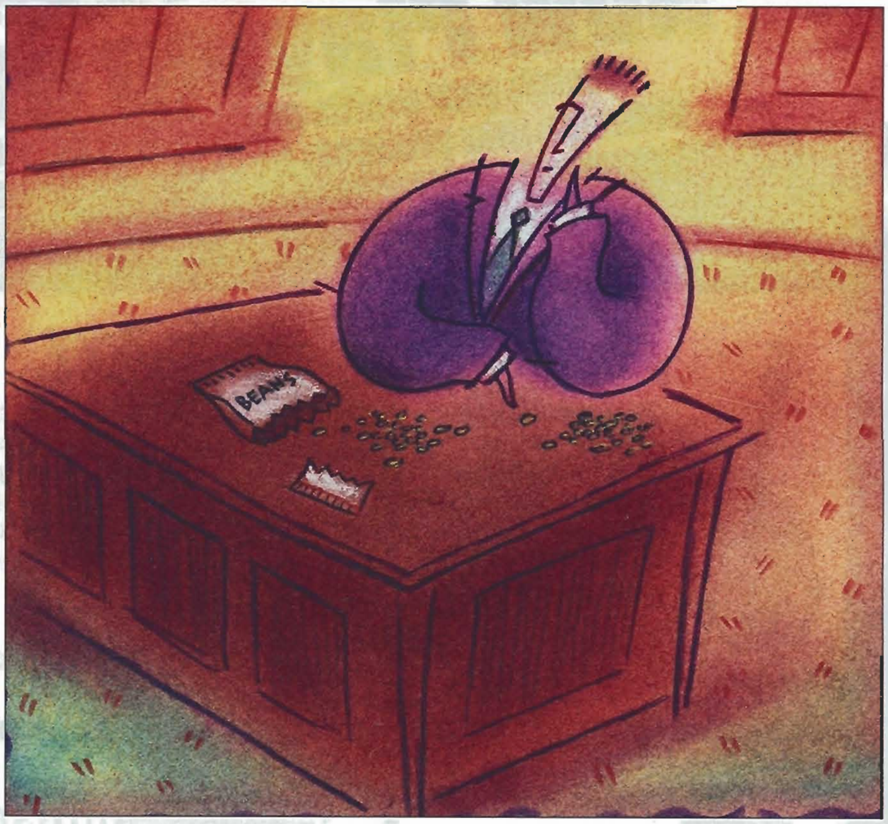
by Alan Friedman

To Hold 'Em or Fold 'Em?



The toughest issues are often best addressed head on, so let's be blunt. Every day music retailers find themselves competing in a marketplace of big-chain, catalog and internet retailers, with a few other well-known players on a hunt to acquire school music dealers.

Add to that stiff competition from local retailers who may be slashing product and rental prices in order to retain market share or just stay alive one more day. Throw in some uncontrollable factors like a questionable economy (evidenced by the continual wave of corporate layoffs) as well as the threat of domestic terrorism, and you have the most volatile music retailing marketplace this industry has seen in the last 50 years.

Consider the unexpected sell-out and demise of some well-known stores, and what do you have? The flawed conclusion that "a tough marketplace + well-known stores sold = sell now before it's too late!" So run out and put your "for sale" sign up, because you've just bought into the biggest and latest bag of music retailing propaganda and bulls**t. (I'll explain why in a minute.)

That's not to say that selling your company isn't the right thing to do given the right set of circumstances. But what's more important is that you address certain fundamental issues before you even think about selling your store. That will help you determine if it's time to hold 'em or if it's time to fold 'em.

That said, here is Part 1 of a two-part series that will examine the ramifications of selling your music store. This month, we will deal with the most important things to consider in selling your store. Next month's Part 2 will shed light on how to determine your store's potential selling price and buyer.

The End Is Not Near

For heaven's sake, don't believe all that crap about "you better get out now while the getting out is good."

First of all, the "getting out" isn't so good. The few large music retailers that are acquiring school music dealers aren't exactly paying top dollar for those stores. For the most part, they simply look at cash flow and ignore many of the other intangible assets that add to a store's net worth.

Second, there will be many costly mistakes made by the "big three" superstore music chains. Mark my words, the final chapter has yet to be written. You will see stores close, you will see a retreat back to home markets and you will see a merger if not an outright bankruptcy.

Third, the independent music retailers in this industry have two major factors in their favor: 1) longstanding relationships with their customers and community, and 2) sheer tenacity—two characteristics that will undoubtedly bring longevity to their business.

Lastly, there are scores of legitimate reasons why business owners decide to sell their stores, like retirement; no "next generation" of family members or management; diminished interest in the business due to boredom or frustration; illness or death of one of the principals; disputes between owners; loss of key employees; a desire to reduce risk; or the lack of working capital or expertise to grow the business any further, to name a few.

Stores get sold for a variety of reasons other than because they're losing money. And just because they're losing money doesn't mean they need to be sold. Don't forget, many problems can be fixed with a little bit of direction and earnest effort. So relax, the wolves are not at your front steps. That said, let's first address the emotion involved in selling your store.

Emotional Rescue

Selling a business is very different than selling a house, a car or any other asset a person owns. A business is not only an income-earning asset, it's a lifestyle as well. Therefore, the decision to part with it can be extremely emotional. Personal goals need to be weighed against economic consequences to achieve a properly balanced decision to sell or not to sell.

There's an old saying that "timing is everything." Smart business owners know to carefully consider all factors relevant to the decision to sell. They recognize that a business should be sold only after careful consideration, and not because of sudden personal frustration or a short-term downturn in business. They also know that negotiating from a position of strength, not weakness, will yield the highest selling price.

Buyers Beware, Too

For those of you who are reading this article as a potential buyer, carefully think through your motives and selection criteria when considering the purchase of a music store.

A buyer should consider their experience and desire for quality of life. If a buyer develops interest in a business that has a niche product or service outside their area of expertise (i.e. instrument rentals), then the buyer should make certain that key employees will stay on after the change in ownership or they can find and hire the needed expertise.

Identifying the desired location or locations should be equally important to the buyer as well as the amount of money they're willing to invest in those locations. If cash money is not readily available, the buyer needs to assess the realistic possibilities of obtaining funds from outside sources. The buyer should also consider the size of the new business in terms of sales, gross profit, overhead, net income and number of employees, as well as the effect the new business structure will have on the current business practices, financial reporting and product distribution channels.

Remember, a buyer will be acquiring either a profitable and stable business or one that has been losing money and in need of new management. The more profitable and stable a business, the more it's going to cost in terms of purchase price. The less profitable and stable, the more it's going to cost in terms of funding after the purchase.

Step 1: Brace Yourself

So let's talk about the most important factors to consider and steps taken when preparing your business for sale, as follows:

1. Documenting Financial Profitability and Stability. Nearly every closely-held business operates in a manner that minimizes annual federal and state income tax liabilities. Unfortunately, these accounting practices and tax minimization techniques—which effectively reduce net taxable income—also minimize the value of a business.

As a result, there's often a conflict between operating a business in a tax-efficient manner and preparing the business for sale at the highest possible selling price. Although it is possible to reconstruct financial statements to reflect the actual operating performance of the business, this process may also require the owner to pay back income taxes and penalties. Therefore, plans to sell a business should be made years in advance of the actual sale. This will provide the time required to make necessary changes in accounting practices that demonstrate a three- to five-year track record of maximum profits.

Without exception, music stores should be properly accounting and reporting their financial results on an annual basis via financial statements that are compiled, reviewed or audited by an independent CPA firm. Proper accounting includes the write-off of bad accounts receivable, the write-down of old or obsolete inventory, the deprecation of fixed assets and rental instrument pools over their useful lives and the recording of all known and measurable liabilities.

Although they're costly, audited financial statements are best because they contain a full financial disclosure of the business and have been subjected to the rigorous examination and scrutiny of an independent CPA firm. However, it's not absolutely necessary for financial statements to be audited for a seller to convey financial assurance. In that most financial statements are either reviewed or compiled, an interested buyer is going to perform their own due diligence on the books and records of an acquisition candidate.

Frankly, it's more important that compiled financial statements (the lowest level of CPA assurance) accurately account for and reflect a business that is profitable and stable than audited financial statements of a company performing poorly. Then again, audited financial statements of a profitable and stable company will provide the best assurance to a potential buyer that the business is not utilizing questionable accounting practices in the reporting of its profitability.

2. Determining the Value of Your Store. Determining the value of a business is the part of the buy-sell transaction most fraught with potential for differences of opinion. Buyers and sellers usually do not share the same perspective, as their objectives are polar opposite—the buyer wants to purchase the store for as little as possible, the seller wants to get as much money as possible. Each has a distinct rationale, and that rationale may be based on logic or emotion, or some of both.

The buyer may believe that the purchase will create synergy or an economy of scale because of the way the business will be operated under new ownership. The buyer may also see the business as an especially good lifestyle fit. These factors are likely to increase the amount of money a buyer is willing to pay for a business. The seller may have a greater than normal desire to sell due to financial difficulties or the death/illness of the owner or a member of their family. These factors are likely to lower the amount of money a seller is will take for the business. For the transaction to come to conclusion, both parties must be satisfied with the price and be able to understand how it was determined.

Accordingly, a business valuation report should be prepared. The valuation report eliminates painful guesswork of determining a fair price that can be relied on. The report should be an integral part of a business presentation package that addresses all facets of the business, including (a) its history; (b) a description of how the business operates; (c) a description of the store's facilities; (d) its suppliers; (e) marketing practices; (f) a description of the competition; (g) a review of personnel including an organizational chart, description of job responsibilities, rates of pay and willingness of key employees to stay on after the sale; (h) identification of the owners; (i) an explanation of insurance coverage; (j) a discussion of any pending legal matters or contingent liabilities; and (k) a compendium of three- to five-years' financial statements.

3. Finding a Buyer. There are a few different ways to find a buyer, including print advertising, trade sources and intermediaries.

Print ads in business sections of newspapers or trade magazines usually describe the business in several short phrases and keep its identity anonymous by listing a phone number or post office box for reply. The ad should communicate the business' best qualities—both financial and non-financial—and include a qualifying statement describing the kind of cash investment or experience required. A telephone number in the ad will draw more responses than a post office box number, but may not permit anonymity.

Trade sources can be a viable channel to sell your store, as key people within the industry, such as suppliers, often know when businesses come up for sale and may be aware of potential buyers. Both NAMM and Music Inc. can help communicate that your store is for sale in a variety of confidential ways.

Business opportunity intermediaries—like business brokers, merger and acquisition specialists, CPA firms—help sellers find potential buyers and often assist in structuring the sale of business. These intermediaries usually ask for a contract with a 180-day or more exclusive right to sell the business, and usually charge a fee based on a fixed percent (usually between 5- and 10 percent) of the purchase price. These specialists often receive a fee in advance to perform some tangible service such as preparing a presentation package for prospective buyers and a valuation report.

An experienced intermediary can

offer assistance in (1) pricing the business; (2) setting the terms; (3) compiling a comprehensive presentation package; (4) professionally marketing the business; (5) screening potential buyers; (6) negotiating and evaluating offers; and (7) making certain that proper legal steps are taken. The result can be a considerable saving of the business owner's or business buyer's time and effort.

4. Get Ready for Steps 4,5,6,7. Once you've found a potential buyer, be prepared for some detailed scrutiny. The potential buyer will want to review business history, understand the way it operates, its business methods of acquiring and serving its customers as well as how sales, marketing, finance and operations interrelate. Then there's a detailed analysis of financial statements, tax returns, financial ratios and cash flow over the past three- to five years.

Based on that financial analysis, discussions and negotiations will begin concerning the purchase price, structuring the transaction and financing the acquisition. Advisors (industry consultants, business brokers, business valuation experts, accountants and attorneys) are usually brought in for professional advice with regard to transaction structure (stock vs. asset purchase), verifying that financial information is accurate as well as complete and then to legally document the transaction. A variety of other issues, such as tax related allocations, installment sales, leveraged buyouts as well as earn-outs are negotiated and settled upon.

Some Final Thoughts

Believe it or not, most of these steps happen "before" a valid offer is made. Only after all parties have gathered the relevant facts do offers and price negotiations begin. If all goes well, the buyer and seller enter into a binding contract, with several conditions to be met before the actual sale and transfer of title occurs. Such conditions often address issues like assignment of leases, verification of financial statements, transfer of licenses or obtaining financing. A date will usually be set for meeting the conditions of sale. If a condition is not met within the specified time frame, the agreement becomes invalidated.

So if all goes well, the purchase and sale occurs—usually several months, or sometimes years, after the initial contact between the buyer and seller. Each party usually walks away feeling that they got screwed in some way, hoping they will never have to sue each other for some unexpected hidden issue that will undoubtedly arise after the closing. Tell me again, why do you want to sell your store?

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