

Thoughts for All Those Planning on Selling Their Company, by Joseph P. Klock, Sep./Oct. 1997. © Copyright 1997 The REAL ESTATE PROFESSIONAL, Wellesley Publications, Inc., Needham, Massachusetts. All rights reserved. Reprinted by permission of the Publisher.

This article could be entitled "Admonitions for would-be FSBOBs" (For Sale By Owner-Broker). If the selling of a home is a highly charged event, fraught with emotion, so too is the very business which provided the income to sustain it.

Joseph P. Klock, CRB, CRS®, is the former Dean of Coldwell Banker University and a 48-year veteran of real estate. He is now actively engaged in writing, speaking, consulting and course designing. Joe is author of "Like Klockwork ... the Whimsy, Wit and (sometime) Wisdom of a Key Largo Curmudgeon," a collection of his short essays, writer/narrator of "In Search Of Maximence," a self-image seminar on audio cassettes and creator of "Management Awareness Workshop," a self-directed cassette/workbook program for new and aspiring managers.

Joe is a regular columnist for The REAL ESTATE PROFESSIONAL and may be contacted at 606 Island Drive, Key Largo, Florida 33037, 305-451-0079, through e-mail (joeklock@aol.com), or his Web site: <http://www.joeklock.com>

Thoughts For All Those Planning On Selling Their Company

By Joseph P. Klock

Five centuries before the birth of Christ, the Greek philosopher Heraclitus observed that there is nothing permanent in human affairs except change (he did not, of course, live to witness the American version of "temporary" taxes). Among the inevitable changes that occur in our business is the passing of ownership from human hands or a corporate entity to new proprietors.

When this occurs, for whatever reason, it usually becomes necessary to ascribe a value to the interest that is being transferred in order to facilitate the sale, merger, dissolution, partition or inheritance of the assets and future potential involved.

How that value is arrived at depends, in large measure, on the circumstances surrounding the change.

Obviously, in such matters as estate settlements, partner withdrawal or divorce proceedings, the evaluation process is little more than a sophisticated variation of bean-counting -- a subject with which we will deal last and least profoundly in a subsequent opus.

Our major objective here is to explore the voluntary transfer of a real estate brokerage operation from one party to another, the motivations that give rise to a "FSBOB" situation and the factors that impact the interests involved.

WHY PEOPLE SELL

Brokerage businesses go "on the block" for reasons as numerous as the full spectrum of virtues, capital sins and human emotions, but several predominate -- some of them having a measurable effect on the value finally agreed upon. Here are a few of the more common scenarios:

o Small to medium-sized companies with a profitable past are suddenly faced with a "lick 'em or join 'em" decision when a strong local company or national image enters the scene, threatening to impinge on the comfortable niches they have been enjoying. This fear is sometimes exacerbated by

a "wave of the future" warning, suggesting that if the little guys don't forthwith identify with a big image, they will go the way of the dinosaurs. There is no shortage of cases wherein this has happened, but there is an abundance of evidence that boutique operations can prosper in the shadow of the "biggies," assuming that they offer quality service and unique customer benefits.

- The advancing age, failing health or diminished drive of a (or the) principal mover and shaker, without a readily available replacement, clouds the company's future and jeopardizes the equity of its present owners, as time erodes present value and the vultures begin to circle overhead. Burn-out and want-out are conditions equally as serious and palpable as illness and old age. This occurs when there are no longer any attractive mountains to climb and/or when what was once a fire in the belly has become an annoying cramp.
- Changes in the nature of the business, when they unduly strain a broker's flexibility, can make an exit scenario attractive. Recent years have seen a lot of daunting changes in real estate brokerage, including anemic profit margins, burdensome commission splits, increased capital costs to keep pace with both technology and the Jones's Company and a litigiousness that often borders on stalking. (When businesses are sold "for reasons of health," it's sometimes because the owners are just sick of it!) One can easily empathize with the old-timers who wistfully recall 50/50 commission splits, low desk costs, one page contracts, and (seemingly) less carnivorous lawyers. In some of their eyes, caveat emptor has been replaced by caveat REALTOR®.
- In some instances, pressures peculiar to an individual business prompt consideration of a sale, merger or simple bailout. Included in this unlovely lot might be the uncertain economic future of the local market, excessive debt load, a succession of red-ink years, imprudent over-expansion, staff defections or a reduced desirability of the trading area, due to crime, pollution or other uncontrollable factors.
- Not to be discounted is the perfectly human urge to scratch a new itch, tilt a new windmill, mow what appears to be greener grass on the other side of the occupational fence, or just cash in the chips and smell a few roses. This temptation is intensified when an eager buyer appears on the scene with an attractive offer -- and it can escalate to the irresistible state when more than one suit-or is serenading under one's balcony. This was a not-uncommon situation a few years back when Sears and Merrill Lynch (neither now in the business) sought to acquire a presence in every size-able town on the U.S. map.

To make a long story longer, there are many reasons for selling a business, all of them legitimate, so long as they reflect the wishes and fill the needs of the vendors involved. But sellers do not a transaction make, unless there be a buyer to round out the deal. Our next logical path of exploration, then, must be to examine the motivations of those on the other side of the FSBOB transaction.

WHY PEOPLE BUY

To buy or not to buy? When that is the question, the answer comes easily to those with a clear picture of where they now are and where they would like to be positioned in the future. True buyers can be identified by their "DNA," an acronym standing for desire, need and ability to pay -- and while these factors may vary in importance, all three must be present.

Working backward through the acronym, it stands to reason that before buyers can truly be interested in making a move, they must have the ability to pay the price of the purchase or merger. The trail of real estate history is littered with the bleached bones of those who bit off more than they could

chew. The price includes both the obvious elements, like scheduled payments, and the future cash flows (both in and out) which are not so easy to predict.

Just as undercapitalization and poor planning account for the failure of most new businesses, acquisitions and mergers tend to fall victim to the same fiscal maladies, usually due to accentuating the positive on the estimated income side and viewing probable expenses and contingencies through the wrong side of the telescope.

As in all other forms of commerce, not all who have the ability to pay for an available brokerage are necessarily "live ones." Enter the need part of the formula.

Potential buyers may need the target firm in order to expand and/or diversify their scope of services without having to start from scratch in a new area, specialty or sphere of influence. This need may be driven by the demands of their existing customers, including corporate clients and relocation companies; it may be related to changes in the economic pattern of a present trading area, future trends in the community, the direction of migration, changing highway patterns, new (or faltering) industries, upgrading to a higher price range, or just to plug up holes in geographic and demographic coverage. Effectively meeting the competition may also mandate growth.

But, as in all other areas of human activity, "needs" are often invented in order to justify that greatest of all motivators -- desire. What people want to do is most likely to enhance their value as prospective buyers, not only causing them to rationalize and/or exaggerate needs, but to stretch their ability to pay (or assume obligations) beyond the limits of prudence.

The desire factor might include a wish to eliminate competition, to enhance the company's image, to effect economies of scale (one of the more overrated benefits), or to create a better bottom line through the "merge-then-purge" procedure (often euphemistically referred to as downsizing or restructuring).

Sometimes, existing activists in an established firm (sales associates and/or staff) want to take over in order to perpetuate the operation when one or more principals withdraws. These can often be the best buyers, because they have a high stake in the success of the firm and an excellent chance of retaining the existing book of business and customer base.

It goes without saying that, as with real estate buyers, there is a direct relationship between the intensity of the prospects' desire to acquire and the upper limit of the ultimate selling price.

WHAT MAKES A TARGET COMPANY ATTRACTIVE?

Obviously, the degree to which a target company can accommodate the "DNA" of prospective buyers is the most reliable measure of its attractiveness, but there are other features that contribute to its marketability.

One of these is the opportunity it may provide for buyers to "hit the ground running" in a new market, price range or sphere of influence where they are not now a presence. Clearly, there is no brokerage service that can't be duplicated from a standing start, but this is usually perceived by buyers as costing more in time and money than acquiring and continuing the momentum of an existing operation. Thus, a target company which provides profit opportunities that the buyers now lack is a natural fit.

Other "glamorizing" features might include premium locations, favorable leases, a protected franchise area, an excellent reputation and a well-trained cadre of staff, management and production personnel which can reasonably be expected to stay on after the changing of the guard.

Curiously, inept and obsolescent management can be a "plus," if it suggests to buyers that there are unexplored pathways to additional profit, through increased efficiency, more aggressive marketing, horizontal and/or vertical expansion, upgrading of facilities, computerization, centralizing records, "liposuction" of an overweight personnel roster, improved training methods, revised advertising policies, ancillary services added -- or all of the above.

Favorable terms, needless to say, are as much a positive factor in this situation as in any other facet of commerce. Minimal down payments, extended repayment schedules and "on the come" payout arrangements all serve to lessen both the initial pain of the buyers and their future risks.

Benefits to the buyers of an extended payout not only reduce the need for initial cash, but often result in the acquired company paying for itself out of future earnings (a strategy widely employed by most of the major acquirers). There is also the fact that future payments are all made with depreciated dollars, the present worth of which can drastically reduce the true selling price of the enterprise.

There is a growing trend among large companies to enhance profitability through alliances with other service providers as diverse as car rentals and aluminum siding -- usually on a scale that the smaller operator can't duplicate.

On the other hand, deferred payments are not all bad news to the sellers, since they mitigate the impact of taxes and, assuming the buyers' stability, provide an annuity-like stream of future income.

WHAT MAKES A TARGET COMPANY UNATTRACTIVE?

The following negative features are presented in no order of priority, since their importance will vary with the "DNA" of each individual prospective buyer. In reviewing them, keep in mind that each "defect" may be viewed by the buyer not only as an excuse to lower the offer, but as an opportunity to turn today's lemon into tomorrow's lemonade!

A personality cult, in which the goodwill of both the customer base and company personnel depends on the presence and influence of a powerful, charismatic leader or leaders, can be a red flag to prospective suitors, unless arrangements can be made to retain him, her or them for an extended period of transition after the sale. In this regard, it should be noted that the zeal of such dynamos is seldom as intense after the sale as before -- particularly if their pockets are stuffed with cash as they leave the closing table. Best remedy, along with a tight employment contract, is an "on the come" payout arrangement, making the continued profitability and growth of the enterprise consistent with the enlightened self-interest of the selling icons. Buyers would be (and usually are) well advised to make sure that the key personnel of the acquired company are bound to a detailed job description and subject to specific penalties for non-performance.

Dependence on one or two major sources of business is another flaw which makes buyers nervous; again, contractual guarantees and payouts contingent on performance mitigate this problem.

Onerous leases, entangling franchise agreements and long-term service commitments can be an obstacle to a meeting of the minds, but most such problems can be resolved by adjusting the price and/or terms.

Crippling commission splits, overimprovements, expensive perks, liberal spending habits and other burdensome policies are also a problem, not only with respect to their impact on future profits, but the possibility that they might corrupt relationships between the acquiring firm and its present personnel. Even more ominous are possible clashes of management styles and latent incompatibilities between the two "fiancee" companies.

The threat (or presence) of litigation looms as a dark cloud over all mergers and acquisitions. In most cases, this hurdle is covered by a combination of contingency reserves, hold-harmless agreements and "tail" coverage in the Errors and Omissions policies of the selling entity.

Most damaging of all, of course, is a poor company image, which might reduce the transaction to a fire sale of physical assets and pending business.

Again, the more compatible be the attractive features of the target company with the desires, needs and ability to pay of the prospective buyers, the better the chances of a favorable transaction.

SO, WHAT'S IT WORTH, ALREADY?

Fair question, and we'll tackle the mechanics in a subsequent issue, but this must be said, at least:

Unlike evaluating an automobile, a loaf of bread or a house, deciding what a real estate brokerage business is worth is, for the most part, a stroll in the desert. Except for past experience, which is available to a few activists in the field, there are no "comps" available on which to build a market analysis and set a price.

However, the general guidelines presented here, coupled with fair-minded people, joined in a sincere quest for a meeting of the minds, should suffice to mount a basis for continuing discussion until at least the bare bones of an agreement can be seen inside the fat of obstacles that need to be cut away.

In the end, if both the buyer and the FSBOB get most of what they want, they've come as close to the perfect deal as could an army of lawyers and bean counters. It should be noted -- and clearly understood -- that the perfect deal, like the perfect marriage, will be made only in heaven -- and will ever remain there!

Some Tips To FSBOBs

- If your payout is partially based on future net profits, be sure to retain enough control of the operation throughout the earnout period to protect yourself from policy, procedure, expense and personnel changes that might negatively impact your ultimate proceeds.
- Guard against costly expansion strategies and tactics that reduce current earnings and will not produce profits until after you're out of the picture. In other words, "milk it" or, if proposed changes threaten the pot of gold at the end of your earnout rainbow, have the right to renegotiate the terms of the agreement.

- Be cautious about accepting stock and notes from a weak, upstart or overextended buyer. Demand certifiable evidence of their solvency and stability.
- Don't try to "time" the sale in order to catch (or avoid) that elusive "wave of the future." Sell when your reasons dictate.
- Never sell so you can retire from a productive life. Hang on until you can retire to something at least as exciting and rewarding as what you'll be leaving behind. Few cases are more pathetic than the busy -- albeit harried -- practitioners who opted out of the "rat race," only to find that they missed running in the maze!

- Joe Klock

Thoughts for All Those Planning on Selling Their Company, by Joseph P. Klock, Sep./Oct. 1997. © Copyright 1997 The REAL ESTATE PROFESSIONAL, Wellesley Publications, Inc., Needham, Massachusetts. All rights reserved. Reprinted by permission of the Publisher.