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From the Editor

Congratulations! You made it through one of the hottest summers on record. Everyone took their vacations and your employees, customers and prospects are now ready for business. It’s time to make some sales.

The good news is you’ve wrung out incredible amounts of expense over the past few years. You’re now lean and mean. Some of your competitors likely have gone out of business. That means your share of the pie has gotten bigger. Pricing pressure even may have lessened a bit.

In short, there’s reason for optimism. Higher profits are in your future. The 2008/2009 stock market crash and big federal bailout were three years ago! The recent stock market swoon will also soon fade into the past and business will “get back to normal.” And now you’re better positioned than ever to make the most of it.

Let’s make the most of what’s left of 2011.

Sincerely,

David L. Perkins, Jr.
Managing Editor
The Business Owner Journal
FINANCE

SBA Can Improve Your Cash Flow

Where’s YOUR bailout?

Good question!! Apparently your business isn’t “too big to fail.” Well, neither is mine. Federal assistance really IS available for businesses like yours and mine. You don’t need to be a minority, and it’s not charity. It’s simply the tried and true federal Small Business Administration (SBA) loan guarantee program designed to improve availability and attractiveness of debt financing and refinancing for small U.S. companies.

It’s not a money grab, but it may be the closest thing you’ll find to “a little help from Uncle Sam.” No, the paperwork is not prohibitive, but it is detailed. Yes, the program still exists and the federal dollars are in place to make these loans happen. Banks are conservative by nature, but this economy has made them extra-cautious. SBA loan guarantees reduce the risk to banks so they can say ‘yes,’” commented SBA loan expert David H. Laughrey, president of The Laughrey Company. “Consolidating and terming out loans can reduce fixed obligations by 40 and 50 percent,” he continued. “It can be a real cash flow godsend for business owners.”

Many business owners collect loans over time — a real estate loan, an equipment loan or two, a working capital line of credit. Rolling them together and refinancing them over a longer amortization schedule can provide meaningful cash flow relief during slower economic times.

Skeptical?

Find out for yourself. Call your banker or email David Laughrey (laughreyco@cox.net). SBA also has a good website that gives general information about its programs and services at www.sba.gov.

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Summary of SBA Loan Guarantee Programs

<table>
<thead>
<tr>
<th>Program</th>
<th>Maximum Loan Amount</th>
<th>Percent of Guaranty</th>
<th>Use of Proceeds</th>
<th>Maturity</th>
<th>Maximum Interest Rates</th>
<th>Guaranty Fees</th>
<th>Who Qualifies</th>
<th>Benefits to Borrowers</th>
</tr>
</thead>
<tbody>
<tr>
<td>7(a) Loans</td>
<td>$5 million gross</td>
<td>85% guaranty for loans of $150,000 or less; 75% guaranty for loans greater than $150,000 (up to $3.75 million maximum guaranty)</td>
<td>Term Loan; Expansion/renovation; new construction; purchase land or buildings; purchase equipment, fixtures, lease-hold improvements; working capital; refinance debt for compelling reasons; seasonal line of credit, inventory</td>
<td>Depends on ability to repay. Generally, working capital &amp; machinery &amp; equipment (not to exceed life of equipment) is 5-10 years; real estate is 25 years.</td>
<td>Loans less than 7 years: max. prime + 2.25%, 7 yrs. or more; prime +2.75%; under $50,000, rates can be higher by 2% for loans of $25,000 or less; and 1% for loans between $25,000 and $50,000. Prepayment penalty for loans with maturities of 15 years or more if prepaid during first 3 years. (5% year 1, 3% year 2 and 1% year 3).</td>
<td>(Fee charged on guarantied portion of loan only) Maturity: 1 year or less 0.25% guaranty fee; over 1 year: $150,000 gross amount or less = 2%; 150,001—$700,000 = 3.0%; over $700,000 = 3.5%; 3.75% on guaranty portion over $1 million. Ongoing fee of 0.55%.</td>
<td>Must be a for profit business &amp; meet SBA size standards; show good character, credit, management, and ability to repay. Must be an eligible type of business.</td>
<td>Long-term financing; Improved cash flow; Fixed maturity; No balloons; No prepayment penalty (under 15 years)</td>
</tr>
<tr>
<td>SBAExpress</td>
<td>$350,000</td>
<td>50%</td>
<td>May be used for revolving lines of credit (up to 7 year maturity) or for a term loan (same as 7(a)).</td>
<td>Up to 7 years for Revolving Lines of Credit including term out period. Otherwise, same as 7(a).</td>
<td>Loans $50,000 or less; prime + 6.5%, Loans over $50,000; prime + 4.5%</td>
<td>Same as 7(a)</td>
<td>Same as 7(a)</td>
<td>Fast turnaround; Streamlined process; Easy-to-use line of credit</td>
</tr>
<tr>
<td>PatriotExpress</td>
<td>$500,000</td>
<td>Same as 7(a)</td>
<td>Same as SBAExpress</td>
<td>Same as SBAExpress</td>
<td>Same as 7(a)</td>
<td>Same as 7(a)</td>
<td>Same as 7(a)</td>
<td>Same as 7(a)</td>
</tr>
</tbody>
</table>

continued on page 4
### Standard Asset Based; Small Asset Based; Contract; Seasonal; and Builders

**CAPLines**

- **Maximum Loan Amount:** $5 million (small asset based limited to $200,000)
- **Percent of Guaranty:** Same as 7(a)
- **Use of Proceeds:** Finance seasonal and/or short term working capital needs; cost to perform construction costs; advances against existing inventory and receivables; consolidation of short-term debts. May be revolving.
- **Maturity:** Up to 5 years
- **Maximum Interest Rates:** Same as 7(a)
- **Guaranty Fees:** Same as 7(a)
- **Who Qualifies:** Same as 7(a), plus all lenders must execute Form 750 & 750B (short term loans) PLUS Lender Qualification Survey for Standard Asset Based CapLine
- **Benefits to Borrowers:** Funds short-term working capital Various lines of credit. Allows business to obtain contracts Larger in size for business growth Can be used to create current assets. Can be used to finance existing current assets

### Small / Rural Lender Advantage Loan (S/RLA)

- **Maximum Loan Amount:** $350,000
- **Percent of Guaranty:** Same as 7(a)
- **Use of Proceeds:** Same as 7(a)
- **Maturity:** Same as 7(a)
- **Maximum Interest Rates:** Same as 7(a)
- **Guaranty Fees:** Same as 7(a)
- **Who Qualifies:** Same as 7(a), Plus streamlined process
- **Benefits to Borrowers:**

### Small Loan Advantage (SLA)

- **Maximum Loan Amount:** $250,000
- **Percent of Guaranty:** Same as 7(a)
- **Use of Proceeds:** Same as 7(a)
- **Maturity:** Same as 7(a)
- **Maximum Interest Rates:** Same as 7(a)
- **Guaranty Fees:** Same as 7(a)
- **Who Qualifies:** Same as 7(a), Plus streamlined process
- **Benefits to Borrowers:**

### International Trade

- **Maximum Loan Amount:** $5 million
- **Percent of Guaranty:** 90% guaranty (up to $4.5 million maximum guaranty) (Up to $4 million maximum guaranty for working capital)
- **Use of Proceeds:** International Trade loan must be only for the acquisition of long-term, fixed assets used to produce products for export.
- **Maturity:** Up to 25 years.
- **Maximum Interest Rates:** Same as 7(a)
- **Guaranty Fees:** Same as 7(a)
- **Who Qualifies:** Same as 7(a), plus engaged/preparing to engage in international trade/adversely affected by competition from imports.
- **Benefits to Borrowers:** Long-term financing for land and building where assets are used to produce products for export.

### Export Working Capital Program

- **Maximum Loan Amount:** $5 million
- **Percent of Guaranty:** 90% guaranty (up to $4.5 million maximum guaranty)
- **Use of Proceeds:** Short-term, working-capital loans for exporters. May be used for revolving line of credit or for a term loan.
- **Maturity:** Matched single transaction cycle or generally 1 year for line of credit. (up to 3 years maximum)
- **Maximum Interest Rates:** No SBA maximum interest rate cap, but SBA monitors for reasonableness
- **Guaranty Fees:** Same as 7(a)
- **Who Qualifies:** Same as 7(a), plus need short-term working capital for exporting.
- **Benefits to Borrowers:** Allows specific financing for exporting without disrupting domestic financing and business plan

### Export Express

- **Maximum Loan Amount:** $500,000
- **Percent of Guaranty:** 90% guaranty for loans of $350,000 or less; 75% guaranty for loans greater than $350,000
- **Use of Proceeds:** Same as SBAExpress
- **Maturity:** Same as SBAExpress
- **Maximum Interest Rates:** Same as SBAExpress
- **Guaranty Fees:** Same as 7(a)
- **Who Qualifies:** Applicant must demonstrate loan will enable them to enter or expand an existing export market. Business must have been in operation for at least 12 months.
- **Benefits to Borrowers:** Fast turnaround; Streamlined process; Easy-to-use line of credit

### Dealer Floor Plan

- **Maximum Loan Amount:** $5 million maximum $500,000 minimum
- **Percent of Guaranty:** Same as 7(a).
- **Use of Proceeds:** Qualifying small businesses, including boats, automobiles, motorcycles, manufactured homes and RV dealers.
- **Maturity:** Minimum 1 year Maximum 5 years
- **Maximum Interest Rates:** Same as 7(a).
- **Guaranty Fees:** Same as 7(a) with the exception of the extraordinary servicing fee (fee cannot be greater than non-SBA loan fee)
- **Who Qualifies:** Same as 7(a).
- **Benefits to Borrowers:** Reasonable financing

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*continued on next page*
Revocable, Irrevocable & Living Trusts

A trust arises when legal title to property is held by one or more persons while its use, enjoyment and benefit belong to another. A trust may be created by agreement of the parties, by grant in a will, or by a court decree. However created, the relationship is known as a trust. The party creating the trust is the creator or settlor, the party holding the legal title to the property is the trustee, and the person who receives the benefit of the trust is the beneficiary. Every trust has a creator or settlor, trust property, a trustee and a beneficiary. Any person legally capable of entering into an agreement or contract may create a trust. Any type of property that currently exists and is owned by the trust creator may be contributed to a trust. Anyone legally capable of holding title to, and dealing with, property may be a trustee. The trustee has three primary duties: (1) to carry out the purpose of the trust, (2) to act with prudence and care in administering the trust, and (3) to exercise a high degree of loyalty to the beneficiary. No special skills are required of a trust under ordinary circumstances. There are very few restrictions on who can be the beneficiary. For example, a pet can be named as beneficiary. The most common types of trusts are express trusts. An express trust is created by voluntary action by written document or, under some conditions, an oral statement. Trusts are all irrevocable unless the power of revocations is specifically reserved by the creator/settlor. Trusts are usually created for a defined span of time. Death of the creator, trustee or beneficiary does not result in termination of the trust unless such is part of the terms established at origination. Living trusts are simply trusts designated to hold assets during an individual’s lifetime. They are most often used to avoid the public nature and expense of estate administration following death. Revocable trusts are more appropriate for this use than irrevocable trusts. In contrast, irrevocable trusts are often created by wealthy individuals who want their assets to be used for the benefit of a person who may need assistance in the management or administration of the assets. Trusts can be expensive to administer and can cause major problems for those who enter into them without competent legal and financial advice from an experienced estate planning attorney or financial planner. The trustee has three primary duties: (1) to carry out the purpose of the trust, (2) to act with prudence and care in administering the trust, and (3) to exercise a high degree of loyalty to the beneficiary. No special skills are required of a trust under ordinary circumstances. There are very few restrictions on who can be the beneficiary. For example, a pet can be named as beneficiary. The most common types of trusts are express trusts. An express trust is created by voluntary action by written document or, under some conditions, an oral statement. Trusts are all irrevocable unless the power of revocations is specifically reserved by the creator/settlor. Trusts are usually created for a defined span of time. Death of the creator, trustee or beneficiary does not result in termination of the trust unless such is part of the terms established at origination. Living trusts are simply trusts designated to hold assets during an individual’s lifetime. They are most often used to avoid the public nature and expense of estate administration following death. Revocable trusts are more appropriate for this use than irrevocable trusts. In contrast, irrevocable trusts are often created by wealthy individuals who want their assets to be used for the benefit of a person who may need assistance in the management or administration of the assets. Trusts can be expensive to administer and can cause major problems for those who enter into them without competent legal and financial advice from an experienced estate planning attorney or financial planner.
ECONOMICS

Federal Bailout, Three Years Later

On February 3, 1959, a small plane crashed near Clear Lake, Iowa, killing three American rock-and-roll pioneers on board: Buddy Holly, Ritchie Valens, and J. P. “The Big Bopper” Richardson. It became known as “the day the music died.”

On September 15, 2008, the U.S. Treasury and Federal Reserve chose not to rescue Lehman Brothers, which was crumbling under a mountain of toxic mortgages and mortgage-backed securities. Lehman filed the largest bankruptcy in U.S. history. The Great Recession ensued, and this day has become known by some as “the day the economy died.”

Stock markets worldwide, which already had been declining, crashed. Fears of a global financial meltdown spread, and in less than 30 days the U.S. Congress passed and President Bush signed legislation authorizing the U.S. Treasury to spend up to $700 billion as it saw fit to stabilize the financial system. This, on top of a $400 billion federal bailout signed into law a few months earlier (July, the Housing and Economic Recovery Act of 2008) to “shore up” Fannie Mae and Freddie Mac.

These were immensely controversial pieces of legislation. Three years later now, the “bailouts” are an emotion-filled issue playing a major role in our political discussions and elections. It is time we clearly document the facts and result of these programs and expenditures.

Federal Bailout #1: Housing and Economic Recovery Act of 2008. Signed into law by President Bush on July 30, 2008. Authorized the secretary of the U.S. Treasury to spend up to $400 billion to “shore up” The Federal National Mortgage Association (“Fannie Mae”) and The Federal Home Loan Mortgage Corporation (“FHLMC” or “Freddie Mac”). Both entities were established by the federal government — the former in 1938 and the latter in 1970 — to aid and expand the availability of financing for residential home purchases. Making home ownership more affordable and accessible to U.S. citizens, and thereby expanding the percentage of people who own homes, has been a major federal economic policy objective since the Great Depression. Fannie Mae and Freddie Mac were created by the federal government and “sold to the public.” Both were publicly traded entities and had been autonomously self-sustaining for many years until the mortgage debt crisis of 2008, brought on by lax mortgage underwriting standards used by mortgage originators (who sold their mortgages to Fannie Mae and Freddie Mac).

A total of $162 billion was invested in Fannie Mae and Freddie Mac, less than half the authorized maximum. None of the monies have been repaid, per se, but the investments yield a return in the form of dividends that to date (through June 2011) have totaled $24 billion, according to ProPublica, a self-proclaimed “independent, non-profit newsroom” tracking “every dollar” of federal “bailout” money paid out and returned.

- Dollars Spent: $162 billion
- Dividends Received: $24 billion
- Net Outstanding: $138 billion

There seems to be little hope for the near-term return of the entire amount invested by the government in Fannie Mae and Freddie Mac, but the eventual return of the funds remains possible, and the return of a material portion in the next few years is likely. In the meantime, the investment should continue to pay a dividend in the 6 percent range.

Federal Bailout #2: Troubled Asset Relief Program (TARP). Signed into law on October 3, 2008 as part of the Emergency Economic Stabilization Act (EESA). Authorized the Secretary of the U.S. Treasury to use up to $700 billion in federal (U.S. Treasury) funds to provide liquidity and capital where necessary to promote financial market stability. The two primary means were the purchase of sub-prime mortgages (to provide liquidity to holders of large portfolios of the same, such as commercial and investment banks), and the lending of funds (via debt, equity or quasi-equity) to businesses and institutions deemed by the Secretary to be critical to the financial system.

On July 21, 2010, the TARP funds maximum amount was reduced to $475 billion as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act signed into law by President Obama. The Treasury has obligated itself to $474.8 billion, and through June 2011 it had spent $411 billion. The largest recipients were AIG, General Motors, Bank of America, Citigroup, JPMorgan Chase and Wells Fargo. According to ProPublica, $312 billion has been returned (or earned), leaving $99 billion net outstanding under TARP. Estimates are for the net outstanding to fall to around $19 billion by the end of 2012.

Where we are today

Multiple groups track the bailout programs: Office of Management and Budget (OMB), Congressional Budget Office (CBO), U.S. Treasury and nongovernmental groups such as the New York Times and ProPublica.

continued on next page
Bailout* Monies Spent
(in Billions of Dollars)

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks and Other Financial Institutions</td>
<td>$245.2</td>
</tr>
<tr>
<td>Fannie Mae and Freddie Mac</td>
<td>$162.4</td>
</tr>
<tr>
<td>Auto Companies</td>
<td>$79.7</td>
</tr>
<tr>
<td>AIG</td>
<td>$67.6</td>
</tr>
<tr>
<td>Toxic Asset Purchases</td>
<td>$15.8</td>
</tr>
<tr>
<td>Mortgage Modification Program</td>
<td>$1.3</td>
</tr>
<tr>
<td>State Housing Programs</td>
<td>$0.4</td>
</tr>
<tr>
<td>Small Business Loan Aid</td>
<td>$0.4</td>
</tr>
<tr>
<td>FHA Refinance Program</td>
<td>$0.1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$573.1</strong></td>
</tr>
</tbody>
</table>

Less: Monies returned or earned ($335.5)
Net Outstanding $227.7*

* both the TARP and Fannie-Freddie rescues

TARP program loans continue to be repaid at higher rates than many originally feared, and TARP investments in companies such as GM and AIG are being exited at yields few thought possible. Most of the outstanding bailout money is in the form of equity ownership in troubled, or previously troubled, companies.

Should the government have intervened? Intervened to this extent? Was it necessary?
We will never know.

But what we do know is that very smart people at the U.S. Treasury and Federal Reserve believed at the time that massive federal intervention was necessary to avoid total collapse. Republicans and Democrats alike voted for both pieces of bailout legislation. Some $1.1 trillion in spending was authorized, but less then $600B was actually spent. The economy, although it remains weak, did not collapse. The stock markets have rebounded and the financial systems have continued to function. The $200 billion that remains outstanding is significantly less than the taxpayers’ cost of the savings and loan crisis of the late 1980s. The cost of that crisis amounted to 3.2 percent of GDP, while the GDP percentage of the current crisis’ cost is estimated at less than 1 percent. Further, there is good reason to expect the net cost to fall well below $100 billion in a few years, and potentially approach zero. This is because the monies were not “given out” but rather loaned (with repayment terms) or invested (in assets or equity).

As I look at the bailout today, I can’t help but be amazed — and relieved. The sky has not fallen and the monies are, to our surprise, being repaid.

RECENT BLOG POSTS
TheBusinessOwner.com/blog

“No Snitch” Culture in American Business
By David L. Perkins, Jr.
August 5, 2011

Again last week I encountered a businessman who declined to reveal the identity of an unscrupulous company. He had recently engaged the company and found its practices unseemly and designed to deceive. He readily shared with me his time- and money-wasting experience, but when I asked the name of the firm, he said, “I’d rather not say.”

Why protect the identity of a bad actor? Even if the harmed is unsure whether it was intentional, why not honestly share the experience and divulge the name?

We’ve all read about the “no snitch” culture that’s so strong in some African American communities. It hinders the efforts of law enforcement personnel and protects perpetrators of crime. I really think it exists to some extent in American business.

Can someone help me understand?

The rule of law and the fair system of justice for all are absolutely essential to quality of life for citizens and efficient operation of our free-market system. Equally as important for our protection and quality of life is casual, everyday sharing of information and experience. Gossip and “the grapevine” play a real functional role in helping us all make informed choices and avoiding harm. When a person refuses to share the identity of a bad actor, he or she denies others the opportunity to avoid a similar fate.

Is it that misery really does love company, so the harmed don’t really want to help others avoid harm? Fear of reprisal?

I say we tell the world our experiences — the good, the bad and the ugly — and share identities. Why not expose the bad actors? Maybe our “no snitch” culture is why so many scammers seem to be in operation today?
Estimating value of an income-generating asset or group of assets such as a business requires considering concepts such as the time value of money, risk and required rate of return. Here is a brief summary.

**Time Value of Money.** Most people would rather receive a dollar today than in the future, and would pay less for a dollar to be received in the future than today. This is the concept of *time value of money*. A dollar received today can be invested to earn a profit. The simple fact that a dollar received today can be deposited into a bank account to earn income supports the concept.

**Risk.** The level of uncertainty about whether expected returns will be realized is referred to as *risk*. Because virtually no investment is 100 percent certain to provide expected return, investors discount anticipated future cash flows by a rate greater than the standard for risk-free investment — U. S. Treasury obligations (the risk-free rate). When presented with an investment opportunity, one of the key tasks in assigning value is to estimate risk.

**Risk-Free Rate.** If receipt of a future stream of cash flows were completely certain, the discount rate used to convert them into present dollars would be the *risk-free rate*. For the past 100+ years, the financial world has looked to U.S. government obligations as the benchmark for risk-free investments, and we presume it still does. As such, we can look at the rate of return or yield paid or earned on U. S. obligations as a pure representation of the time value of money for investors. In theory, to entice investors to contribute money to an investment that is risk-free, a rate of return at least equal to the rate paid on U. S. obligations would be required. A one-year U.S. Treasury bill today earns around 0.2 percent, a very low rate historically.

**Discount Rate.** The rate at which future dollars are converted or discounted to present dollars is called the *discount rate*, also commonly referred to as the *hurdle rate*, *cost of capital*, *opportunity cost of capital* or *required rate of return*. The discount rate is made up of two components, the *risk-free rate* (to compensate for the time value of money) and the *risk rate* (to compensate for the uncertainty of the expected future cash flows). This can be represented by the equation $R_f + R = D$, where $R_f$ is the risk-free rate, $R$ the risk rate and $D$ the discount rate.

**Discounting.** The mechanism used to adjust the value of a dollar received in the future into value today is called *discounting*. If one were to determine that he or she would pay just 80 cents for a dollar that was certain to be received in one year, the implied discount rate is 25 percent. If the time value of money for this particular investor is consistent over time, then for every year a dollar’s receipt will be delayed, a discount of 25 percent will be applied.

The present value of a delayed payoff may be found by multiplying the payoff by a discount factor. If $C_1$ denotes the expected payoff at time period 1 (one year from today), then:

$$\text{Present Value (PV)} = \text{Discount Factor} \times C_1$$

The discount factor is expressed as the reciprocal of 1 + rate of return:

$$\text{Discount Factor} = \frac{1}{1+r}$$

The rate of return $r$ is the reward the investor demands for accepting delayed payment. If we use the numbers from the hypothetical example above, we find that $100,000 to be received in one year, discounted at 25 percent, is indeed $80,000.

\[
\begin{align*}
\text{PV} &= \frac{1}{1+.25} \times 100,000 \\
&= \frac{1}{1.25} \times 100,000 \\
&= 0.80 \times 100,000 \\
&= 80,000
\end{align*}
\]

To illustrate how this concept is applied, let’s assume we buy XYZ business and expect to receive $100,000 at the end of each year for five years. To calculate the present value, list the payment to be received in each year, then discount the dollars to the present value as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income to be received</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Discount rate (@ 25% per year)</td>
<td>.800</td>
<td>.640</td>
<td>.512</td>
<td>.409</td>
<td>.328</td>
</tr>
<tr>
<td>Present value of year’s cash flow</td>
<td>$80,000</td>
<td>$64,000</td>
<td>$51,200</td>
<td>$40,960</td>
<td>$32,768</td>
</tr>
<tr>
<td>Present value of business</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$268,928</td>
</tr>
</tbody>
</table>

*continued on next page*
The value of XYZ Company is $268,928 or the sum of the present values of each expected future cash payment. To avoid having to calculate each discount factor, refer to any present value table that can be found online (for free) or in the back of any finance textbook.

**Return on Investment.** The return on investment is generally referred to as the cash or profit gained from equity dollars invested. This is also referred to as Return on Equity (ROE). The return can be expressed as a dollar amount, or converted to a percentage by dividing the return by the equity deployed. Typically, returns are calculated on an annual basis and referred to as annual rate of return.

\[
\text{Dollars Received} \div \text{Dollars Originally Invested} = \text{Rate of Return}
\]

The return also can be calculated on total capitalization (debt and equity) as follows:

\[
\text{Dollars Received} \div (\text{Equity Capital + Debt Capital Invested}) = \text{Return on Total Capitalization}
\]

Example: If $50 was received in year one as a return on $200 invested, the rate of return would be 25 percent.

**Required Rate of Return.** When considering the discount rate or required return, it is helpful to study the historical returns of various investments. The table below lists the average annual total returns earned on a variety of investments. Each of the investments is publicly traded (due to lack of information available on private investments).

<table>
<thead>
<tr>
<th><strong>Average Annual Returns</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflation</td>
<td>3.1%&lt;sup&gt;1&lt;/sup&gt;</td>
</tr>
<tr>
<td>U.S. Treasury Bills (30 days)</td>
<td>3.7%&lt;sup&gt;1&lt;/sup&gt;</td>
</tr>
<tr>
<td>U.S. Treasury Bonds (5 years)</td>
<td>5.5%&lt;sup&gt;1&lt;/sup&gt;</td>
</tr>
<tr>
<td>U.S. Treasury Bonds (20 Years)</td>
<td>5.8%&lt;sup&gt;1&lt;/sup&gt;</td>
</tr>
<tr>
<td>L.T. Corporate Bonds (20 years)</td>
<td>6.2%&lt;sup&gt;1&lt;/sup&gt;</td>
</tr>
<tr>
<td>Large-Cap Stocks</td>
<td>11.8%&lt;sup&gt;1&lt;/sup&gt;</td>
</tr>
<tr>
<td>Micro-Cap Stocks</td>
<td>18.2%&lt;sup&gt;2&lt;/sup&gt;</td>
</tr>
</tbody>
</table>

<sup>1</sup> Source: SBBI Valuation Edition 2010 Yearbook. Returns are the average annual total (income and capital appreciation) arithmetic mean for 1926 to 2009 in the United States.

<sup>2</sup> Micro-Cap Stocks is defined as the portfolio of stocks comprising the 9th and 10th deciles of the New York Stock Exchange. According to the Center for Research in Security Prices, University of Chicago, the average capitalization of micro-cap companies from 1926 to 2009 was $68 million.

Each investment listed in the table above is publicly traded, thus marketable, i.e., it can be liquidated and turned into cash in about three days or less. The lowest historical rates of return were U.S. Treasury bills at 3.7 percent annually. The highest was micro-cap stocks at 18.2 percent. Of course, these were the investments with the lowest and highest risks, respectively. If we try to relate the returns on this table to small, privately held businesses, we can assume the required returns for such would be higher than the riskiest investment on the table — micro-cap stocks. The primary reasons are as follows:

1. The private company will be less marketable (very illiquid) than the average publicly traded micro-cap-size company and therefore riskier.

2. The average private company will be smaller than the average publicly traded micro-cap-size company and therefore has poorer access to equity and debt capital, lower levels of diversification, diminished opportunities to attract and retain talent, etc.

Business owners should have a working knowledge of the basic concepts of time value of money, return on investment and required rate of return. "Yeah, the 3D really brings it home, doesn’t it?”

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Today’s Business Sale Climate

Undeterred by the weak economy, a surplus of buyers remains ready, willing and able to purchase businesses of every size, and contrary to the ever-present scuttlebutt about banks not willing to lend, they are, in fact, making loans, including loans for purchase/sale of businesses. After all, that’s what commercial banks do. They must make loans to earn a profit.

The federal government, via Small Business Administration loan guarantees, makes it easier for bankers to say yes. Interest rates are very low, which lowers the cost of debt financing and raises the purchase price that can be amortized. Banks just need sensible deals, just as they always have. A sensible deal is one that cash flows with a reasonable cushion (the exact amount hinging on risk factors such as volatility of earnings) and also has a meaningful secondary source of repayment, i.e., collateral or a good personal guarantee.

Equity contributed by the buyer will reduce the amount that must be borrowed and thereby improve the cash flow, i.e., “bankability” of the deal. And when the sum of the equity contributed and debt that can be borrowed falls short of the purchase price, the only way to make it up is seller financing. Most deals include some seller financing. That’s just the way it is. Yes, and the bank will want the seller note and payments subordinated to the bank.

“Banks get a lot of flak as being unfriendly to business, unjustifiably in many cases, in my view,” says Brit Callahan, a private business owner. True, banks are not set up to take much risk. They earn a slim profit on each loan, and one bad loan can wipe out profit earned on hundreds. “Many people get confused between equity investors and commercial lending institutions,” Brit adds. “Equity investors are ‘partners’ of the owner as they are in the same position, as holders of equity. It’s referred to as risk capital because they take larger degrees of risk. They only get what’s left over after the liabilities and cost of the same have been paid. As compensation for their more risky position, they have the chance to earn returns far in excess of their lenders.”

Cash Flow is King

“It’s extremely difficult to sell a business that is not making a profit,” says Blayne Frieden, dealmaker with Acquisition Advisors. “Buyers just aren’t very imaginative. They assume what the business is doing now (and in the recent past) is what the business will do in the future. So if your business is performing well, this works in your favor. Storm clouds may even be on the horizon, but you will likely be able to get a deal done based on current (recent) cash flow. But if your business is not profitable, it’s almost impossible to sell the potential,” Frieden continues. “Try and you’ll almost certainly waste time and energy, unless you’re willing to give it away.”

And so the rich get richer. Those with profitable companies today can sell for a bit of a premium. This is because buyers of all types — individual, industry and private equity — are “out there” in great quantity; they just want profitable firms. Those earning profits today have the opportunity to sell for nice valuations as a multiple of cash flow. Owners of unprofitable businesses are stuck until they succeed in establishing a track record of profit.

Buyer Types and Selling Prices

“Much is written about business purchase prices and multiples,” says David L. Perkins, Jr., also of Acquisition Advisors, “but it’s not that darn complex and it doesn’t fluctuate all too much over time.” Businesses with less than $500,000 in annual earnings almost exclusively sell to individual buyers at multiples of EBITDA in the 2.5 to 4.5 range, depending on risk factors and rate of growth. Private-equity groups and corporate buyers (primarily peers and competitors) will begin to enter the picture as possible buyers as annual EBITDA exceeds $500,000 but don’t become real players until annual profits exceed $1,000,000. Purchase prices (for all the non-cash assets and the assumption of working liabilities of a business) are in the 4x to 5x range. Higher growth rates can command higher multiples, as can synergies with the buyer. When annual EBITDA exceeds $3 million, the industry, i.e., corporate and private-equity buyers, come out in full force. These are the deals that have been bid up of late because of the supply-demand imbalance. Multiples of 6x are now pretty common, and growth and synergies can raise prices further. Look at it this way: It’s a reward for being able to operate profitably during a very weak economy.

It’s a fine time to sell a business. Nothing is holding you back except, well, the performance of your business. Many businesses, of course, are struggling because of the moribund economy. Unfortunately, business salability and sale price are a function of current and near-term profit performance. There’s just no getting around it. If your business is performing well and you really want to do something different, it’s a fine time to exit. And you can expect to be rewarded for your business operating profitably during these difficult economic times.
Income Taxes Paid by U.S. Households

- $152,000 taxable income
- $136,452 after tax income
- $15,659 tax paid
- $484 tax paid

50% of households with above average annual incomes
50% of households with below average annual incomes

Median household income $50,221

$22,729 taxable income
$22,245 after tax income

50% of households with above average annual incomes
50% of households with below average annual incomes

Note: There are 140 million U.S. households. So, the groups above have 70,000,000 taxpayers each. The 50% of U.S. households that earn more than the median pay 97% of the taxes and retain 86% of all after tax income.

Effective Individual Income Tax Rate

- Lowest Quintile
- Second Quintile
- Middle Quintile
- Fourth Quintile
- Top 1%

Source: Congressional Budget Office.

Notes: Effective tax rates are calculated by dividing taxes by comprehensive household income.

Percent of Total Wealth Held by Top 1% (United States)


Tax Revenue as Percent of GDP

- Kuwait
- Iran
- Mexico
- Indonesia
- China, Republic of (Taiwan)
- Hong Kong
- Egypt
- China, People’s Republic of
- India
- Chile
- Bahamas, The
- Argentina
- Colombia
- Venezuela
- Korea, South
- United States (all levels)
- Jamaica
- Japan
- Switzerland
- Australia
- Ireland
- Canada
- Greece
- Poland
- New Zealand
- Israel
- Russia
- Portugal
- Spain
- Brazil
- United Kingdom
- Netherlands
- Swaziland
- Iceland
- Germany
- Italy
- Austria
- Finland
- Cuba
- France
- Belgium
- Sweden
- Denmark

Source: Index of Economic Freedom, The Heritage Foundation.

Note: Tax revenue as % of GDP obtained from individual country pages.
The sale of high-value assets is commonly made on “terms.” That is, the seller agrees to accept payment over time in “installments.” If there is a gain, should the tax bill on the entire transaction be due and payable in the year the transaction is consummated? What if the buyer defaults? What if the first payment does not provide enough cash to allow the seller to pay all the tax due?

Well, the Internal Revenue Services (IRS) actually wants you to remain solvent — so you can continue to pay taxes, of course! And so, there is the Installment Sale election. The election entails breaking up the transaction into a series of smaller transactions that “occur” when each payment is made. For example, if an asset is sold for $100,000, to be paid in five equal annual installments of $20,000, it’s like selling one-fifth of the asset in five consecutive tax years. So, if the seller’s basis in the asset is $50,000, the gain to be recognized with each payment is $10,000 or 50 percent. If your tax rate is 20 percent, then you’ll owe $2,000 in tax with each $20,000 payment received.

The above is a simplified example. Talk to your tax professional before selling any high-value asset. To be sure, every seller wants cash at closing, but in the real world it sometimes takes seller financing to get a deal closed. In the sale of a business, seller financing occurs more often than not.

The Fine Print

Taxes are paid only on “gains.” That is, the difference between your cost basis and sale price for any asset. Expenses associated with the sale are added to basis. Installment payments do not have to be equal dollar amounts, and not even fixed amounts (see Contingent Payments below).But tax due on depreciation recapture is not deferrable, so deprecion recapture tax is calculated at closing for the entire transaction. Only the capital gains portion of a sale may be “amortized” or deferred with the installment method election.

Interest Income

Capital gains tax rates are currently lower than ordinary income rates. Interest income is taxed as ordinary income. Interest paid to the seller on amounts financed by the seller is taxed in the year the payments are received. If the stated interest rate on an installment sale note is not “fair market” in the eyes of the IRS, the IRS may input a fair interest rate.

Business Sale

Most businesses sell with the “asset method” in which the buyer purchases all the assets of the business — inventory, tools, equipment, receivables, websites, company name, phone numbers, customer lists, files, etc. — for a single price. For IRS purposes, whether or not seller elects the Installment Sale method, the parties must agree on the allocation of purchase price among the various types of assets, using fair market value (FMV) as the guide. Once this is done, the seller can determine whether the installment sale method is available — and desirable — for any asset or group of assets.

Example: You sold your business September 1 for $220,000. The terms were $100,000 down and a note for $120,000. The note payments are $15,000 each plus 10 percent interest due every July 1 and January 1. Your selling expenses are $11,000.

To analyze the application of the installment sale method to this transaction, the first step is to calculate the percentage of your gross selling price taken up by your selling expenses. In this case, it’s 5 percent ($11,000/$220,000).

The FMV, adjusted basis and depreciation claimed on each asset sold are as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>FMV</th>
<th>Depreciation Claimed</th>
<th>Adjusted Basis</th>
<th>Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$10,000</td>
<td>-0-</td>
<td>$8,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Land</td>
<td>42,000</td>
<td>-0-</td>
<td>15,000</td>
<td></td>
</tr>
<tr>
<td>Building</td>
<td>48,000</td>
<td>$9,000</td>
<td>36,000</td>
<td></td>
</tr>
<tr>
<td>Machine A</td>
<td>71,000</td>
<td>$27,200</td>
<td>36,800</td>
<td></td>
</tr>
<tr>
<td>Machine B</td>
<td>24,000</td>
<td>12,960</td>
<td>22,040</td>
<td></td>
</tr>
<tr>
<td>Truck</td>
<td>6,500</td>
<td>18,624</td>
<td>5,376</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$201,500</td>
<td>$67,784</td>
</tr>
</tbody>
</table>

Under the residual method, you allocate the selling price to each of the assets based on its FMV ($201,500). The remaining $18,500 ($220,000 – $201,500) is allocated to goodwill (section 197 intangible).

The assets included in the sale, their selling prices based on their FMVs, the selling expense allocated to each asset, the adjusted basis and the gain for each asset are shown in the following chart.

<table>
<thead>
<tr>
<th>Sale Price</th>
<th>Sale Expense</th>
<th>Adjusted Basis</th>
<th>Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$10,000</td>
<td>$500</td>
<td>$8,000</td>
</tr>
<tr>
<td>Land</td>
<td>42,000</td>
<td>2,100</td>
<td>15,000</td>
</tr>
<tr>
<td>Building</td>
<td>48,000</td>
<td>2,400</td>
<td>36,000</td>
</tr>
<tr>
<td>Machine A</td>
<td>71,000</td>
<td>3,550</td>
<td>63,800</td>
</tr>
<tr>
<td>Machine B</td>
<td>24,000</td>
<td>1,200</td>
<td>22,040</td>
</tr>
<tr>
<td>Truck</td>
<td>6,500</td>
<td>325</td>
<td>5,376</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$201,500</td>
<td>925</td>
<td>-0-</td>
</tr>
<tr>
<td></td>
<td>$220,000</td>
<td>$11,000</td>
<td>$150,216</td>
</tr>
</tbody>
</table>

continued on next page
The building was acquired in 2002, the year the business began, and it is Section 1250 property. There is no depreciation recapture income because the building was depreciated using the straight-line method.

All gain on the truck, Machine A and Machine B is depreciation recapture income since it is the lesser of the depreciation claimed or the gain on the sale. The total depreciation recapture income is $5,209: $3,650 on Machine A, $799 on the truck and $760 on Machine B. As mentioned earlier, these gains are reported in full in the year of sale and are not included in the installment sale computation. Similarly, the $10,000 for inventory assets cannot be reported using the installment method. Inventory is simply excluded from the installment method.

The contract price for the installment sale totals $108,500. The assets included in the installment sale, their selling price and their installment sale bases are shown in the following chart.

<table>
<thead>
<tr>
<th>Selling Price</th>
<th>Installment Sale Basis</th>
<th>Gross Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land $42,000</td>
<td>$17,100</td>
<td>$24,900</td>
</tr>
<tr>
<td>Building 48,000</td>
<td>38,400</td>
<td>9,600</td>
</tr>
<tr>
<td>Goodwill 18,500</td>
<td>925</td>
<td>17,575</td>
</tr>
<tr>
<td><strong>Total $108,500</strong></td>
<td>56,425</td>
<td><strong>$52,075</strong></td>
</tr>
</tbody>
</table>

The gross profit percentage (gross profit ÷ contract price) for the installment sale is 48 percent ($52,075 ÷ $108,500). The gross profit percentage for each asset is figured as follows:

- **Percentage**
  - Land — $24,900 ÷ $108,500 22.95%
  - Building — $9,600 ÷ $108,500 8.85%
  - Goodwill — $17,575 ÷ $108,500 16.20%
  - **Total** 48.00%

The sale includes assets sold on the installment method and assets for which the gain is reported in full in the year of sale, so payments must be allocated between the installment part of the sale and the part reported in the year of sale. The selling price for the installment sale is $108,500. This is 49.3 percent of the total selling price of $220,000 ($108,500 ÷ $220,000). The selling price of assets not reported on the installment method is $111,500. This is 50.7 percent ($111,500 ÷ $220,000) of the total selling price.

Multiply principal payments by 49.3 percent to determine the part of the payment for the installment sale. The balance, 50.7 percent, is for the part reported in the year of the sale. When you receive principal payments in later years, no part of the payment for the sale of these assets is included in gross income. Only the part for the installment sale (49.3 percent) is used in the installment sale computation.

The only payment received in Year 1 is the down payment of $100,000. The part of the payment for the installment sale is $49,300 ($100,000 × 49.3 percent). This amount is used in the installment sale computation.

**Installment income for Year 1.** You figure installment income for years after Year 1 by applying the same gross profit percentages to 49.3 percent of the total payments you receive on the buyer’s note during the year.

**Contingent Payments**

A contingent payment sale is one in which the total selling price cannot be determined by the end of the tax year of sale. This happens, for example, if you sell your business and the selling price includes a percentage of its profits in future years. If the selling price cannot be determined by the end of the tax year, you must use different rules to figure the contract price and the gross profit percentage than those you use for an installment sale with a fixed selling price. For rules on using the installment method for a contingent payment sale, see Regulations section 15a.453-1(c).

Selling an asset with terms? Don’t pay the entire tax bill now. Pay it as you receive the payments. The methodology may appear complex, but it’s simple in its essence. Turn the details over to your accountant.
“Healthy-looking people are more likely than sickly ones to be repaid when they lend money or perform a favor. It appears humans want to maintain amicable relationships with people that will live longer and have more time to ‘make it worth our while.’”

Apparent Health Encourages Reciprocity, May 2011, Evolution and Human Behavior
To Maximize Value, Be Open to Seller Financing

Naturally, you want 100% cash at closing. We all do, but studies show* you’ll receive a lower total sale price if you refuse to provide any seller financing. This is because the amount of cash the buyer has, and the amount the banks are willing to lend, are fixed. If you don’t accept seller financing, the sum of the buyer’s cash and bank financing will be the maximum you receive at closing. Now, would you like more? Well, then offer some seller financing. Worst case is you don’t get paid your entire seller-financing portion, but you receive more than the all-cash price!

You see, we don’t suggest that you agree to forgo up-front cash in lieu of a promise to pay, i.e., a “note.” Of course not. Insist that the buyer contribute all the equity and bank debt that he or she can, but once these are maximized, why not get some additional “paper” from the seller? You have nothing to lose.

*Transaction Patterns by Toby Tatum
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