

## **Selling Out: When it comes to selling your firm, understanding the process is the key to maximizing your return.**

*By Paul L. Peterson, CPA, MBA*



“Bigger is better” is a growing trend. It seems as though every few days we read about another mega-merger that changes the landscape of American business. Mergers and acquisitions (M&A) have been on the rise across every business sector, and the highly fragmented engineering and construction industries are no exception. While the reasons for and dynamics of M&A among engineering firms are very different than for the Fortune 500, M&A is still a key means of strategic growth and transition of management for firms of all sizes.

Firms who are looking to sell, however, frequently underestimate—or ignore entirely—the complexities involved in structuring a deal and maximizing their return, particularly from the tax and liability perspectives.

### **Why Firms Merge**

Having an understanding of the basics is the first step toward best preparing yourself for the long and complex process of putting a deal in place. The simplest explanation for the rationale behind a merger is that Company A has something to offer that Company B wants. There are myriad reasons a particular target may be attractive, but the most common are that it is located in a desirable city, has market penetration, service lines, or other expertise the acquiring firm wants, or simply the need or want to be bigger.

### **What Buyers Want**

Understanding what the buyer wants is critical to the success of any business transaction, and never more so than when it comes to selling your business. Unfortunately many experienced and successful business people allow the deeply rooted emotional ties to a business they spent decades building to cloud their judgment. Selling your firm is often your legacy and the crowning achievement in your professional career, and for that reason above all others you must prepare yourself to retain the objectivity that made you successful in the past and leverage what the buyer wants in order to get the best return.

The buyer’s due diligence will focus on four main areas: (1) quality of management, (2) evidence of strong and consistent revenue growth and profitability, (3) retention of key clients and specialized talent, and (4) market presence. The buyer’s goal is simple: to create a new entity whose sum is greater than the individual parts. It’s your job as a seller to ensure that the parts your firm is bringing into the equation are attributed the highest possible value.

### **M&A in Engineering**

Buying, rather than building, is an increasingly attractive growth strategy for engineering and construction firms. The allure of the industry to private equity firms is also at an all-time high, as is international investment given the continued decline in value of the U.S.

dollar and limited growth opportunities overseas, particularly in Europe. These trends have been driven by a number of factors, including:

- Demands for housing, commercial facilities, and infrastructure fueled by demographic and population shifts as well as the frequency and severity of recent disasters
- Need for new leadership, specialized technical skills or knowledge-base
- Critical mass to shore up the ability to take on large-scale projects
- Economies of scale to improve overall efficiency
- Access to new markets, wider client base, and larger projects
- Improving access to capital
- “Herd mentality” – when a company sells it sparks the idea in other firms that they need to sell as well
- Increased legislation in some sectors (most notable environmental)

The particular nature of the engineering and construction industries is also a significant factor. There is abundant room for consolidation in any fragmented industry with lots of small and medium-sized players. There are also a large number of firms whose owners are nearing retirement. In many cases these proprietors and principals have not put in the years of work necessary to ensure a smooth transition to potential managers among their younger staff – they’ve been too busy focusing on building a successful company! For these proprietors and partners their primary form of retirement savings is going to come from the proceeds of turning their business over to someone else, and in many cases selling the firm will be their most lucrative option.

### **Preparing to Sell**

First you need to be honest with yourself about your firm’s value. In many ways, this is determined along the same lines you would use when marketing your company: how you differentiate yourself from your competition and why you secure and retain loyal, high caliber clients and employees. You need to position yourself to tout your strengths and mitigate your weaknesses. There is no such thing as a perfect company – even behemoths like Microsoft, Citibank, and Wal-Mart have weaknesses, so be realistic about yours so that you are best prepared to address challenges from your potential acquirer and align your strengths appropriately.

The need for objectivity is best evidenced when it comes to price. Nearly every seller has an inflated sense of value and entitlement. Considering the likelihood that the buyer may initially suggest the lowest possible offer this tends to lead to the single most common deal-breaker. The only way you will avoid an impasse is to hire a neutral third party to evaluate your business and determine an appropriate price range. This will not be based on how much you take home a year extrapolated out over a period of time. They will base their recommendation on everything from your growth rate, profitability, and leadership to talent, competition, and market conditions.

Another common pitfall owners face is the idea that they have to do all the work. Most owners of smaller engineering firms have never been through the acquisition process

before, and therefore are surprised to discover how long it can take to court and negotiate with a buyer. Yes, you will play an important role in the process – in fact you are probably underestimating the degree of involvement, energy and disruption of your time the process will require. But assembling a team of trusted, experienced advisors is the only way you can ensure you get the most for your company. In addition to bringing in an advisor to determine your market value, you need to prepare yourself with a transaction attorney, an accounting firm with expertise in the engineering and construction industries, and a qualified insurance agent. The sooner you get this process underway the better. Any delay on the part of the seller increases the chances that an attractive buyer will walk or demand a lower price.

### **Structuring the Deal**

The acquisition process involves three key elements: (1) strategic assessment of the firm to be bought, (2) planning and structuring of the purchase, and (3) execution and integration into the acquiring company. All three factors need to be taken into account if you're thinking about selling your company, and putting the hard work into careful planning will have a tremendous impact on your valuation.

Every sale of a company is a unique transaction that determines the particulars of the deal. The tax implications of which method you choose to structure the deal, in particular, can make a huge difference in what you take home. What sounds like a \$2 million deal initially may actually result in only \$750,000 going into your pocket depending on how you structure the deal. The three most common ways a merger or acquisition is structured are: (1) asset purchase, (2) stock purchase, and (3) tax-free reorganization.

### **Asset Purchase**

An asset purchase involves the buyer acquiring the assets of your company outright, rather than an acquisition of stock. Buyers benefit from a stepped up basis in purchased assets to the extent the purchase price is allocated to inventory, accounts receivable, and depreciable assets.

This can however decrease the net after-tax return to the seller since a C corporation entity will incur two levels of tax on the sale, and may even result in a lower return to a pass thru entity owner (of a Partnership or S Corp.) since recapture of tax benefits or accelerated recognition of cash basis items may result in allocations of purchase price to ordinary income type assets.

Keep in mind the buyer can opt to acquire only selected assets and assume only agreed upon liabilities, and any of your contingent liabilities will generally not carry forward. Certain contract rights, patents, copyrights, trademarks, etc. will be separately purchased or bargained for.

With asset purchases, the purchase price must generally be allocated among the assets in accordance with their fair market values. The remainder is allocated to goodwill and going concern. This is known as the "residual method." Both the buyer and the seller must report the transaction's details, including the allocation of purchase price to intangibles and any modifications thereof.

Because engineering firms may have most of their asset value in the owner's reputation, relationships, and expertise, goodwill may be personal in nature. Recent court decisions regarding the segregation of "personal goodwill" from corporate assets have been taxpayer favorable. However any attempt to separate goodwill should be supported by an appraisal, since this is a factually intensive analysis, and may be challenged upon examination by the taxing authorities.

If supported by the facts this result can be extremely beneficial from a tax standpoint because it could minimize the dreaded "double tax," where the company is taxed at corporate rates (at the rate of 35% Federal and 9% New Jersey) on gains from the sale of corporate assets, and the shareholders are taxed on the cash proceeds distributed in liquidation of the corporation.

Removing a percentage of the total selling value from the corporation and allocating it to personal goodwill, results in a single level of tax on this amount, potentially payable at lower personal long term capital gains rates of 15% on the Federal level.

The sales contract should reflect this allocation, or optimally should be memorialized in a separate agreement with the purchaser to clarify the intent and understanding of the parties down the road if the allocation is challenged.

### **Stock Purchase**

With a stock purchase your operations continue uninterrupted and all contract rights, assets, patents, copyrights, trademarks, etc., remain intact. Because a stock purchase involves the buyer assuming any contingent liabilities these will most likely need to be addressed before the sale is completed, or else they will potentially reduce the overall valuation of the deal. Generally there will be no effect on the basis of your assets and you will recognize the entire gain as capital gain.

An election to treat a stock purchase as an asset sale for tax purposes is available under the Internal Revenue Code.

### **Tax-Free Reorganization**

In general, a tax-free reorganization means neither the corporations involved nor their shareholders recognize taxable income or loss upon the various exchanges of stock and assets that occur under the plan of reorganization. The selling shareholders generally receive stock in the acquiring corporation and can defer any gain inherent in the target shares until they sell the shares of the acquiring corporation.

For an acquisition to be tax free there must be a business purpose, a continuation of the business enterprise and a continuation of proprietary interest by the target shareholders. The three types of reorganizations are named after their respective code sections:

- Type A is a statutory merger or consolidation

- Type B is where stock of the acquirer is exchanged for at least 80% of the stock of the target
- Type C is where stock of the acquirer is exchanged for substantially all of the assets of the target

As the seller, you will generally not recognize any gain or loss in a reorganization in which you transfer property in exchange for stock of the buyer. However, if you receive cash or other property in addition to stock, you may have to recognize gain (but not loss).. You also recognize no gain or loss on the distribution of the stock or securities to your shareholders pursuant to the plan of reorganization. If you distribute other property (e.g., assets retained rather than transferred to the buyer), gain (but not loss) is recognized as if the assets were sold to the shareholders for FMV.

Payments directly to shareholders of the target that are reasonable in amount in exchange for the executive's consulting or employment services are deductible and are treated as ordinary income to the recipient. Keep in mind that payments in exact proportion to stock ownership will face additional scrutiny and potentially be re-characterized as part of the purchase price. Such payments could be one-time payments such as a signing bonus or retention bonus.

### **Conclusion**

Given current market conditions and the increasing attractiveness of engineering and construction firms to buyers and the private equity sector, the valuation for selling your company could be high simply due to supply and demand factors. The tax impact on the sale of your business cannot be overlooked as the net result is what you are going to receive for the transaction. As you give serious consideration to the future of your firm, begin to objectively assess your company's market position and potential value, look for qualified outside advisors to help you navigate the complex path toward making a deal, and always keep focus on what will best position you to lead your company to the most equitable and lucrative outcome.

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