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Ask the Advisor

Intangible but valuable

A strong brand fosters growth, attracts buyers

A company's brand can help it grow and become more profitable, or it can be an obstacle. All else being equal, a company with a strong brand will be more profitable — and valuable — than one with a weak brand. That's at least in part because its customers are likely to be more loyal.

Brand can also make a difference when selling a business. A well-respected brand can be what initially attracts buyers to a company. And though brand is an intangible asset, professional valuators take into account brands when calculating the market value of a business.

Key components

A business's brand is made up of four key components:

1. Customers' and other outsiders' perceptions of the attributes of the company's products and services,
2. Perceptions of the business itself — sometimes referred to as its corporate reputation or image,

3. Perceptions of employees and the nature of their relationships with customers as they service a business's brand, and
4. The visual imagery, or graphic look and feel of the company.

This final component includes the appearance of products and packaging, corporate logos, business stationery and forms, advertisements, employee uniforms, and company vehicles.

Sometimes companies confuse their brand with their corporate identity. The difference is simple: A company's brand is how it's perceived by customers and others outside the company; its identity is how it regards itself. And it's always a mistake to assume the public perceives a company the way it regards itself.

Importance of a brand strategy

Of course, a business's brand can be affected by factors that are out of the company's control. Changes in the economy, the industry or competition can all damage a brand. There are, however, actions companies can take to shape external and internal perceptions of their firm, their products or services, and their employees. Taken together, these proactive steps are referred to as a brand strategy.

The branding process starts by understanding the attributes of the organization and its products and services in relation to others in its industry. Asking questions like these can get to the essence of the organization:

- Are the business's products or services high or low quality?
- Are they high cost or low cost relative to the competition?
- Is the company focused on growth or profitability?
- To what extent does the company value innovation, client service, integrity or other goals?

Once a company defines its cultural values and business strategy, management needs to communicate them clearly

and continuously throughout the organization. If employees don't understand and endorse the corporate values and strategy, they can't carry them out. Rewarding and recognizing performance that meets those goals is a particularly effective way of reinforcing them.

Shaping public perceptions

In addition to shaping the brand from the inside, a brand strategy must also address the many ways the business interacts with the outside world. Whether delivering products or services via sales, marketing, advertising, customer service, or other functions, a business should always try to differentiate itself from the competition.

> *Companies must know who their most important public constituencies are and how they view the company.*

For example, a business may have more branches in convenient locations than its competition does. Consistently emphasizing that message in brochures and ads will give customers a clear idea of the value the company provides.

Every single contact a business has with the public should strengthen its brand. This requires constant vigilance, because if a company doesn't work hard to control its reputation, others — competitors, disgruntled customers, the media and regulators — will.

Even large companies as sophisticated and successful as Nike have been hurt by underestimating the effects of certain public perceptions about them. Nike initially dismissed activists' complaints about working conditions in the overseas manufacturing plants of its subcontractors — until the unfavorable publicity on college campuses and elsewhere affected footwear sales and raised concerns on Wall Street. It has since adopted proactive strategies aimed at restoring its public reputation.

Feedback is key

Understanding — and acting on — how customers and others view the business is the final key to a successful brand strategy. Companies must know who their most important public constituencies are and how they view the company.

Market and customer satisfaction research is critical. An understanding of who customers are and how the company can best meet their needs will improve customer loyalty. This helps fuel growth and profitability during boom periods and sustains the business when the economy slows.

Valuing brands

Though brands — most often categorized as goodwill — are intangible assets, business valuators can attach an actual value to them using several methods. The most common is to measure discounted cash flow — or the present value of future cash flows.

Other methods measure the replacement cost of the brand (what it would take to rebuild it), or compare the relative value of a brand against those of competitors. Some valuation experts apply several approaches, combining financial-based methods with a subjective analysis of a company's brand strategy.

Big payoff

When it's time to sell, a strong brand will reinforce market value. Of course, most prospective buyers initially will be attracted by positive financial results.

But due diligence — including testimonials from customers, vendors, peers and even creditors — should reveal brand strengths that reinforce a company's financials.

Complete the deal *and* save on taxes

The benefits of installment sales for C corporations

The IRS defines an installment sale as a sale of property in which at least one payment is made following the tax year of the sale. Installment sales are common in the small business world, where buyers may not qualify for conventional loans that would enable them to buy a business outright.

Instead, sellers finance the purchase through a promissory note, and buyers use the cash flow of the acquired business to make loan payments over time. Access to seller financing can be one of the deciding factors for someone looking to buy a business.

An installment sale provides benefits to both parties to the transaction. But they vary according to how the business is sold — via a stock or asset sale — and whether you're a buyer or seller. If you're a C corporation owner, an installment sale can help you both reduce taxes and defer them over time.

Selling a C corp

An installment sale is a relatively simple transaction for a C corporation owner who sells company stock instead of company assets. If the owner has held the business's stock for more than a year, gains on the sale are considered long-term and are thus taxed at a lower, 15%, capital gains tax rate. The seller also defers taxes because gains are recognized only as installment payments are received over time — rather than all at once on the date of the sale.

As in any stock sale, the seller transfers the business's liabilities as well as its assets, unless the purchase and sale agreement provides otherwise. Transferring liabilities is generally to the seller's advantage.

All installment sales, including stock sales, have a downside for sellers: risk that the buyer will default on installment payments before paying off the loan. This risk is partially offset when the loan is adequately collateralized by the business's assets. And insurance policies on the value of the collateral can provide security for the seller.

Pros and cons

The buyer of C corporation stock benefits from the option to stretch payments out over time, and, if the transaction is seller-financed, the buyer with lower credit ratings doesn't need to worry about meeting the prohibitive standards of most conventional lenders.

As is true for both installment and noninstallment sale transactions, a major disadvantage for buyers in stock deals is that they may inherit past liabilities such as product-related and employee lawsuits, environmental damages and back taxes.

Buyers, therefore, need to perform careful due diligence to avoid unforeseen problems. Appropriate indemnification language in the purchase and sale agreements can also insulate buyers from these risks. Sellers, however, may not agree to the insertion of this language.

Lastly, buyers in stock transactions can't step up the current market value of the business's assets as buyers in asset deals do. By not being able to increase the tax basis of the company's assets, the buyer will have lower depreciation expenses for tax purposes, resulting in a higher tax bill.

Asset sales favor buyers

Selling a C corporation in an asset sale using the installment method offers benefits to both parties to the transaction, but the advantages are less favorable for the seller. In an asset installment sale, the seller can't protect its profits by reporting them as capital gains to the same extent it can with a stock sale. Most of the business's assets don't qualify for capital gains treatment, so profits from their sale are considered ordinary income. What's more, the seller can't defer payment of taxes on ordinary income, even if it receives the proceeds of the sale in installments.

The buyer, on the other hand, can benefit significantly from an asset sale because it can write up the value of purchased assets and then depreciate them for tax purposes. This helps boost the buyer's cash flow. The other benefit to the buyer is that the liabilities of the business remain with the seller, unless the contract provides otherwise.

Reporting profits as ordinary income

In asset deals, profits from the sale of accounts receivable, inventory and personal property used for a year or less are all considered ordinary income — not capital gains — for tax-reporting purposes. In addition, recaptured depreciation on personal property and real estate must be reported as ordinary income. Taxes on ordinary income can't be deferred over the life of an installment sale but must be paid for the year of the sale.

In general, only assets that have appreciated in value over and above their purchase prices qualify for capital gains treatment. From the C corporation seller's point of view, this makes a stock deal more attractive during an installment sale.

Right for you?

In a C corporation installment transaction, sellers prefer stock deals because they can treat the sale proceeds as capital gains rather than ordinary income. Plus, they can defer tax payments over time. Conversely, buyers prefer asset deals because they can increase the tax basis of depreciable assets, which lowers income taxes annually and increases cash flow.

Why would a seller agree to an asset deal, or a buyer agree to a stock deal? Sometimes there's no choice. The seller may be in a hurry, so the buyer can dictate the terms. Or the buyer can't get financing elsewhere, so the seller can dictate them. Installment sales continue with both asset and stock transactions because a less-favorable deal is often better than no deal at all.

5 things you should know about prospective M&A advisors

Selecting advisors is one of the most important decisions you can make when selling or buying a business. Because most of us don't have the knowledge, contacts and time to buy or sell a company on our own, deciding that an M&A professional can help you with the complicated process is an important first step.

Gathering information

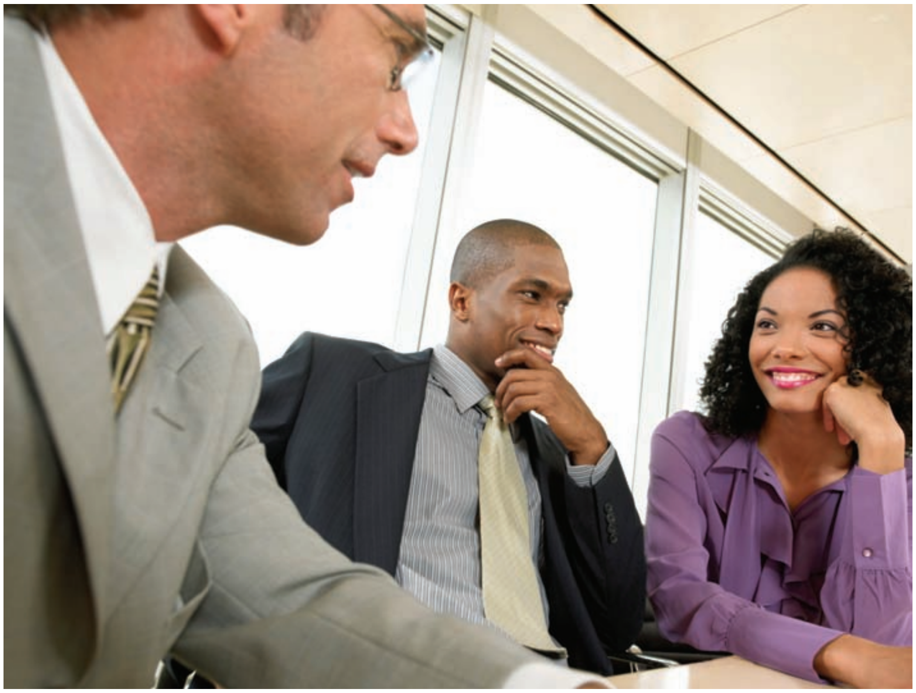
Fortunately, there are many qualified people willing to assist you. But how do you decide who'll represent you out of a pool of candidates, each of whom argues they're the best for the job?

These five general questions will enable you to narrow your list of prospects and select the advisor who best matches your business and your goals:

1. Training and experience. The M&A field is specialized and, depending on the transaction, may require specific training and experience. While working with you, your advisor may need to draw on knowledge of corporate finance, accounting, business valuation, contract law, real estate, insurance and negotiating.

So ask about the educational background, professional qualifications and, most important, work experience of your prospective advisors — including every member of the team.

2. Reputation. Request the names of at least three recent clients and contact them. The more references you talk to, the better. Ask past clients what the advisor did well and if they'd have any reservations about engaging the advisor again. Also get the names of attorneys, accountants, bankers and other professionals who work with the advisor. Are they reputable? The company your advisor keeps is a good indicator of his or her standing in the M&A field and business community.



client more than the other. Business brokers tend to work for people who want to sell a business, while investment bankers generally represent sellers and buyers. Either type of intermediary may be able to help you. What's important is their demonstrated knowledge of, and experience with, the kind of transaction you're seeking.

4. Contract and fees. Knowing how much advisors charge is as important as knowing what services they'll provide. Start by verifying the length of the contract and ask if the services will be unbundled or bundled.

If you think you may locate a buyer or seller yourself at some point in the process but know you'll need help with other aspects of the transaction, you can request a fee-reduction provision in the contract. But if you want the advisor to handle the entire process, a bundled contract is appropriate.

Further, learn how the contract is split among the upfront retainer, ongoing retainer payments and the success/placement fee. Finally, understand what percentage of the final sales or purchase price the total commission represents.

5. Personal qualities. A business relationship depends heavily on intangible, personal qualities. As you interview prospective advisors, ask yourself if they:

- Are good listeners,
- Seem interested in your goals and understand them, and
- Appear to be willing to take the time to complete the transaction to your satisfaction or are more focused on getting the deal done as quickly as possible.

Finally, does the advisor seem like a good negotiator? This is an extremely important skill when it's time to close a transaction. To make the most effective use of the answers, consider creating a grid and assigning scores to the responses of the prospective candidate.

Further, contact the appropriate regulatory agency to learn whether the advisor has been cited or penalized for questionable behavior. Your local Better Business Bureau and your state's securities regulatory agency may also have information on client complaints.

There are a number of professional organizations that educate and accredit M&A professionals, depending on their profession and type of expertise. Ask advisors about their professional affiliations and participation in continuing education seminars.

Ask past clients what the advisor did well and if they'd have any reservations about engaging the advisor again.

3. Strategy. A good advisor should have a well-defined strategy, so ask the advisor how he or she plans to meet your goals. Request a timeline with specific milestones and a detailed description of what the advisor will do at each step in the process. This includes what business valuation methodology the advisor or the advisor's valuator will use.

Some M&A professionals specialize in representing both buyers and sellers, whereas others focus on one type of

Making the decision

As you perform your due diligence, remember the three fundamentals of business relationships: cost, service and quality of result. When you find an advisor who can provide all three, you've found a good match.

Q. What does it mean when it's said "companies are sold, not bought"?

A. Many business owners know that selling their company is a future possibility, but may not realize how important it is to proactively market their firms to prospective buyers. The "sold, not bought" school of thought believes that it's unrealistic to wait for an unsolicited buyer to show up with an attractive offer.

Even when companies receive unsolicited offers, they're rarely prepared to evaluate and accept them. How do they know, for example, if the price offered is fair? As they do with their products or services, companies need to package their business for sale.

Experienced M&A advisors can help market your business in a way that gets attention from serious buyers. Usually, advisors start preparing your company for sale by "normalizing" your financial statements. This process, which involves adjusting your company's reported revenues and expenses, brings them in line with the expected accounting methods of likely buyers. Often, normalizing enhances the profitability picture of your business and makes it a more attractive acquisition prospect.

Advisors then circulate normalized financial statements and other information about the client's business to prospective buyers and intermediaries. Like any good matchmaker, M&A advisors refine their searches to concentrate on those likely to make the best offer — often strategic buyers. Strategic buyers seek synergies with your business and their own company and are therefore likely to offer a higher transaction price than strictly financial buyers.

To more effectively market your business, advisors might also suggest your company address perceived shortcomings. For example, you may want to eliminate excessive or unnecessary expenditures and equipment no longer in use but still on the books. This is also the time to make image-enhancing improvements, such as updating marketing materials, cleaning up facilities and closely examining your business's management team for weak links. All of these efforts should make your company more attractive to buyers and even help at the negotiating table.

But there's another school of thought among M&A professionals that's the opposite: Businesses are bought, not sold. This philosophy, in a nutshell, is that it's better to be approached by buyers that already perceive value in your business than to market to them. Instead of trying to convince potential buyers how valuable your business is — and risk appearing desperate to sell — it's better to let superior financials and a competitive position speak for themselves.

To put your company in such an enviable position, you must continually run it as if it's on the market, whether you intend to sell or not. This means producing strong cash flow and boasting a solid balance sheet at all times. The probability of a buyer knocking on your door, however, may be as likely as a college athlete being offered a professional sports contract. Generally, the "bought, not sold" philosophy works best for market leaders.

Whether they believe in "selling, not buying" or "buying, not selling," most M&A experts agree on one thing: Owners should prepare to sell long before they actually need to. Foresight can mean the difference between an offer you can't refuse and a deal you wish you didn't have to accept.