceless asset in that process.

While the market value of a manufacturing company is based to some extent on past performance, much depends on anticipated and predictable future earnings, both short-term and long-term. Plans and initiatives for increasing efficiency and productivity, introducing new products, and expanding markets can add tremendous value.

If there are problems, they need to be addressed openly and honestly. Current management needs to assess the steps that can be taken to overcome those deficiencies and determine if the potential benefit outweighs the cost. Sometimes the best course of action may be to be realistic about the value and offer the business "as is"; sometimes it pays to invest in the business to maximize the potential selling price.

Once the decision to sell has been made, strategies should change accordingly. Everything should be focused on maximizing short-term cash flow at the minimum cost. I describe it simplistically as "coupons not billboards." Non-essential discretionary spending

should end; and only expenditures that contribute directly and immediately to the bottom line should be made. No new management positions should be created or filled, no long-term marketing efforts or research projects should be initiated, and no major equipment should be purchased. But don't skimp on repairs and maintenance; you want a well-oiled, smooth-running, money-making machine with no cracks or squeaks.

Finding the right buyer is critical. Is the manufacturing company best suited to an absentee investor or a hands-on entrepreneur manager? An expert in this industry sector or a neophyte? An existing competitor or someone new to the industry?

Who the buyer is can affect the negotiation process. The buyer could be an employee, a relative, an individual or corporate investor, a platform company rolling up synergistic operations, a competitor. For each of these a different approach is needed.

Again, the experienced business broker can manage the process most effectively.

"What is my company worth?" For many types of business, especially retail and service companies, there are standard formulas that are regularly applied based on sales of comparable businesses. Valuation of the manufacturing company, however, presents a more complicated and sophisticated challenge. Each manufacturer is unique and the valuation process involves consideration of fixed assets (fixtures, equipment, and possibly, real estate), intellectual property (patents, trademarks, trade secrets, formulas), current inventory (raw material, work in process, finished goods), personnel, order backlog and future contracts, market presence, distribution network, the elusive "good will," and other factors unique to each manufacturer.

So, what is "good will"? Mathematically, it's the portion of the sale proceeds that exceeds the fixed tangible assets and other intangible assets paid for in a business sale (e.g., training, non-compete, intellectual property). This is the value of the earnings potential of the company. Basically, "good will" is the potential or ability of the business to generate profit in the future.

What is the earning potential of a manufacturing company? How is it projected and quantified? An old adage says that one who ignores history is doomed to repeat it. The first and best indicator of future earnings is past performance and, importantly, past trends. But what is the past performance? It can be best determined through "recasting" the company's profit and loss statements to reflect the true compensation received by the owner(s) by adjusting interest, depreciation, one-time or non-recurring expenditures, extraordinary and discretionary expenditures, and business expenditures that inured to the personal benefit of the owner(s). It's a complex process, involving both objective and subjective considerations. Again, this is a process that the business broker with manufacturing experience is best equipped to handle.

Valuation of the business can also be dependent upon whom the likely or actual buyer is. All buyers fit one of three categories. (1) The purchaser could be a "strategic buyer"—someone already in your industry seeking to expand market share or product offerings or capability. (2) The purchaser could be an "investor," seeking a business that can be run

by "semi-absentee management" with the existing management team or one brought in by the buyer. (3) And, lastly, the buyer could be a "career-seeker/entrepreneur," looking not just for an investment but also for a job with independence and security. Not only can the type of buyer affect the negotiation process, it can also affect the perceived value of the business in the eyes of the purchaser. Same numbers, but different value.

Part of this valuation process must be preliminary due diligence. Eventually a buyer under contract is going to be examining everything, and the best way to snatch defeat out of the jaws of victory is to encounter "surprises" at the eleventh hour. So, the wise manufacturing company owner should evaluate, objectively and dispassionately, the strengths, weaknesses, opportunities, and threats to the business, and be prepared to address any issues that could diminish the value to a prospective buyer.

Once the valuation is completed, the time has come to offer the business for sale. One critically important factor is absolute confidentiality. This is of particular concern to the manufacturing company. Unlike the service provider or retailer, the number of manufacturers in a particular sector is relatively small and the identity of the business for sale can be more really determined if the confidentiality isn't handled with great care. Why does confidentiality matter? Employees leaving, customers looking for alternate sources, suppliers tightening credit terms, competitors seizing an opportunity, lenders getting nervous, landlords considering their options. One of the most valuable services that the business broker provides is the marketing and promotion of the business in a way designed to get the maximum exposure with the least amount of disclosure—that's a tough call and part of the way they earn their commission.

Your business broker will also prepare the prospectus or confidential information memorandum ("CIM") to be given to potential buyers once they have signed a comprehensive nondisclosure agreement and have provided sufficient financial data to substantiate that they have the apparent ability to acquire the business. This prospectus is the first comprehensive "picture" that the buyer will see, and it's critical to the process. You don't get a second chance to make a good first impression. The CIM should describe the business in a positive light, but honestly and objectively. For a manufacturing company, this document could run 20 to 40 pages, and will include an executive summary, summaries of financial data for several years, descriptions of the company, details of the equipment and physical plant, product descriptions, market overview, sales history and projections, personnel information, terms and structure of the sale, and supporting material. Based on the CIM, potential buyers will decide whether to continue to the next step.

While the small manufacturing company can be sold by selling the stock of the corporation, this rarely happens. The usual transaction is the sale of all the assets of the business—tangible and intangible, with the possible exception of accounts receivable, accounts payable, and cash. There are many situations, though, particularly for a

manufacturing operation, where it would make sense to sell the accounts receivable and accounts payable as well.

There can be significant tax consequences to the manner in which the deal is structured. This should be discussed very early in the process with the seller's CPA and business attorney, even before the business is offered for sale; and the business broker should have access to the seller's CPA and attorney.

Often in the sale of a manufacturing business, seller-financing is expected; but, beware. The wary seller will require security in the form of personal guarantees of the principals of the buying corporation (and their spouses), a UCC-1 financing statement on all the physical assets, a lien on accounts receivable (both current and future), collateral in nonbusiness tangible assets, the right of reversion (taking back the company) in the event of a default. Also beware of the offer of stock in the purchasing corporation; a minority stock interest in a non-publicly-traded corporation is not only potentially worthless, it can also create a tax liability. (See my article on "*Overcoming the Minority Shareholder Disadvantage in the Small Business Corporation*.")

The sale process will typically involve the prospective buyer receiving summaries of financial and other data on the business, meeting with the seller, and touring the facility—either after hours or under the guise of being a potential customer, supplier, or "insurance appraiser." Then the next step is for the buyer to make an offer accompanied by a substantial deposit in escrow—5% to 10% depending on the size of the deal. Once the offer and acceptance process is over and a contract is in place, the seller has an absolute obligation to sell; but, the buyer's obligation is contingent on the buyer's satisfaction with "due diligence." This is not just the "tire kicking" stage, but the "let's take the engine apart and see how it runs" stage.

For the manufacturing business, due diligence is particularly intricate and involved. The buyer will examine all the typical factors: accounting and financials, human resources, suppliers, customers, equipment and physical plant, legal issues, etc. But, the buyer will be examining other matters unique to manufacturing.

Will key management and essential employees stay? If not, can the operations continue effectively with new personnel? The buyer will be looking for detailed documentation of all operating procedures and policies, bills of material, sources of supply, engineering specifications, prints and schematics, maintenance procedures, distribution channels and procedures, and more.

The buyer will also be giving close scrutiny to the physical plant and the inventories. Does the equipment really exist? What is their state of repair and functionality? How easily and inexpensively and quickly can they be repaired or replaced in the event of a failure? Are their dies, jigs, or fixtures off-site at sub-contractors? Is it clear who owns them? Is there custom-made tooling? What would be the impact of its failure?

Are the business operations inherently dangerous? Is there inordinate exposure to liability? Are there environmental or work safety issues? Is the seller currently insuring the risk adequately? How much will appropriate insurance cost?

Do the inventories actually exist and what condition are they in—both raw materials and finished goods? Are there redundant suppliers for critical raw materials? Can the buyer rely on just-in-time purchasing or will they need to stockpile materials in advance? Will preferential supply contracts be transferable to a new owner? Are there outside consultants or experts essential to the success of the business? Will those relationships continue?

Are the computer systems for tracking and managing finances, orders, operations, marketing, shipping, billing, etc. up to date? Is the software the most recent version? Does it work efficiently and reliably? Can it be transferred to a new owner?

Is the lease of the business premises transferable? On what terms? Can the business be moved, or must it be moved? What costs are involved?

Can contracts and purchase orders be transferred to a new owner? What about government contracts?

Another key issue in due diligence will be the transfer of knowledge from the current owner to the buyer. Often this will entail the seller staying on in an advisory/consulting/training capacity for weeks … or months. At whose cost? Under what conditions? How many hours per day, per week?

To the extent that all these due diligence issues can be considered and addressed in advance, under the guidance of a business broker with manufacturing experience, the eventual transaction will be smoother and more likely to succeed.

While selling the small manufacturing business is a complex and intricate process, using the expertise and skill of an experienced professional business broker can make this the ultimate reward for all the hard work and investment of time, talent, and treasure.

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About the Author:

With more than four decades of experience as an entrepreneurial manager, Tim Cunha has developed, purchased, and sold businesses in various fields, including computer hardware and software development, instrument manufacturing, biotech, wholesale distribution, publishing, marketing, and retail.

He founded Artronics, Inc., a graphic arts computer and software development company, in central New Jersey. Five years later, he sold it to Genigraphics Corporation, a former GE subsidiary, for several million dollars and corporate stock, and then served on their board of directors. He went on to handle numerous business transactions, including the transfer of intellectual property and the sale and acquisition of manufacturing businesses.

Tim earned a BA from Rutgers and a JD from Georgetown, is licensed to practice law in New Jersey (retired), and is a licensed California real estate (business) broker. He was the host of "The Business Beat" radio program on AM1220/KDOW.

Prof. Cunha taught undergraduate and MBA students on the faculty of the College of Business at Eastern New Mexico University, and prior to that was an adjunct professor at Stockton State College, Raritan Valley College, and Rutgers University. Currently, he teaches MBA students part-time as a Senior Lecturer on the Management faculty of a prestigious West Coast graduate school.