



Harvard Business Review

Small Business: Part III

-
- 1 The question of growth

 - 2 Organizational planning & control

 - 3 Developing a personal style



Harvard Business Review

Small Business: Part III

© Contents of this book copyrighted
1971, 1972, 1973, 1974, 1975,
1976, 1977, 1978
by the President and Fellows
of Harvard College.
All rights reserved.
No part of this publication may be
reproduced or transmitted in any form or
by any means, electronic or mechanical,
including photocopy, recording, or any
information storage and retrieval system,
without permission in writing from
the publisher.
Printed in U.S.A.

ISBN 0-86735-186-1 (soft cover)
0-86735-187-x (hard cover)

Editor's note

Many of the articles we include in this series were written before women started to play an important role in management in impressive numbers. For this reason, the authors of certain pieces assumed all readers were men and that the typical manager was a "he" instead of a "he or she." In planning this series, we wanted to correct our older articles but found that the expense of resetting them would increase the price of the series and thus limit its distribution.

The editors ask that whenever you read the words "he," "him," or "his" in an article, you take it to mean "she," "her," or "hers" as well. Whenever you see "man" either alone or as part of a word, think of a person of either gender. We hope that the archaic use of the masculine gender does not undermine the effectiveness of the articles.

Table of contents

Kenneth J. Hatten Page 1 Preface

The question of growth

Douglas E. Kellogg 5 How to buy a small manufacturing business

Herbert N. Woodward 16 Management strategies for small companies

James D. Hlavacek,
Brian H. Dovey, and
John J. Biondo 25 Tie small business technology to marketing power

R. Karl van Leer 36 Industrial marketing with a flair

John T. Hackett 44 Drawbacks of continuing corporate growth

Fred R. Wittnebert 47 Big equals less profitable (still)

William E. Fruhan, Jr. 49 Pyrrhic victories in fights for market share

Richard Salomon 57 Second thoughts on going public

Organizational planning & control

Larry E. Greiner 64 Evolution and revolution as organizations grow

William W. George 74 Task teams for rapid growth

Louis B. Barnes and
Simon A. Hershon 84 Transferring power in the family business

Robert E. Linneman and
John D. Kennell 94 Shirt-sleeve approach to long-range plans

Kenneth J. Hatten 104 Case of the pugnacious presidents

Developing a personal style

William Oncken, Jr. and
Donald L. Wass 112 Management time: Who's got the monkey?

Ruth G. Newman 118 Case of the questionable communiqués

John F. Donnelly 128 Participative management at work

John H. Johnson 139 'Failure is a word I don't accept'



Preface

This collection of HBR articles represents the thinking of business executives, academics, and consultants. It should be challenging reading for managers of most smaller businesses because the articles raise some tough questions—questions that the lonely executive in the president's chair has to ask himself or herself as there is rarely anyone else to ask.

The theme that pervades the volume is corporate growth, and it is both encouraging and cautious, warning "As ye grow, so shall ye weep!"¹ The warning is brought out in questions such as why grow, how should new business be developed, how should growth be organized and controlled, and when is the timing right. This volume is in three sections, dealing with the pros and cons of corporate growth, organizational problems and planning, and how the personal style of the president affects the people he works with.

The first section begins with Douglas E. Kellogg's "How to Buy a Small Manufacturing Business." Although his advice is meant for a prospective buyer, most of the points he covers suggest questions that are equally appropriate for a company's present owner to consider—particularly those points concerning efforts to establish aware and sensitive relationships with customers, suppliers, and employees. Next, Herbert N. Woodward counsels the ambitious executive that growth per se may be a mistake and suggests that attention to profits and efficient asset usage may be more rewarding.

The third and fourth articles explore two avenues for sales growth that many small businesses overlook: James Hlavacek, Brian H. Dovey, and John J. Biondo discuss undertaking joint ventures with other companies that have complementary strengths and weaknesses, and R. Karl van Leer looks at ways to engage in joint efforts with customers.

The next four articles in this section suggest, "Stop and think before you grow." John T. Hackett cites what he sees as the "drawbacks of continuing corpo-

rate growth": problems in maintaining adequate controls, making responsive and timely decisions, and encouraging individual creativity. Fred R. Wittnebert points to research that indicates smaller companies are more profitable than large ones, although indirectly he concedes that small companies may be more vulnerable to economic downturns. William E. Fruhan, Jr. claims that many companies fight foolishly and fruitlessly for market share in battles they cannot win or for prizes they cannot defend. He suggests they should think twice before beginning the fight.

Of the hardy souls who opt for growth in spite of the previously mentioned articles' advice, some may have a dream of public offerings. For them, Richard Salomon offers some second thoughts in the last article of this section on growth. The one that struck me is, "In retrospect, it seems to me that for the last ten years of my career the joy of business had vanished." He says this despite obvious corporate and financial success. Even successful growth may invoke tears it seems.

Larry E. Greiner's "Evolution and Revolution as Organizations Grow" leads off the next section. This article suggests that growing companies move through distinguishable and predictable phases of stability and turmoil. Interesting is his reiteration of Salomon's last words, ". . . new problems that led to a new decision, which led to a new set of problems." What is important to the manager is Greiner's typology of solutions—organizational practices that he says work in each phase.

In the next article, William W. George gives an example of what Greiner calls a "Phase 5" company that uses task teams. George describes many of the growth-related problems he has had to grapple with at Litton's Microwave Cooking Division. Then, Louis B. Barnes and Simon A. Hershon offer some limited advice, based on their research, on, first, how to minimize or resolve family squabbles and, second, when family companies have the greatest chance of successfully changing strategies.

"Shirt-Sleeve Approach to Long-Range Plans" is a no-nonsense prescription for low-cost planning. The authors, Robert E. Linneman and John D. Kennell, emphasize neither planning nor plans as ends in themselves but show them as aids to achieving sound strategic thinking and sensible resource allocations. Kenneth J. Hatten's "Case of the Pugnacious Presidents" is a study of a manager who has a growth strategy but whose commitment to it is ineffective. He is embroiled, as a result, in a personal struggle for control that is the byproduct of an ill-managed and poorly conceived attempt to expand his company. This case illustrates many of the points raised in the previous articles.

The third and final section of this collection is concerned with personal style. Most smaller company managers will read it with interest and to their advantage. William Oncken, Jr. and Donald L. Wass lead off with a creative presentation on the timeless issues of delegation and control. The executive who chooses growth has to delegate authority and control his subordinates, and the payoff is "time"—something every manager has an equal amount of but which few use well.

The case by Ruth G. Newman is a valuable analysis of written communications. It appropriately describes communications as one of the manager's tools to forge better relationships. Managers, especially when under pressure to grow, tend to forget their employees and neglect to maintain a two-way flow of communications—resulting some-

times in later discomfort, such as when their employees unionize.

John F. Donnelly, in "Participative Management at Work," sets forth his way of maintaining close employee relations. His style is based on his confidence in people's desires to succeed and on his belief in fairness, equity, and consistency. Like Salomon and Greiner, he cautions that "each success seems to create a new problem."

In "Failure Is a Word I Don't Accept," John H. Johnson emphasizes the total commitment of the small company manager to his business and illustrates the impact of personal style on a company. Yet, Johnson notes, "the best manager is a good teacher" and ". . . I can't do it all by myself." The effective manager, he says, can control growth by hiring and developing key people and by then making sure that they are happy and satisfied with their work. It's a simple prescription but one that is difficult to live up to.

Collectively, the articles in this series will be a useful resource for smaller company management. They are written with a sense of awareness of the difficulty managers of smaller companies have in making time for strategic thinking, with an awareness of the importance of managing internal relations with employees, and with a recognition of the constraints that limited financial and human resources place on the smaller company manager's freedom to act.

Kenneth J. Hatten
Assistant Professor of Business
Administration,
Harvard Business School

1

The question
of growth

How to buy a small manufacturing business

*The purchase can be
fun and profitable if you know
how to value and evaluate it
correctly*

Douglas E. Kellogg

If you are tired of climbing up the corporate pyramid and want to be your own boss, company ownership can be a satisfying experience. However, it can also involve great risk if you are inexperienced or have not carefully prepared for the purchase. During the past 15 years, the author has analyzed over 200 small manufacturing companies. From his experience in acquiring and operating small companies, he has developed some basic guidelines for evaluating a business. He asks the prospective buyer to consider in what financial shape the owner has left the company, how he has prepared it for sale, what risks the buyer will take on, and what the company's real earning power is. The author then shows how many hidden costs and savings can be discovered through a careful examination of the profit and loss statement. But the key to a wise purchase is establishing a value for the business, one that the buyer can justify to the seller. Once the buyer has picked his method of

valuation and gone through with the purchase, he will find the author's caveats on taking over ownership helpful.

Mr. Kellogg is president of Blackstone Industries, Inc., a group of small manufacturing and agricultural businesses. Before going into "small business," he spent ten years at American Chain and Cable as a division manager.

As they face badgering stockholders, sit helplessly in holding patterns over Kennedy or O'Hare airports, listen to their wives complain because they're never at home, or worry about the values their children are acquiring, thousands of disillusioned executives of large U.S. corporations are wondering today whether they have really achieved success. For many, the answer has clearly been no. For a few, a sense of satisfaction has come in a switch from working in big business to owning a small manufacturing business.

The opportunities to acquire a small manufacturing company are greater today than they have ever been before. In January 1975, Dun & Bradstreet indicated that there were about 185,000 small manufacturing companies in the United States with annual sales of \$100,000 to \$500,000. (This price range is attractive because it is large enough to make the company interesting to manage and also remunerative.) At any given time, at least 20% (or about 37,000) of these companies are for sale.

This article is written not only for the prospective buyer but for the prospective seller as well. The wise business owner will spend considerable time preparing his business for sale. If he does not take this time, he may have to sell his business for less than it is worth.

If he wants the best possible offer, he will do everything he can to make his situation attractive. The prospective seller may see some warning flags in the experience of owners who have made their companies appear less attractive through errors in valuing their investment and in capitalizing their profits.

However, this article is primarily intended as a practical guide to the pitfalls and joys of small company acquisition. Where does one begin?

The first step is to evaluate a company's financial health. Are the real values hidden? Have the owners capitalized their profits skillfully? What are the risks of buying a small company?

After he has made an initial evaluation, the prospective buyer should take a look at some areas in the profit and loss statement that deserve special attention—hidden expenses and opportunities for cost reduction in direct and indirect costs, the strengths and weaknesses of marketing activities, the deceptive nature of owner compensation, and, finally, the process of placing a value on the company's assets.

The final section offers some suggestions to the prospective buyer on the "care and feeding" of a company once he has made the decision to go ahead with the purchase, and the last section also places a perspective on this new way of life.

Taking a close look

The principal problem in acquiring a small manufacturing business is correctly assessing the opportunity. In evaluating a business, you should consider the financial shape in which the owners have left it, the risks you take in buying it, and what its earning capacity is. Let's look at each of these considerations in turn.

Previous management

In most cases, the owner has not prepared his business for sale. This situation presents the first opportunity for the buyer to make a smart purchase. There is nothing more attractive to a prospective buyer than solid earnings based on logical and productive expenses. If the owner has to give a lot of excuses to explain why his business does not show good earnings, he has to expect offers that reflect the buyer's doubts.

Through shortsighted management, the owner may produce a discouraging set of financial statements.

How does this happen? In the majority of small businesses, the owner manages his finances to yield the greatest short-term advantage to himself. For example, he may deliberately curtail sales to avoid paying higher taxes. ("I can only wear so many suits," he says.) Or he may indulge in unjustified (although perfectly legal) expenses to reduce his taxable income. He may price his products unrealistically low or high for short-term profits. Or he may take "planned" losses. All of these activities have a tendency to obscure the real value of an enterprise.

To understand why the owner acts in this way, remember that some one who has founded a business with very little capital frequently tends to think of it as a job—as a source of wages rather than as an investment. Thus he may not capitalize his assets correctly. One of the most common errors he may make is to consider only his compensation and to neglect to put a fair value on the earning power of the assets. Here is another opportunity for the buyer—to point out to the seller that his salary is very commendable but that his return on investment is negligible.

As a typical case, consider a clever engineer or salesman who leaves a good job with a large company to go into business for himself. He takes a lot of specialized know-how with him and maybe a few customers, but not much else. The money that he needs for getting started comes from his own savings (which could be earning 6% in the bank) and from the advances of someone who has been persuaded to join him. He realizes that he is often working twice as hard for half as much money as he made with his former employer. But eventually, through his hard work and tremendous sacrifice, his business prospers; then his income more than meets his needs, and he considers himself a success.

In the meantime, his company assets have increased, but he has neglected to consider that these capital assets should be earning a fair return. When he separates his compensation from the net earnings of the company, he will find that the assets are not earning anything.

This example shows that net earnings, owner's compensation, return on investment, and the interrelationships among the three are all important factors for the buyer to consider in arriving at a fair market value for the business. Because these factors are so important, they deserve a closer examination.

Exhibit I

Profit and loss statement for a company with sales of \$250,000

| Categories | Year Ending 31 December 1973 | Pro forma \$250,000 | Buyer's comments |
|---|---------------------------------|------------------------|---|
| Sales | \$256,321 | \$250,000 | Allow for drop in sales. |
| Direct cost of goods | 134,678 | 140,000 | Allow for some slippage in efficiency. |
| Gross profit | \$121,643 | \$110,000 | |
| Factory expense | | | |
| Indirect labor | \$ 15,307 | \$ 16,000 | Allow for raise for foreman (he's important). |
| Miscellaneous factory expense | 5,653 | 5,000 | This can easily be cut down. |
| Depreciation | 2,046 | 2,500 | Allow more depreciation because you write up assets. |
| | \$ 23,006 | \$ 23,500 | |
| General and administrative expense | | | |
| Officer's salary | \$ 20,000 | \$ 20,000 | You can take more (this depends on tax situation). |
| Office salaries | 24,651 | 12,000 | Seller's wife is not necessary on payroll. |
| Telephone | 5,385 | 5,500 | Allow for increase, but the figure should be lower. |
| Rent | 3,600 | 3,600 | New location is \$3,600 a year. |
| Postage | 4,187 | 4,100 | You can easily do with less. |
| Professional services | 1,850 | 1,800 | You might do with less. |
| Insurance | 1,275 | 1,500 | It's better to be safe. |
| Office supplies | 2,114 | 2,000 | You can do with less. |
| Payroll tax | 2,276 | 1,800 | Wife is not on payroll. |
| Other taxes | 1,208 | 1,500 | Allow extra - taxes always go up. |
| Contributions | 280 | 0 | Make no gifts. |
| Depreciation | 1,096 | 1,500 | Allow more depreciation because you write up assets. |
| | \$67,722 | \$55,300 | |
| Selling expense | | | |
| Commissions | \$ 1,785 | \$ 1,700 | This remains about the same. |
| Advertising | 4,649 | 6,000 | You have some ideas, so it will cost more. |
| Travel and entertainment | 10,872 | 2,500 | This is not necessary, but it can help the tax situation. |
| Printing | 3,691 | 4,000 | Allow a little more. |
| | \$ 20,997 | \$ 14,200 | |
| Net Income | \$ 9,918 | \$ 17,000 | This is too much. Raise your salary or expenses. |
| Interest income | 240 | 0 | Owner keeps this small asset. |
| Interest expense | 250 | 7,000 | Borrow most of the purchase price. |
| Net Income before tax | \$ 9,908 | \$ 10,000 | |
| Federal income tax | 1,982 | 2,000 | |
| Net Income after tax | \$ 7,926 | \$ 8,000 | |

Owner's compensation: As a prospective buyer, you should look for all of the owner's benefits—the owner's salary; his wife's salary as "vice president" or "treasurer"; his profit share, use of a car, life insurance, expense allowance, travel, and entertainment; personal services that are charged to the company for lawyers, accountants, and brokers; and personal use of company equipment, facilities, and personnel. A prospective buyer does not necessarily have to plan to curtail these expenses, but the seller

does have to explain them. The seller might have spent enough money here to allow for two or three full-time executives under a different ownership, and this sum could represent a substantial hidden value.

Earnings: When you purchase a company, you expect a fair return on your investment; if you are active in the business, you also expect a fair salary—and not at some indefinite time in the future, but

immediately. If this return is not forthcoming, you are investing in promises and high hopes.

If adequate earnings (or equivalent compensation) do not show on the profit and loss statement, the seller is dealing from weakness. However, although there are many unprofitable small businesses, their owners often sell them at fancy prices to unsophisticated buyers. As a buyer, beware.

Risks to buyer

The risk factor is the most difficult to assess in evaluating any small manufacturing enterprise because the risk often varies under different managements; it will be different under your management from what it was under the previous management. Nevertheless, the following general guidelines may help you determine your risk:

Because most business failures occur within five years of the founding of the business, the longer the enterprise has been in existence, the lower the risk you take will be (unless the business is on the verge of bankruptcy).

If the business is being run badly by an obviously incompetent manager, the risk may not be unacceptable if you know that you can turn the business around quickly (within a year or two).

If there is a long history of gradually shrinking sales and profits, and you know what to do to prevent further decline, the company may not be a high risk. Even if you decide to accept the decline and liquidate the company according to a carefully worked-out plan, the business might still be a good investment. Because most investors generally shun this kind of business, it could represent an unusual opportunity at a bargain price.

A business that depends heavily on a very few customers or on the knowledge or skills of a very few people is a high risk.

A highly competitive market for the company's products generally means high risk, especially for the buyer who has no recognized expertise in the field.

A direct cost of labor and materials that is high in relation to sales often indicates a high-risk situation. Direct costs are generally the most difficult to con-

trol; if they are too high, there is little margin for error or profit.

To put the risk factor of buying a small manufacturing business in perspective with other investment risks, consider the trade-offs between risk and return. The rate of return for a low-risk investment, like savings accounts or mortgages, will not exceed 9%, whereas a moderate risk, like growth stocks, may yield up to 20%, and a high-risk investment, like raw land ownership or a new manufacturing company, can range from a low of 0 to 10% to a high of 100%.

Earning power

The true earning power of an enterprise is the profit that it can generate under the most competent management—not, as is often assumed, profit under ideal conditions, because ideal conditions seldom exist.

When you evaluate a small business to determine what its earning power would be under a new management, compare its past performance with that of similar businesses. Since information on the performance of other businesses is difficult to find, you will have to develop it yourself by contacting trade associations, reading their publications, using case studies, or analyzing similar businesses that are for sale.

In evaluating the company itself, the best place to start is at the profit and loss statement. (See the sample profit and loss statement for a company with \$250,000 sales in *Exhibit I*.) Every item of expense is important.

First, analyze the expenses to find out how the figures were determined. It is essential to understand how the owner arrived at his figures so that you can determine whether you can eliminate or control any element of cost better. Remember that an owner is constantly seeking ways to minimize his taxes. He will charge all expenses legally possible to the enterprise in order to reduce his tax liability.

Second, analyze how the expenses compare with those of similar businesses. One of the best management tools of small business is comparative figures. Studying these comparisons will almost always yield ideas on how to improve your own operations.

Operating cash

One aspect of evaluating earning power is determining how much operating cash is needed on a monthly basis to run the company. You need cash to buy materials and services, to pay wages, taxes, and interest, and to maintain your building and machinery; and you should plan on keeping some ready cash in the bank for emergencies. Can the business generate all the cash you need from the first day that you take over ownership of the company? You can find out by doing a simple cash-flow analysis.

Using a conservative pro forma profit and loss statement (see *Exhibit I*), you can make an estimate of monthly cash expenses and cash income. The sample monthly estimate in *Exhibit II* provides a breakdown of expenses. The monthly sales figures from the previous year can serve as a basis for estimating the pro forma sales figures.

This analysis would show a monthly cash need of about \$20,000, if sales were fairly level. Calculations almost never work out exactly in this type of cash-flow projection, so it would probably be wise to count on a cash need of at least \$25,000.

Checking the P&L statement

One important element of success in acquiring a small business is your ability to identify and eliminate what the seller is not doing well. Expense items in the P&L statement are the best place to start looking for these hidden advantages. (See *Exhibit I* for a breakdown of items.)

If you are lucky enough to find obvious evidence of management errors or incompetence, you should make out a pro forma P&L statement. Use costs that you feel you can easily realize under your own management. This type of P&L statement will give a projected profit under your management. If this profit is greater than what the present owner is achieving and if you are completely confident that you can realize it, then you are at an advantage in negotiating a good deal for yourself. Poorer past performance will heavily influence the asking price.

Now let's look more closely at some areas in the P&L statement.

Direct and indirect costs

While the indirect costs of factory overhead and administrative expenses are more controllable than the direct costs of material and labor, the perceptive buyer can find opportunities for reducing expenses in each—as well as find areas where cost projections are unrealistically low. For example, look at material and labor, factory overhead, and administrative expense.

Material and labor: To determine whether raw materials have been purchased at the best possible prices, check the invoices and compare them with market prices. If you are not familiar with the average market prices, ask someone who is familiar with the raw materials you need. You may uncover an opportunity here to reduce the cost of goods; or you may find that some material that the owner bought at bargain prices is no longer available at those prices.

In addition, you should examine the labor factor in the cost of goods. Is the amount spent reasonable? Could you run this aspect of the company more economically, or are the employees underpaid and due for a substantial raise?

Be especially watchful for other items charged to the direct cost of goods. Are there any items of direct cost that should be charged to indirect costs or to administrative or selling expenses?

When you are satisfied that the cost of goods is fairly represented in either the owner's figures or in your reconstructed ones, compare it with the sales figure. If the direct cost of goods is high in relation to sales (over 75%), the margin for error and profit may be unacceptably small. In other words, the higher the direct cost of goods (materials and labor) is in relation to net sales, the less money there is available for indirect administrative and selling expenses and, of course, for earnings.

In a sense, the ratio of direct costs to sales determines where you, as a new owner, will direct your attention. If the cost of goods is high, you will want to maintain very tight control over manufacturing procedures. If the cost of goods is relatively low, you will probably spend more of your time on administrative and selling problems.

Factory overhead: All manufacturing expenses that are not directly associated with production can be considered indirect and can be grouped together

Exhibit II Cash flow analysis

Average estimated monthly expenses

| | |
|--------------------------------------|-----------------|
| Direct cost (labor and materials) | \$11,666 |
| Indirect labor | 1,333 |
| Miscellaneous factory expense | 417 |
| Officer's salary | 1,667 |
| Office salaries | 1,000 |
| Telephone | 458 |
| Rent | 300 |
| Postage | 341 |
| Office supplies | 167 |
| Payroll tax | 150 |
| Other taxes | 125 |
| Commissions | 142 |
| Advertising | 500 |
| Travel and entertainment | 208 |
| Printing | 333 |
| Interest expense | 583 |
| Total | \$19,390 |

Note: The one-time expenses for insurance, income tax, and professional services (\$1,500, \$2,000, and \$1,800, respectively) are not included in average monthly expenses.

under manufacturing overhead. They include such items as factory rent, light, and heat, and supplies, maintenance, and supervisory wages. Since these expenses are somewhat more controllable than the direct expenses of labor and material, examine them closely to determine whether there is any room for improvement or whether the expenses are unrealistically low.

Administrative expense: This category generally covers clerical functions (such as processing orders, handling correspondence and telephone calls, and maintaining files), bookkeeping, and general management. In a very small company where the owner handles production, administrative, and sales activities, it would be proper to apportion his compensation to all of these areas. However, this procedure is seldom followed—a fact to remember in evaluating the expenses.

Administrative expenses is the category in which relatives may be listed on the payroll; this category needs a close look, since they may be performing a useful function or they may only be "advisory."

Marketing activities

Although many small businesses still use the term *selling expense* to describe a section in their profit

and loss statement, the success or failure of a small business often hinges on its marketing activities, which should include a lot more than just selling. This area requires much attention because it is generally the true indication of the enterprise's earning power or lack of it.

If your reconstructed financial statements indicate that the business has low earning power, look at the marketing activities to see why the owner has failed to produce satisfactory earnings and how you can improve the earnings.

In looking at the marketing activities, try asking yourself these questions:

1
Does the owner have a detailed, carefully thought-out marketing plan with clearly defined objectives and means to achieve these objectives? Or does he say, "This business could be a real gold mine, if I wanted to do a little advertising"?

2
Is the sales literature up to date and of good quality?

3
Does the company have an advertising program and use the services of an advertising agency?

4
Does the marketing department seek out and properly handle sales inquiries?

5
Does the owner have any method for measuring the effectiveness of his advertising?

6
Has any market research been conducted? Does the owner have an intimate knowledge of his current markets? Does he have any plans for developing new markets?

7
How much does the owner spend on marketing? How much do you think he should spend? How much would you spend if you owned the business?

Through working with different companies, I have found that using a marketing budget that represents 5% of sales is a good rule of thumb to follow. In examining the marketing area, look for potential advertising and promotion expenses. Many owners are product oriented, as opposed to being market oriented. Some of them realize this and feel that a marketing expert could do a lot with their product.

If the strength of the prospective buyer lies in marketing, he will recognize this opportunity, but he

must make allowances for a substantial increase in marketing expenses—for example, the cost of reprinting or developing new sales literature. These increases in expenses should be written into the pro forma P&L statement, especially if the seller brings up the subject. This adjustment may reduce projected earnings below current levels, but it will put the buyer in a stronger bargaining position. And it is an essential element in determining the true earning power of the enterprise.

If the marketing costs and manufacturing expenses in your prospective company seem to be reasonable, you cannot improve the earnings unless you can increase the sales. Making an increase in sales requires an intimate knowledge of the market. If you do not have this knowledge before buying a business, you will generally be able to pick up the information you need within a year or two, just from running the company.

Most buyers of small manufacturing companies generally search for opportunities in fields in which they know the market well and have lots of ideas on how and where to sell the products. However, many small business owners do not have any idea of the size or character of their company's markets—and, what is worse, they have no idea of where to go to find this information.

For example, some manufacturers of specialized products like milling machine attachments do not know how many milling machines there are in their own state, to say nothing of the entire country. Yet this information is readily available in trade papers and magazines.

The owner's compensation

In evaluating any closely held company, take a careful look at the compensation of the owner/stockholders. Often this compensation does not reflect the true value of their services. But you will find a range of personal whims, fancies, and occasionally logical reasons to explain it.

Here are a few things to look for:

□ Examine the owner's job. The owner of a small business frequently assumes unbelievable responsibilities: he is the chief executive, the sales manager, the production manager, the treasurer, and the janitor, all in one—and he may feel (and the IRS may

agree) that he is entitled to two or three full salaries. When you see very high individual compensation, remember that it may require two or three people to replace this jack-of-all-trades.

□ Look for fringe benefits that may not be appropriate or required under new ownership—exorbitant car and travel expenses; pension plans; life insurance; and costly trade shows, conventions, seminars, entertainment, and sales meetings (especially those meetings in resort areas and foreign countries). The IRS may consider a \$4,000 trip to Europe a deductible expense for the chief executive of a small manufacturing company whose sales are \$250,000 per year—but it is probably not essential to the welfare of the company.

□ Watch out for very low owner compensation. The owner may be grossly underpaying himself because he is running the business inefficiently and can't pay himself a decent salary; or he might be taking a low salary to make the company's earnings look better.

□ Check the balance sheet for loans to officers and officer loans to the company. The circumstances behind these loans will often reveal valuable information that will help you evaluate the company's operations.

Assessing the value

If you have assessed the "real" costs of running the prospective business—by discovering higher or lower costs hidden in the charges for goods, labor, overhead, marketing, and owner compensation—you should have arrived at the true earning power of the enterprise. The next step is to calculate the net profit of the business—your return on investment. An immediate return on your investment of at least 10% after taxes is appropriate for a small manufacturing business in a medium- to high-risk situation. This capital value is one valid way of arriving at a fair price for the business.

The real fair market value of anything is defined as "the price and terms agreed on between a willing seller and a willing buyer." However, in interpreting this definition, give careful consideration both to your circumstances and to those of the seller.

Exhibit III
Evaluation methods

| Assets | Current book value | Fair market value | 20% return | 10% return | Buyer's asking price |
|--|--------------------|-------------------|------------------|------------------|----------------------|
| Cash | \$ 1,537 | * | * | * | |
| Accounts receivable | 8,376 | * | * | * | |
| Inventory | 57,101 | \$67,795 | \$ 67,795 | \$ 67,795 | |
| Securities | 4,000 | * | * | * | |
| Machinery, equipment | 40,420 | 25,000 | 15,705 | 50,000 | |
| Less accumulated depreciation | 10,395 | | | | |
| Automobile | 4,268 | 1,500 | 1,500 | 1,500 | |
| Less accumulated depreciation | 2,721 | | | | |
| Goodwill* | | | | 50,705 | |
| Total assets | \$102,586 | | | | |
| Less cash, securities, and accounts receivable | 13,913 | | | | |
| Total | \$ 88,673 | \$94,295 | \$ 85,000 | \$170,000 | |

*The owner keeps these assets.

*Know-how, patents, trade secrets, and trademarks are also considered assets, but no value is assigned to them for these calculations. It's better to pay more for machinery and less for goodwill.

Because many small business owners don't really know the value of their business, they may either ask an unreasonably high price for it or be persuaded to sell it at a lower price than they should expect. Yet some buyers may place a higher value on the business than the owner does because the earnings (or the losses) of the business may produce tax advantages for the buyer that the seller doesn't know about. (In most cases, it is to your benefit to buy only productive assets.) Other prospective buyers may place too high a value on the business from ignorance, lack of experience, or poor advice.

You may have a difficult time trying to get the owner to put an asking price on the business. If you were a sophisticated, knowledgeable, and *disinterested* businessman, your appraisal of his business might be a good measure of its fair market value. However, you are not a disinterested appraiser; you are a prospective buyer, and you want to buy the business for the lowest possible price. Furthermore, you do not want to reveal initially the value you place on the assets; you simply want to make an offer that may be less than you think the business is worth. If the owner thinks that your offer is too low, you may wish to convince him of its validity by telling him exactly how you have placed a value on the assets.

A method of valuation

The assets of a small manufacturing company are generally considered as:

- Physical or tangible assets—land and buildings; machinery and equipment; inventory; accounts receivable, cash, and securities.
- Intangible assets—goodwill (earning power); skills and knowledge of the owner and employees; patents, trade secrets, and trademarks.

To put a value on these assets, list them on a sheet of paper, allowing four or five columns to the right of this list for various values (see *Exhibit III* for a sample page). The first column to the right of the list of assets should contain the values taken from the seller's latest balance sheet, minus depreciation. These values represent current book value, which in all probability is not the assets' fair market value.

Initially, you have to take the seller's word for the value of the inventory (which is often higher than that shown on his balance sheet). However, the inventory should be checked later in greater detail to determine how it is valued, whether it is all current and in first-class condition, and whether the supply is balanced. If there are discrepancies, you should adjust your offer accordingly.

For example, a three-month supply of one part and a five-year supply of another is an unbalanced condition; any amount over a one-year supply (and less in some cases) should be valued at a lower rate than is the first year's supply. In a product line where changes and improvements take place frequently,

a five-year supply of some parts might be almost worthless. On the other hand, a five-year supply of some common parts like nuts and bolts might be greatly undervalued.

In the second column, write down your estimate of the assets' fair market value. If you cannot make a reasonable estimate, you will have to get help, preferably from professionals.

To do the calculations in the third column, assume that you want to yield a 20% pretax return on your investment. To determine what the value of the assets should be, first estimate what the earnings of the company would be under your ownership; *Exhibit I* shows this estimate. Let us assume that, after carefully studying several years' profit and loss statements, you decide that you can operate the business to produce a \$17,000 profit (before taxes and interest charge for borrowed money are deducted).

Now write down in the third column the value of your assets so that they equal five times the pretax return on your investment (\$17,000), or \$85,000. (Five times estimated pretax earnings is a reasonable multiple to pay for a small manufacturing company.) If you must place values on the assets that are much more than their fair market value (the second column), you may have to assign some of the excess value to goodwill (not depreciable). The figures in *Exhibit III* are, of course, arbitrary.

Assuming that profits remain the same, you may be satisfied with a pretax return on your investment of 10%. If this is so, go to the fourth column and value the assets so that they total \$170,000. In this case, the values do not seem justified because the goodwill is not deductible and because 10% is really a small return on your investment.

If you have correctly figured the true earning power of the company to be somewhere between \$10,000 and \$20,000 per year before taxes (as the actual P&L statement and your pro forma in *Exhibit I* show), a fair price for the business would range from \$50,000 to \$100,000. If you feel confident that you can easily increase sales and earnings, \$85,000 would be a bargain price for the business (if you think in terms of future benefits, which should rightly accrue only to the buyer and not to the seller).

Study these figures; note how the total value of the assets varies according to the point of view taken.

Try to put yourself in the position of the seller. What values do you think he might assign to the assets? How would he react to the values you have assigned to them?

Now make one more column of values—the price that you are willing to pay for the assets. When you arrive at this total, decide how much less the seller might accept. Then go ahead and make your initial offer.

Running the company

Assuming that you have found the company you want, that you have reached an agreement with the owner on price and terms of payment, and that you have a firm commitment on financing, now is the time to plan your approach to running the company. By this time, you should be on very cordial terms with the seller, and you should have complete access to his plant, personnel, and records. You should also have a very good general idea of the strengths and weaknesses of the seller's modus operandi. Two important areas need your initial attention—sales and costs.

Improvement of sales

You should make a formal announcement of the new ownership. At that time, it might be helpful to state or restate the company's general sales policies that affect your dealers and customers. You could solicit suggestions from them for changes and improvements in the business.

Can you see ways to increase sales during the first year? Could advertising be more effective? Should you switch the marketing effort from trade-paper advertising to direct mail or vice versa? Should you consider switching from manufacturer's representatives to your own salesmen?

You will profit not only from answering these questions but also from carefully studying the costs and results of past sales programs. Another important tactic is to become intimately familiar with all of your best customers. Plan to visit them if it is practical, and commit their names, key personnel, and sales volumes to memory.