

The Business Owner[®]

Your Return on Equity — A Capital Issue

The way you finance your business can have a significant impact on your wealth, and that of your co-owners.

How so? The two biggies are:

Return: Use of debt raises return on investment for the owner of a profitable company. For certain companies, the difference can be substantial.

Risk: Use of debt raises risk of insolvency.

As a business owner, you should understand these and make rational decisions about how you finance your business. This entails periodically assessing the business' unique characteristics, prevailing costs of debt and equity capital, owners' risk tolerance, and then selecting an appropriate capital structure (i.e., mix of interest-bearing debt and equity).

By way of background, a business is simply a compilation of assets and inputs that generate revenue and – if profitably deployed – profit. Typical assets are cash, inventory, marketing materials, equipment, furniture, fixtures, vehicles, customer databases, recipes, formulas, etc. Add to this the labor and know-how of employees – contributed toward production, sales and administration – and you have a business. For a going concern selling on terms, you also have accounts receivable. None of this has anything to do with debt or equity capital, except that these assets don't just appear – they must be purchased. They can be purchased with equity contributed by the business' owners (i.e., no repayment terms but simply ownership in the business) or borrowed funds (i.e., debt).

To demonstrate how debt can raise the rate of return earned by a company's owners, let's take two companies identical in every respect except their level of debt. Both earn \$250 annually in EBIT (earnings before interest and taxes) and have \$1,000 of assets. But Company A has \$250 in trade debt, no interest-bearing debt and \$750 of equity.

Company B has \$250 of trade debt, \$500 in interest-bearing debt and equity of \$250.



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- How to Be a Great Radio Guest
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- Need More Time? Get Serious

- **Book Review:** Rich Dad, Poor Dad
- Laugh a Little: A Cowboy and a Yuppie
- Tips from the Top
- Selling a Company Tax-Free
- Corporate Finance and Merger & Acquisition Expertise

D. L. Perkins, LLC

7010 S. Yale, Suite 120, Tulsa, OK 74136

918-493-4900 • 800-634-0605 • Fax: 918-493-4924

E-mail: info@TheBusinessOwner.com • www.TheBusinessOwner.com

From the Editor

Businesses require capital – cash, labor, equipment, inventory, facilities, etc. Of course, not every business requires each, but every business requires some or all of these “inputs” to varying degrees. These items may be purchased (funded) with equity or debt. Most businesses use both. The particular blend impacts the business in important ways, such as return on equity and financial risk. Similarly, the mix appropriate for each business depends on characteristics unique to the particular business and owner(s). The focus of this issue is these characteristics. Read and begin to more proactively and appropriately manage your capital structure.



David L. Perkins, Jr.

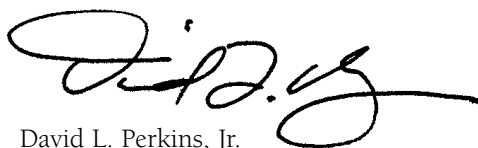
Want to generate extra cash and improve return on assets and return on equity? Reduce the amount of assets tied up in your business. Read “Harvest Cash, Improve Returns” on page 5.

Booking healthy profits these days? We are in the fourth year of a general economic expansion. Many companies are enjoying record profits. What should you do with the money? Good options are to pay down debt, invest in ways that will lower your operating costs or increase profitability, and fund retirement accounts. Don't delay. Time's a-wastin'.

Considering selling your business? Well, timing is everything — and times are certainly good right now. Buyers are abundant, capital is aplenty, tax rates are low and times are good. If you're thinking “maybe in the next few years,” you might want to move up your time frame. If the economy hits the skids, it could be another six to eight years before we enjoy another seller's market.

It is a tremendous pleasure to serve you. Please call me!
Cell 918-760-2715.

Sincerely,



David L. Perkins, Jr.
Publisher and Editor

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ssoule@hallestill.com

Jean Wilcox – Cattle Logos
AREA OF FOCUS: Marketing and Advertising
jwilcox@cattlelogos.com

This publication is owned and published by D.L. Perkins, LLC,
7010 S. Yale, Suite 120, Tulsa, Oklahoma 74136; 918.493.4900;
Fax 918.493.4924. Info@TheBusinessOwner.com.

David L. Perkins, Jr.
Publisher and Managing Editor

Cindy Vogel, Business Manager – cindy@thebusinessowner.com

Doug Ricks, Sales Manager – doug@thebusinessowner.com

Renae Williams, Marketing & Fulfillment Manager – renae@thebusinessowner.com

John Maybury, copy editor and proofreader – mayburrito@goolbuster.com

Kathy Piersall, A Blue Moon Arts, graphic design – kathyp@ablumoonarts.com

Cover illustration: © Getty Images Photodisc

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Price \$199⁹⁹ per year.

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SPECIAL SECTION FINANCE & CAPITAL

Strategic Framework for Financing Your Business

Your business' assets must be purchased, or funded, somehow. Buy equipment and you have to buy it outright using equity or obtain financing (i.e., debt). Sell on "terms" and you have to cover the cash delay by some means. Buy inventory and – assuming your credit is acceptable – you're likely able to obtain interest-free payment terms (i.e., trade credit). But most companies cannot turn their inventory into cash quickly enough to completely finance inventory using trade credit, so the gap must be funded with some combination of interest-bearing debt and equity.

In deciding how to fund your business, you should use the least expensive and inhibiting means. The cheapest is trade credit. Once trade credit is exhausted, interest-bearing debt tends to be the next cheapest. But the business owner must not lose sight of the fact that borrowing (i.e., leverage) adds financial risk. The higher the leverage, the higher the risk of default.

Risk can be generalized to refer to volatility of earnings. Companies with very predictable earnings can afford to use higher levels of debt. Companies with unpredictable earnings have, of course, a higher degree of uncertainty in predicting their ability to meet fixed obligations and, therefore, a lower tolerance for debt. Business owners must balance their desire for ROE-boosting benefits of debt with their own personal tolerance for risk and the business' unique ability (or inability) to safely handle it.

Evaluating funding options, many criteria should be considered. Here are a few.

Cost: The rate of interest charged on debt is the most visible cost of debt financing, but there are other costs and considerations. First, the effective cost of debt financing is lower than the nominal cost because interest expense is tax-deductible. Costs of equity capital are not tax-deductible. Second, origination fees may accompany debt and equity financing. Third, time is a very important dimension, and raising equity financing can be very time-consuming – both to secure and maintain.

Repayment terms: Debt financing always has repayment terms. It is critical that the terms match the use of funds and/or the cash flow cycle of the business. More flexible terms, such as interest only and longer maturity dates, reduce risk. Equity capital typically is the least risky because it has no repayment terms or obligations.

Restrictions: The beauty of equity capital is that it comes with few restrictions. Debt capital often comes with certain covenants that restrict the actions of management. These restrictions serve the purpose of lowering the risk borne by debt providers to a level acceptable to them and that conforms with their lending parameters. The borrower should consider the true cost of these covenants when choosing funding options.

Control: Substantial powers and benefits accrue to the controlling owners of a company, and controlling interests tend to trade at substantially higher values than non-controlling interests. For this

Companies with very predictable earnings can afford to use higher levels of debt.

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Terms to Know: Debt and Equity Capital

Asset Utilization: Efficiency in how a business uses its assets. Key driver of profitability, return on capital and return on equity. Can be measured by sales/average assets. The more sales a business can generate from a given level of assets, the more productive and profitable it should be.

Capital: Sum total of debt and equity, which is the same as total book value of asset. (Note that some use the term capital synonymously with equity, which differs from our use here.)

Cost of Capital:

Def. 1: Rate of return required by an investor (see also “Hurdle Rate”).

Def. 2: Blended cost of debt and equity contributed to a business. One method for calculating overall cost of capital to a firm is the weighted average cost of capital (WACC) formula, as follows:

$$\text{WACC} = (\text{Cost of equity} \times \% \text{ of total capital that is equity}) + [\text{Cost of debt} \times \% \text{ of total capital that is debt} \times (1 - \text{tax rate})]$$

In calculating WACC, non-interest-bearing debt is ignored.

Example: Company A has total equity of \$250,000 and total interest-bearing debt of \$250,000. As such, 50% of A's capital is debt and 50% is equity. Let's assume that the required rate of return on the equity is 30% (for an

explanation, see “Required Rate of Return” below) and the average rate of interest charged by interest-bearing debt providers is 8%. Here's the calculation:

$$\begin{aligned} \text{WACC} &= (.5 \times .30) + [.5 \times .08 \times (1 - .35)] \\ &= .150 + .026 \\ &= .0176 \text{ or } 17.6\% \end{aligned}$$

Debt: Amount owed; general term for financial obligations such as notes, bonds, mortgages, etc.

Equity: Ownership; residual interest that remains after deducting all liabilities.

Hurdle Rate: Minimum rate of return acceptable. In the example above for “Cost of Capital,” the WACC of Company A is 17.6%. As such, the business owner should invest monies of the company only into projects that earn 17.6% or more annually. If lower returns are earned, equity holders are undercompensated for the risk they bear. If the business does not earn at least a rate of return that equals the cost of its debt (8% pretax in our example) financing, no value (or return) will accrue to the owner(s).

Return on Assets (ROA, aka Return on Total Capital): Measure of company profitability in how efficiently it uses its assets. Calculated as follows:

$$\text{ROA} = \left[\frac{\text{Net Profit} + [(\text{Interest Expense} \times (1 - \text{tax rate}))]}{\text{Avg. Total Assets}} \right] \times 100$$

continued on next page

Debt vs. Equity — Know the Differences

Equity Capital

Residual claim on income and assets of the business

More expensive

Lowers financial risk

High levels justified when business is more risky and earnings more volatile

More difficult to raise because equity investments are more risky, are highly illiquid, and usually offer no guarantee of return

Higher levels lower return on equity (investment)

Cost of equity not “subsidized” by government (i.e., not a tax-deductible expense)

Higher equity lowers volatility of earnings

Minority equity investments typically have little or no restriction on how company is managed

Decreases risk of insolvency

Debt Capital

Senior claim on income and assets of the business

Less expensive

Raises financial risk

Higher levels may be acceptable when business is less risky and earnings more predictable

Often easier to obtain because lenders are more prevalent, and receive a lower-risk senior claim on business' income and assets, and often obtain a personal guarantee from the owners

Higher levels raise return on equity (investment) as long as business earns return that exceeds cost of the debt

Cost of debt “subsidized” by government (i.e., interest cost is tax deductible)

Higher debt increases volatility of earnings

Often comes with covenants that restrict how company is managed

Increases risk of insolvency

Harvest Cash, Improve Returns by Reducing Assets

To succeed in the game of business, you must know how to win. It's a complex game with myriad rules and imperatives, but the bottom line is always – well – the bottom line. You must make a profit to be able to financially afford to stay in business. Furthermore, if you have competitors, you will survive long-term only if you operate at least as efficiently, that is profitably, as your competitors. And the criterion is not dollars of profit but profit per dollar of assets. Yes, return on assets is one of the most basic barometers of business performance.

So as the business owner makes capital decisions, the strategy always should be to figure out how to get more from less. And because assets must be funded with either debt or equity, minimizing assets will lower the capital requirement and the capital cost that must be incurred to generate a given level of profit. Lowering assets also will generate one dollar for every dollar that assets are lower. As such, the benefits are twofold.

Ideas for getting more from your assets? Here you go:

Get paid more quickly: For many businesses, receivables are one of the largest categories of assets and thus tie up a large amount of

You will survive long-term only if you operate at least as efficiently, that is profitably, as your competitors.

cash. Most of us take it for granted that we must offer terms, but every day you reduce your average days outstanding will unlock dollars tied up in A/R. The first step is to simply collect more aggressively. The second is to see if you can restructure your sales to lower the amount you finance. Certainly, an early-pay discount can help. But if your products are highly valued, don't be afraid to consider whether your customers would

tolerate a tightening of terms you're willing to extend. Change your terms to net 20. Or consider asking for payment up front. Some businesses get away with it. Some probably do it to you. Maybe it's as easy as "ask and ye shall receive."

Reduce Inventory: Inventory turns. How often do you turn over your inventory each year? To reduce inventory, unlock cash, and improve efficiency and profitability, you need to reduce inventory you carry on hand. First, sell inventory that's old and not turning. Second, begin tracking turns and levels. Often the simple exercise of tracking and sharing information will result in improvement. Third, ask your vendors to help you lower inventory and improve turns. You know — the ol' "just in time" stuff.

Lease rather than own: Owning things ties up capital. Renting can substantially reduce the amount of capital tied up in your business and thereby improve return on assets. But it's a form of debt, and will raise the fixed operating costs and thereby increase financial risk. Still, the business owner and manager should understand his business, his tolerance for risk, the business' ability to handle debt, cost of capital, target returns, and make rational decision on issues such as lease versus buy.

Outsource capital-intensive segments: Business requires all sorts of processes: marketing, sales, administration, fabrication, warehousing, shipping, etc. Just as few of us would buy our own trucks and planes and hire our own drivers and pilots to handle our own shipping (rather, we outsource this need to others), you should consider the possibility of outsourcing each of the many parts of your business. Technology and the evolution of our highly specialized economy make it possible.

In fact, current business strategy says we should do only what is critical to our business' success AND what we can do ourselves better than anyone else we could outsource to. So, to reduce money tied up in our business, and increase asset productivity, consider using more outsourced providers.

The first place to look is parts of the business that require dedicated assets and at employees not being used near capacity.

Invest excess cash: Cash is an asset. The profit maximization game entails maximizing dollars of profit that can be squeezed from every asset. Cash not used in the business, even for short periods, can be invested to gain some yield.

Do you have more ideas? Please send them to Editor@TheBusinessOwner.com so we can share them with everyone. □

The strategy always should be to figure out how to get more from less.

Terms to Know: Debt and Equity Capital, continued from previous page

Return on Equity (ROE): Measure of efficiency in how a company uses its equity. Calculated as follows:

$$ROE = (\text{Net Profit} / \text{Average Net Worth}) \times 100$$

Return on capital: See Return on Assets.

Risk: Degree of uncertainty as to whether expected cash flow will be realized. For an established company, risk can be simplified to be the volatility of earnings. Companies with very predictable earnings are considered less risky and can afford to use higher levels of debt. Companies with volatile earnings have, of course, a higher degree of uncertainty in predicting their ability to meet fixed obligations and therefore a lower tolerance for fixed obligations (i.e., debt).

Required Rate of Return: Return that the rational investor requires based on perceived risk of a particular investment. For assets traded publicly in an efficient market, required rate of return equals actual rate of return. This is so because investors dictate their own rate of return by the price they are willing to pay for the asset. Rates of return generated for ownership in small public companies have averaged around 19% per year over the past 90 years. Required rates of return for private companies are not as evident because they are not publicly traded, but it is presumed that – due to the illiquidity, lower levels of diversification and higher overall risk – equity in private companies merits annual returns well north of 25%. □

Your Return on Equity — A Capital Issue, continued from cover

Here are the balance sheets:

	Company A	Company B
Cash	\$50	\$50
Accounts Receivable	\$250	\$250
Inventory	\$250	\$250
FF&A	<u>\$450</u>	<u>\$450</u>
TOTAL ASSETS	<u>\$1,000</u>	<u>\$1,000</u>
Accounts Payable	\$200	\$200
Other Payables	\$50	\$50
Line of Credit	\$0	\$250
Term Debt	<u>\$0</u>	<u>\$250</u>
Total Debt	<u>\$250</u>	<u>\$750</u>
Equity	<u>\$750</u>	<u>\$250</u>
TOTAL DEBT AND EQUITY	<u>\$1,000</u>	<u>\$1,000</u>

} \$250 { \$200
} = \$500 { \$50

Here are the return-on-equity calculations:

	Company A	Company B
Revenue	\$1,750	\$1,750
Gross Profit (40% margin)	\$700	\$700
Operating Expense	\$450	\$450
EBIT	\$250	\$250
Interest Expense (8%)	<u>\$0</u>	<u>(\$40)</u>
<i>Taxable Profit</i>	<i>\$250</i>	<i>\$210</i>
Income Tax (@ 35%)	(\$88)	(\$74)
<i>Profit After Tax</i>	<i><u>\$163</u></i>	<i><u>\$137</u></i>
Return on Equity	<u>22%</u>	<u>55%</u>

Company B delivers a 55% (\$137/\$250) return on equity to its shareholder, versus 22% (\$163/\$750) for Company A – and the only difference between the two companies is the way they fund their assets (i.e., their capital structure).

How does this take place in the real world?

Case Study: Let's assume Christa has \$750 of investable cash, is buying the assets of Company A above for \$750, and needs to decide how much debt and equity to use. She runs the numbers and chooses to borrow \$500 of the \$750 purchase price. Here's her analysis.

First, she worries about putting all her equity in any single investment. If she borrows, she can leave some of her equity in other investments, thereby achieving a little diversification.

Second, she knows that by using debt she can lower her equity contribution in the business and increase her after-tax return on her equity.

Third, she makes a few assumptions for her analysis:

1. Investment horizon is 20 years.
2. The business is not growing.
3. Any equity not in the business is in a diversified portfolio of publicly traded stocks earning an after-tax rate of return of 8% (\$10.5% pretax).
4. After-tax profit generated by the business is taken out at the end of each year and invested in public stocks.

5. If debt is used to finance the business, the desired level will be set and then maintained for all 20 years (through refinancing).
6. Ignore depreciation because it is a non-cash expense and will simply serve to reduce taxes and thereby provide a positive margin for error in the analysis.

Fourth, she runs numbers to estimate the value of her total \$750 in equity in 20 years under various debt/equity mixes. Here are two of the mixes – No Debt (\$0 debt/\$750 equity) and Leverage (\$500 debt/\$250 equity).

The No Debt option begins with \$750 invested in the business and \$0 in public stocks. But each year, \$163 is generated by the business and invested at 8% after tax. The Leverage option, in contrast, leaves \$500 in public equities on Day 1 and \$250 in the business. Annual cash generated under the leverage scenario is \$137. The result?

Her total equity in Year 20, No Debt option: \$8,188*

Her total equity in Year 20, Leverage option: \$8,827*

* Sum of original equity placed in business plus equity in public stocks.

The Leverage option, under these assumptions, leaves her with more wealth in Year 20 and significant diversification (i.e., just 33% of her total equity in the business on Day 1; 66% in a diversified portfolio of public equities) in her investments.

Fifth, she calculates breakeven points for the various debt/equity mixes. She does this by adding up all the fixed costs of running the company, before costs of debt financing. She comes up with \$450 – the total annual operating expense. Using the breakeven formula, she finds her breakeven level of sales under the No Debt scenario as follows:

$$\begin{aligned} \text{Breakeven level of sales} &= \text{fixed charges/gross profit margin} \\ &= \$450/.4 \\ &= \$1,125 \end{aligned}$$

Breakeven point under the No Debt scenario is annual sales of \$1,125, a whopping 36% drop, and she still can make ends meet. The Leverage scenario (\$500 debt/\$250 equity) adds annual fixed obligations of \$82, assuming the line of credit is interest-only and the term debt calls for repayment by equal payments of principal over a six-year amortization. As such, the annual fixed obligations are \$532 per year and the breakeven level of sales is \$1,330, calculated as follows:

$$\begin{aligned} \text{Breakeven} &= \$532/.4 \\ &= \$1,330 \end{aligned}$$

So, under our leverage scenario, revenue can fall 24% without a crisis.

continued on next page

Remember, total assets always equal the sum of debt plus equity. This relationship is demonstrated by the following equation:

$$\text{Assets} = \text{Debt} + \text{Equity}$$

Of course, simple algebra can be used to manipulate the formula into equations that are also true, such as:

$$\text{Equity} = \text{Assets} - \text{Debt}$$

Your Return on Equity — A Capital Issue, continued from previous page

Sensitivity Analysis

Gross Profit	\$550		\$650		\$750		\$850	
Operating Expense	\$450		\$450		\$450		\$450	
EBIT	\$100		\$200		\$300		\$400	
	<u>No Debt</u>	<u>Leverage</u>	<u>No Debt</u>	<u>Leverage</u>	<u>No Debt</u>	<u>Leverage</u>	<u>No Debt</u>	<u>Leverage</u>
Interest Expense	\$0	(\$40)	\$0	(\$40)	\$0	(\$40)	\$0	(\$40)
Taxable Profit	\$100	\$60	\$200	\$160	\$300	\$260	\$400	\$360
Income Tax	(\$35)	(\$21)	(\$70)	(\$56)	(\$105)	(\$91)	(\$140)	(\$126)
Profit After Tax	\$65	\$39	\$130	\$104	\$195	\$169	\$260	\$234
Principal Due	\$0	(\$42)	\$0	(\$42)	\$0	(\$42)	\$0	(\$42)
Cash Flow	\$65	(\$3)	\$130	\$62	\$195	\$127	\$260	\$192
ROA	9%	5%	18%	14%	26%	23%	35%	32%
ROE	7%	16%	13%	42%	20%	68%	26%	94%

Sixth, she assesses solvency at varying profit levels and across various debt/equity mixes. The results are presented in the accompanying table.

As one can see, our investor has done her homework. She weighs her options, assesses her analysis, and chooses to borrow \$500.

What is right for you and your business? There is no correct answer but rather a choice based on the investor's goals, confidence and risk tolerance; and on the business' predictability and profitability. But this writer believes that – as in the example above – one should give significant weight to the fact that borrowing enables meaningful diversification. Of course, if the debt requires the investor to pledge outside equities, then the value of the diversification would be significantly diminished.

What is the meaning of all this? As we said at the beginning, business owners should understand the impact of capital structure (mix of debt and equity used to capitalize the business) on their business and their wealth. The use of debt raises the rate of return enjoyed by equity holders – as long as the business is profitable and the return earned by the company exceeds the cost of the debt. In general, companies that enjoy steady cash flow have a greater ability to predictably meet fixed obligations

and thus use incrementally higher levels of debt while keeping financial risk at manageable levels. Of course, the opposite is true for companies with more volatile operating cash flow.

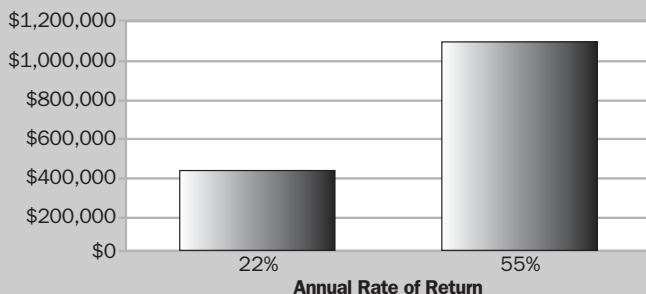
For further introduction to these and related concepts, please read the accompanying articles. Methods for calculating optimal mix of debt and equity for a particular company call for considerable discussion. That is not the purpose of this article. The purpose is simply to introduce the concepts. A future issue of this publication may attempt to tackle this subject, but the business owner should seek the advice of a financial advisor skilled at private-company capital strategy. □

Rate of Return Means Real Money!

Cash generated over 20 years from \$100,000 returning 22% annually: \$433,000

Cash generated over 20 years from \$100,000 returning 55% annually: \$1,092,000

Total Cash Generated by \$100,000 Invested Over 20 Years



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Strategic Framework for Financing Your Business, continued from page 3

reason, controlling owners should seek to maintain control and minimize risk of losing control. Raising debt and equity capital can bring to the fore scenarios that could cause partial or total loss of control. Such risks should be carefully assessed by the owner when choosing capital alternatives.

Personal Financial Risk: Business owners choose the corporate form as a means for shielding themselves from personal financial risk. But lenders of debt often require personal guarantees from controlling owners. The purpose is to bring the lender's level of risk down to a level that is acceptable and in line with lending policy. Business owners should consider all of their capital options and rationally decide which risks to bear, to what extent, and for what period of time.

With these criteria in mind, we offer the following framework for making your capital decisions:

> Strategy Imperative # 1 – Maximize Return on Assets: One of the most basic barometers of business performance is return on assets. This is simply the amount of profit earned from a given dollar value of total assets. In a competitive marketplace, the goal must be to maximize return on assets. That is, getting as much profit as possible from the smallest amount of assets. This is also referred to as asset utilization. As the business owner makes capital decisions, the first strategy should always be to figure out how to get more from less. And because assets must be funded with either debt or equity, minimizing assets will lower the capital requirement – and the capital cost that must be incurred to generate a given level of profit.

For ideas on reducing the amount of assets your business requires, see the accompanying article, "Harvest Cash, Improve Returns by Reducing Assets".

In a competitive marketplace, the goal must be to maximize return on assets.

> Strategy Imperative #2 – Use the Least Costly Capital Source: In addition to the ongoing search to lower the required amount of assets (i.e., improve efficiency), the owner should seek to fund the required assets using the least costly source. Clearly, trade debt is the cheapest. It often comes with little or no cost (remember that it might not be free in light of such things as early-pay discounts) and rarely requires collateral, operational restrictions or personal guarantees from the owners.

Once trade debt is maximized, the options turn to interest-bearing debt. Credit cards could be considered a low-cost form of interest-bearing debt if the balance is paid off monthly. Traditional bank borrowing is the primary form of interest-bearing debt, and for the healthy business it's readily available. Working capital financing is often the least costly and lowest risk because it is secured by assets that will quickly turn to cash – receivables and inventory.

Equity capital is considered the most costly form of capital because it is the most risky. This is primarily because equity holders are the last to get paid. That is why it is referred to as "a residual interest in the assets of the business." In a private company, it is also very risky because it is highly illiquid. To be sure, equity interests in private companies are difficult and expensive to sell.

Wondering how equity can be so much more expensive than debt when it does not require any debt service payments? Consider what you would have to offer investors to entice them to contribute equity into your business. Likely, it would be very difficult unless you GUARANTEED them terms that you yourself don't enjoy. These "extra" terms would deem their stake to be superior to yours and thus would classify their share as preferred stock or stock with convertibility options such as warrants. In short, you'd have to offer quite a rate of return, and provide terms that lowered their risk or offered liquidity to entice any investor to contribute equity into your business. It is sobering to note that you also should be earning a healthy (25% or greater) return on your equity investment in the business – given the risk you bear each day.

> Strategic Imperative #3 – Maximize returns. A business that does not make a profit is not long for this world. Given that you own the business' equity, your equity is worth something only to the extent that money is left over after all other obligations are met. For a going concern, this is achieved only if you invest the assets of the business at a rate that at least exceeds the cost of your debt financing. Only in this case will any value accrue to you, the owner.

To obtain a fair return on your investment – one commensurate with the risk of your equity stake – your business must earn a return that equals your weighted average cost of capital. See the definitions of "Weighted Average Cost of Capital" and "Hurdle Rate" in the accompanying "terms to know" article. □

About the Publisher

David L. Perkins, Jr. owns, writes, edits and publishes *The Business Owner*, the newsletter of choice for more than 35,000 paid

business-owner subscribers who are serious about building wealth through successful private business ownership.

Perkins draws editorial ideas and inspiration from his daily work as a merger and acquisitions consultant, where he has advised on more than 100 purchase/sale transactions involving both private and public companies. His M&A consulting firm is Vercor, which has 10 North American offices and a European affiliate. Vercor specializes in sell-side representation of businesses valued between \$5 million and \$50 million (see www.VercorAdvisor.com).

Perkins holds a BA in psychology from the University of Oklahoma and an MBA from the University of Notre Dame. He has formal training in business valuation. He also pulls editorially from prior experience in commercial real estate leasing and brokerage, commercial bank lending and private company financial management.

Perkins is the author of [A Concise Overview of Business Valuation](#) and co-author of [The Business Sale, An Owner's Most Perilous Expedition](#). Both may be purchased at www.TheBusinessOwner.com.

Perkins is a professionally trained, content-rich platform speaker available for both keynote and breakout sessions. He is a Certified Toastmaster and a member of the National Speakers Association.

Contact him at 800-634-0605 or David@DavidLPerkinsJr.com.

Federal Tax Appeals Not Futile

The U.S. Government Accountability Office estimates, in a recently released study, that 41% of tax appeals cases received some relief.

IRS audit frequencies are rising, up some 20% in 2005 to 1.2 million returns. They're expected to rise even further in 2006. Prime targets, according to the IRS, are wealthy individuals and tax shelter users.

If you are audited, you may be assessed more money. If you disagree, you can appeal. The recent study seems to show that you have a reasonable chance of winning. For more information, see IRS Publications 5 and 556 at www.irs.gov. □

INVESTMENTS

C-Corp Stock Sale by "Middleman" Is Illegal

The May/June 2006 issue of this publication, *The Business Owner Journal*, page 9, contained an article titled "Selling a C-Corp? Try These Tax Strategies." Item 4 of the article described a tax reduction technique called "Stock-buying Middleman." We cautioned against the transaction but have since learned that this type of transaction is "listed" by the IRS. To quote from IRS Notice 2001-16:

"The Service may challenge certain transactions in which the assets of a corporation are sold following the purported sale of the corporation's stock to an intermediary. Such transactions are designated as 'listed transactions' for purposes of sections 1.6011-4T(b)(2) and 301.6111-2T of the regulations."

In short, the IRS warns taxpayers that this type of transaction does not conform to tax law, and parties involved in it may be subject to penalties or other disciplinary action.

For more information, see IRS Notice 2001-16. You may find a copy at www.TheBusinessOwner.com. Click on "Members Only," Archive Issues, enter the password "Value," and look right below the PDF of the September/October 2006 issue. □

"As an employee, I marveled at the executives that would persist with ideas that clearly were not working. Just pay attention to what works and do that."

*Tom Anderson, co-founder of MySpace**
*sold for \$580 million less than two years from start-up

How to Be a Great Radio Guest

1. **Be confident.** Present yourself and your message with confidence. Know your topic inside and out. Be confident that your message is something that the audience wants to hear about. The audience will perceive you as more credible.
2. **Don't try too hard.** Just relax, let go and let your message flow. Don't try to work too much information into too short a time. If you come across as trying too hard or you rush your message, you'll risk losing the attention of the audience.
3. **Compliment the host.** Radio hosts typically have fairly healthy egos. Massage those egos whenever you can and you may reap the benefits on the air. Compliment them on their show or on their line of questioning, when appropriate.
4. **Remember names, and use them.** When taking calls from listeners, write down the first name of the caller and use it when possible and appropriate. This helps the listening audience relate to you. You may want to also write down the host's name beforehand, just in case. Forgetting the name of the person interviewing you on the air is a big "no-no."
5. **Be prepared for confrontation.** You may be ambushed on the air by a combative radio host or call-in. While this is rare, be prepared to deal with it. Don't argue with the host, because he or she will always win and get the last word. Be firm but polite.
6. **Don't sound like an infomercial.** Plug yourself, your product or your company when a natural opportunity arises or when prompted by the host. Listeners are turned off when they perceive a guest as being overly pushy or "salesy."
7. **Learn what you can about the show beforehand.** Check out the station or show Web site before an interview. By familiarizing yourself with the host and show, you avoid any surprises and you will be more relaxed and collected.
8. **Be punctual.** Whatever you do, don't be late. Some hosts will cancel your interview if you don't call at the designated time. If the station/host is to call you, stay by the phone and keep your line clear.
9. **Be sensitive about political views.** If you are discussing a controversial political issue, acknowledge that the other side has some good points. Radio audiences are diverse. By "giving and taking" you will win credibility points with the audience. Obviously, this tactic won't work on shows such as Rush Limbaugh or Al Franken, where the hosts have distinctive viewpoints.
10. **Don't try to hide anything.** If you have made mistakes, admit to them. They may come out at some point in your interview and you are better off coming clean from the get-go. We all make mistakes and listeners will relate better to someone they see as honest. □

This article is based on the written work of Marsha Friedman, founder and CEO of Event Management, Inc.

How to Keep Small Orders from Undermining Profit

At a certain point, some small orders become unprofitable – when paperwork, salesperson time, shipping, billing and collection make the order not worth the effort. But sometimes there are reasons to take good care of small orders. One is that small orders may lead to big orders. Another is that many small orders may mean more customers and therein a more healthy diversification of your customer base. Regardless, the task of management is to find ways to improve profit while dealing with competing realities.

The first step toward more profitably managing small orders is to assess your order spread, i.e., what percentages of your total sales volume are from small, medium and large orders. Break down the analysis as follows:

- Number of orders
- Sales total in each category
- Percentage of total sales
- Average sales value per order

Example:

Order Size	# of Orders	Total Revenue	% of Total Rev	Avg Rev/Order
Under \$100				
\$100 to \$500				
\$501 to \$1,000				
Over \$1,000				

Naturally, you should select order-size ranges that reflect your particular business. Now, compute the average revenue per order. For example, you may find that 300 orders are in the \$100 to \$500 range but the average is only \$120. This may be acceptable, but it may pay to concentrate your sales efforts on, and compensate your salespeople for, moving the average order nearer to \$500.

Completing this exercise may take some time, but the information will be well worth it. For example, you may determine that the volume of small orders is so low that you don't have a problem. Or you may discover that most orders are very small and that you are spending considerable overhead running around filling small, unprofitable orders. By offering a small incentive to your customers or salespeople to increase average order size, for example, you could improve overall profit.

Before we consider ways to boost profit on small orders, ponder the following:

- A. You may discover that a great number of your orders are very small but together sum to just 5% or 10% of total revenue. If this is true, you could probably increase overall profit by simply not filling these orders. But this may not be good business. There are other ways to address this issue (see below).

- B. For most businesses, order processing costs are about the same no matter the order size.

Five Steps to Higher Profit:

Step 1: Calculate Your Annual Gross Profit. It's annual revenue minus cost of goods sold (i.e., direct costs such as raw materials purchased, factory labor, and other production costs). Example:

Sales	\$2,000,000
<u>Less Cost of Goods Sold</u>	<u>(\$1,200,000)</u>
Gross Profit	\$800,000

It's the profit earned and available to pay for sales, general and administrative expenses and capital costs (interest expense and return to equity).

Step 2: Compute your Gross Profit Percentage. It's simply the gross profit divided by total revenue. In the example above, it's 40% (\$800,000/\$2,000,000).

Step 3: Estimate Total Overhead Costs for Order Receipt, Processing, Shipping and Collection. Include the salaries of people who work directly in the order processing and billing departments, annual costs for equipment ownership or rental dedicated to the same, space ownership or rental, etc.

Example: \$150,000 a year.

Step 4: Calculate the Overhead Cost per Order. Divide your total estimated annual order cost (Step 3) by the number of orders processed during a year.

Example: \$150,000/5,000=\$30 per order

Step 5: Calculate the Breakeven Point for Order Size. Divide your overhead cost per order by your gross profit margin.

Example: \$30/.4 = \$75.

The result is your breakeven order size (in dollars). It's the order size that results in zero bottom-line profit. That's because the gross profit earned on the order simply equals your estimate of the direct overhead cost of processing the order.

How to Use It: From a pure dollars-and-cents perspective, one might simply reject any order that does not meet the breakeven order size. But in the real world, that may not be the best tack.

Here are other business steps you might consider to decrease the burden of those no-profit orders.

Increase your prices on smaller orders: Impose a handling or service charge for small orders, e.g., a \$15 or \$25 charge for orders under \$100. That way you recapture some of your cost and still keep the customer.

continued on next page

Need More Time? Get Serious

You want to get more accomplished but can't find the time? Get serious. Determine what you want to accomplish. Write it down. Set dates. What are your goals? What are your daily priorities? Then, stop letting others dictate where you spend your time. Get downright selfish. Develop new ways for working and living. You can do it. Here are some suggestions.

1. **Jump in and knock it out, NOW.** The best way to get something done is to get started. Stop procrastinating and making excuses. Few things are as hard as they seem. Get to work. Knock it out.
2. **Reduce drivetime.** Your time is valuable as is that of your staff. Driving is downtime. Drive only when necessary. Ask and you'll be amazed at how many people will deliver to you; come to you. Or request that they send it by email or common carrier. If you or yours must drive, do so when traffic is light, when it can be combined with a commute or another trip, and try to make good use of drivetime by listening to audiotapes from an industry conference. Finally, confirm that the information or person will be ready when you get there. And just in case, take something to do if you have to wait.
3. **Get Help from Others:** If nobody else existed we wouldn't have any interruptions, would we? It's other people who get in our way. So to get control of your time, you must enlist the help of those around you. Start by helping your staff, friends, family and vendors understand that you try to get the very most accomplished each day. Teach them what things you want to receive and the types of things you'd rather not hear about. Give them constant feedback and thank them for helping you stay productive.
4. **Telephone, Mail and Email:** Productivity is the key. Before you begin a communication, consider if it is necessary. Will it get you down the road to reaching our goals? Avoid a serious problem? If not, forget about it. If it IS necessary, what means is swift and sufficient? Often, that's email. Letters are good for documentation, but saved emails are also documentation. Letters are "nice" and have become almost for show. Telephone is best when things need to be discussed and/or care needs to be taken in delivery. Use each communication method wisely. Choose them with intent to be more productive and effective.
5. **Paperwork, Reports and Memos:** Is it necessary and productive? If so, keep it to a minimum. Have a purpose. Make it clear. Keep it short and simple. Periodically ask the recipients if the work has value to them. If not, change the format or eliminate it altogether.
6. **Meetings:** Try to avoid regular meetings. Too often they become self-perpetuating. Every meeting should have a very clear purpose of what will be accomplished. Set the agenda; achieve the goal; document the conclusions; who will do what and by what date; and how accomplishments will be re-visited for appraisal and confirmation.
7. **Just Say No.** Success is not wasted on the weak. Be strong enough to say no to projects that are not important to you and yours.
8. **One day at a time:** Our productive lives are lived one day at a time. Put one good and productive day after another and you'll accomplish great things. So make the most of each day. Begin each day the evening before. Write down your schedule for the coming day and "what's important now." Ponder the opportunity and your priorities. Establish a vision of what and how you'll make the most of it. Include the time you will wake. When the alarm goes off, review your plan. Then make it happen. At the end of the day, review your performance, consider how you will do better the coming day, then make your plan. □

Parts of this article were derived from and/or inspired by an article titled "Top 10 Time Wasters" by Arthur A. Hawkins II. His article can be found at www.timemanagement4u.com.

How to Keep Small Orders from Undermining Profit, continued from previous page

No commission paid on orders below breakeven. Maybe pay only half commission on orders between breakeven and twice breakeven.

Two-tiered pricing: Raise prices on all product, but offer an across-the-board price break on all orders over a certain amount.

Incentive-weighted commissions: Calculate your profit margin on each product and consider offering your salespeople a higher commission for sales of the company's most profitable products – and at good quantity levels.

To conclude, profits don't often improve on their own. Be proactive in managing your business to maximize profit. One important way is making each order profitable.

Finally, don't be rigid in applying your program. There are exceptions to every rule. For example, suppose you have been trying unsuccessfully to get business from a customer known to buy large quantities. Finally, they send you a little order.

You might want to accommodate them! □

"No one can possibly achieve any real and lasting success or 'get rich' in business by being a conformist."

J. Paul Getty



"Time is money – order more clocks."

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Book Review: Rich Dad, Poor Dad

By Robert T. Kiyosaki, Published by Warner Business Books

Personal-wealth books are a dime a dozen. Why would I want to read another? A friend gave me a copy of *Rich Dad, Poor Dad*. I held little hope that it would say anything eye-opening or original. But it was a gift; I appreciated the thoughtfulness and felt obliged to take a look and demonstrate that I did so. And you know — Mike Youngworth is a sharp man. He wouldn't give it to me if it did not offer something of value.

Sure enough. He did me a favor.

Mike and I are both in our early 40s with kids, cars, a house in the suburbs and a country club membership. We work our tails off and I'm certain he wonders, as I do, "How can I step off this train!?"

Rich Dad, Poor Dad is an easy read. It spoke to me as I guess it did to him.

It's a simple story – supposedly true – about Robert Kiyosaki, who has two fathers. One highly educated and with a good job but no accumulation of wealth and forever beholden to a boss. The other with little formal education but a commitment to build wealth and freedom. Kiyosaki listened to both, then decided to

Rich Dad says a house is not an asset – unless you rent it to someone at a profit.

follow the advice of his rich dad, a street-smart entrepreneur. Kiyosaki, by following that advice, says he found substantial wealth that he continues to build. Through *Rich Dad, Poor Dad*, originally published in 2001, he tells his story and offers the lessons to all of us.

The book has sold multiple millions, perpetually resides on the best-seller lists and garners a four-star rating on Amazon.com.

What is the path of the Rich Dad? It's really what all of us in the rat race know we should do – spend less and more wisely.

Here's my summary of the lessons:

1. The poor and middle class work for money. The rich make money work for them. You should, too. It's a lot more fun and substantially easier to amass real wealth.
2. Don't focus on getting higher-paying jobs. Focus on learning about money, finance, and how to make money. This is your foundation. Start by reading and trying. Start making little investments and learn from them. Go to lunch with people who are making money through investing. Listen and learn.
3. Amassing "things" won't make you rich. Amassing things that make money will. Rich Dad seems to like real estate. Residential and commercial. Buying and holding; buying and selling.
4. When you make money, spend it on income-generating assets. Don't waste it on consumables or items that decrease in value and/or require cash. Contrary to conventional wisdom, Rich Dad says a house is not an asset – unless you rent it to someone at a profit. With *you* living in it, it does not generate income but rather considerable expenses in the form

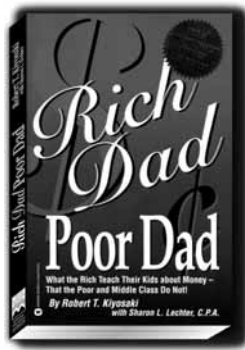
of taxes and maintenance. Resist the temptation to buy big homes and expensive cars unless you adhere to #5 below.

5. When you want something that costs money, like a boat, resist the accepted means for acquiring it – borrowing money. Challenge yourself to find a way to earn the money and pay cash. When Rich Dad wants a new Porsche, he challenges

It's really what all of us in the rat race know we should do – spend less and more wisely.

himself to earn the money through his creativity, innovation and initiative. By reading and learning through trial and error, he's gotten to where it's easy. He just searches around, typically for real estate, and finds a deal such as a residential property that can be bought cheap and rented for monthly cash flow.

Thank you, Mike. This simple little book reinforces principles that I need to keep in mind and in practice. We all should. If not for the money, for the freedom and quality of life. □



LAUGH A LITTLE

A Cowboy and a Yuppie

A cowboy is herding his livestock in a remote pasture when a brand-new BMW advances out of a dust cloud toward him. The driver, a young man in a Brioni suit, leans out the window and asks, "If I tell you exactly how many cows and calves you have in your herd, will you give me a calf?"

The cowboy looks at the man, obviously a yuppie, then looks at his peacefully grazing herd and calmly answers, "Sure. Why not."

The yuppie parks his car, whips out his notebook computer, connects it to his cell phone and surfs to a NASA page on the Internet. He calls up a GPS satellite navigation system to get an exact fix on his location, which he then feeds to another NASA satellite that scans the area in an ultra-high-resolution photo and sends it to him. He then accesses an MS-SQL database through an ODBC-connected Excel spreadsheet with hundreds of complex formulas, analyzes the image and delivers a count.

"You have exactly 1,586 cows and calves," he says.

"That's right," says the cowboy as he watches the young man select one of the animals and stuff it into the back seat of his car.

Then the cowboy asks, "Hey, if I can tell you exactly what your business is, will you give me back my calf?" "Okay, why not."

"You're a consultant," says the cowboy. "Wow! That's correct," says the yuppie. "How did you guess that?"

"No guessing required," answered the cowboy. "You showed up here even though nobody called you. You want to get paid for an answer I already knew, to a question I never asked, and you don't know anything about my business."

"Now give me back my SHEEP." □

T. Boone Pickens, Jr.



T. Boone Pickens, Jr.

Born in Oklahoma in 1927, son of a land man, T. Boone Pickens graduated from Oklahoma State University in 1951 with a degree in geology. He married at 20 and had four children. He took a job as a

roughneck for a refinery and then as a geologist with Phillips Petroleum. Citing difficulties with company bureaucracy, he resigned to work for himself. With \$2,500, he began well-site and geological services work and soon found some investors to back him on a drilling project. He hit eight in 16 tries. He went on to build an oil and gas company – Mesa Petroleum – that by 1982 had assets of \$2 billion. He became a corporate raider, profiting from successful and failed attempts alike. He earned \$760 million from his “unsuccessful” attempt to purchase General American Oil.

Today, Pickens is chairman of the billion-dollar energy hedge fund BP Capital Management and ranks among Forbes’ 400 richest Americans with an estimated net worth approaching \$2 billion. Earlier this year, he made a donation to his alma mater that is currently valued around \$250 million.

What tips does he have for the owner of a small private company? Plenty.

- Find assets and put them to profitable use.
- You must have total dedication, at all levels for your organization, to adding value to the customer.
- Instill and nurture entrepreneurial instincts – a willingness and ability to assess risks and make decisions quickly.
- Give employees a “cut of the pie.” It creates a team spirit, with everyone working toward a common goal.
- Strive to constantly improve your ability to communicate the common vision, goals and culture. The result will be a highly motivated, cohesive team working toward the same goals. That, in turn, leads to high

productivity – which should translate to higher profit.

- Make sure everyone in your organization is a contributor. Give them responsibility and the authority to get the job done. Fewer people with more authority increases productivity and enables the company to react more quickly to opportunities. Also, fewer and more productive employees enable the company to pay higher salaries and better benefits.

Additional Pickens quotes that offer lessons for private business owners:

About resigning from Phillips Petroleum at age 26 and “going solo”:

“(While working for Phillips) ... I rode a bicycle to work. It brought a few snickers but it was sure easy to park.”

“I was twenty-six years old and on my own. It scared the hell out of me, but I felt as though somebody had taken their boot off my neck.”

“Only a few people were as blunt as my wife’s uncle Pete. ‘Boone,’ he told me soberly, ‘you don’t have a chance. You don’t know anything. How could you? You only worked for Phillips for three years.’”

“I knew the warm-up was over. I needed to make a deal and fast.”

“My back was against the wall. If I could find a good prospect and sell it, I would get some cash and maybe a piece of the action.”

“Money was tight. I had learned to hunt squirrels years before, living in Holdenville. Once, Lynn [his wife] asked if I couldn’t shoot some younger, more tender squirrels.”

“I was a sole proprietor: I had no employees and even did my own typing.”

“I had a prospect that I thought would be an easy sell. I took the deal to a local independent, Walter Caldwell. He would drill two wells ... and I would get \$2,500 for putting the deal together. Both wells were small gas producers. Caldwell tagged me ‘boy geologist.’”

“I had been on my own for about thirty days. The success of those two

wells ended any doubts I might have had about leaving the corporate umbrella. This was what I was born to do.”

“There was plenty left to learn and mistakes would help me. I just had to avoid making the same mistake twice.”

“I tried to distinguish the players from the tire-kickers.”

“At some point, it seems everybody starts to pull for you.”

“The key to making deals was for me to develop ‘drillable’ ideas.”

The Early Years:

“I decided that we had to get into an area that was not picked over if we were going to do any good.”

“... I was also starting to realize that I wanted to do more than scramble through life as a one-man operation. There had to be a better way.

“I had become an independent oilman, which meant a life of difficult decisions, personal risk, and grueling hours. Independence meant you were free to drive a couple of thousand miles a week, eat when you could and try to outsmart leaseholders, big oil companies, the weather and the geology. I thrived on it.”

“It was time for me to redefine my idea of success. I wanted to expand my business and hire someone to help carry the load, to handle some of the details. That was the first step toward what became of my larger dream. To build a real company.”

“... plenty of opportunity if you could get financing, keep your health and hold on to your sanity while juggling a dozen different deals.”

“Feeling the pure joy of work and success – jumping out of bed in the morning charged up to accomplish something in the day ahead – is necessary for an entrepreneur.”

“The reason for my getting the work was price: I was cheap and fast.”

“We were doing whatever it took to survive and we were learning. By the early 1960s, I had enough experience to start doing some interesting things.”

continued on page 14

Selling a Company Tax-Free

During negotiations, the purchase price of the deal is established along with a general idea of which assets are to be exchanged. The major objective of structuring a transaction is the ability to transfer the expected value of the deal to the seller while operating within constraints suitable to the buyer. The type of structure depends on the law, the tax code and the creativity of the professionals involved in the deal. There are a number of different ways to structure a transaction so that benefits to the buyer and seller can be maximized. This article provides an introduction to a variety of tax-free strategies that, when used properly, will maximize the value to both buyer and seller.

Generally, stockholders who sell or exchange their stock, and corporations that sell or exchange their assets, must recognize gains and losses for tax purposes. But the Internal Revenue Code (IRC) contains various rules that provide for tax-free treatment. IRC Sections 354-368 provide the basic rules for tax-free reorganizations. IRC Section 368 specifically identifies various types of corporate reorganizations that can qualify for tax-free treatment.

By way of background, a business may be transferred either by the corporation selling the assets of the business or by the owners of the corporation selling their shares. In the typical stock sale, the selling stockholders accept cash and notes for their stock and recognize a gain or loss at closing. The buyer receives a basis in the stock equal to the purchase price, and the tax basis of the assets and liabilities, within

the acquired corporation, including any tax assets, such as net operating loss carry forwards, capital loss carry forwards and tax credit carry forwards, are unaffected. But use of these tax assets may be limited after an ownership change.

By way of contrast, selling stockholders can dispose of their stock in a tax-free reorganization by exchanging their shares for those of the acquiring corporation (i.e., instead of accepting cash and notes). The selling stockholders generally recognize no gain or loss, and obtain a basis in the acquiring corporation's stock equal to their basis in the selling corporation's shares. The tax basis of the acquired corporation's assets and liabilities are unaffected, and the acquiring corporation inherits the tax attributes of the acquired corporation. Similar to the taxable sale, the use of any tax attributes may be limited.

Such a tax-free reorganization is essentially a mere rearranging of the corporate ownership structure. But be aware that there must be a valid business reason for such a reorganization. For example, an individual may sell shares of his company in exchange for shares in a much larger company to remain involved with management or ownership of a much larger business entity.

Tax-free reorganizations generally are divided into three categories:

1) *Mergers, consolidations and stock exchanges* that lead to the acquisition or combination of corporations. In acquisition reorganization, the acquiring corporation ultimately ends up in control of the target

corporation's assets or stock. These types of reorganizations typically are known as Type A, B and C reorganizations.

2) *Divisive reorganizations* that are otherwise known as spin-offs, split-offs and split-ups. The purpose is to divest a corporate business segment or divide the ownership of a corporation. These typically are known as Type D reorganizations, but a Type D reorganization also can be acquisitive.

3) *Restructuring reorganizations* that involve the change of form, place of organization or identity. These typically are referred to as Type E, F and G reorganizations and involve both the corporation and its stockholders.

A tax-free reorganization is advantageous if you are selling out to a corporate buyer whose stock is a good investment. Remember, you'll be exchanging a non-diversified investment over which you had control (your own company) for a non-diversified investment over which you may have little or no control. The IRC typically restricts how soon the acquired may sell the stock obtained in the transaction – typically for two years. What risk do you bear during those two years? That's your call. □

Jeffrey J. Presogna, CPA CVA, is a Vercor partner and consults on the purchase and sale of midsize private companies. You can reach him at Jeff@vercoradvisor.com.

IRC Section 368 specifically identifies various types of corporate reorganizations that can qualify for tax-free treatment.

TIPS FROM THE TOP

T. Boone Pickens, Jr., continued from page 13

“Undercapitalization afflicts 90 percent of the new businesses in America, and we were all too typical. Every time we got a little cash something would happen and we'd be back at the starting line.”

“When all was said and done, the chances were slim that any one strategy would ever make us a major player. We needed to fish with more lines out.”

When things got really bleak, financially:

“We had our backs to the wall again.”

“Boys,” I said, ‘this is it. We've got to figure out a way to make \$300 million, and we've got to make it fast. A field goal won't do it – we need a touchdown.’”

“I was used to having my back against the wall. But \$300 million was a lot of money – more than half of Mesa's net worth. You don't find that kind of money under a rock. We were about to enter a risky game that would make us famous, and in some circle's infamous,

initiating deals involving corporations much larger than Mesa: Gulf, Phillips and Unocal. We would identify the undervalued, mismanaged companies and then make a huge investment in them. We would try to force the managements to do something for their stockholders, including us. And if they refused, we would try to take them over.”

continued on next page

T. Boone Pickens, Jr., continued from previous page

About executives of large public corporations:

“Far too many executives have become more concerned with the ‘four P’s’ – pay, perks, power and prestige – rather than making profits for shareholders.”

“Too often, company managements are more concerned with their own preservation than enhancing their shareholder’s (value). These managements are generally not good risk takers, and their companies suffer from a lack of productivity.”

“If you are a stockholder, the chances are that one way or another, most corporations are misappropriating your money. It is legal under the system. Every day this respectable crime is perpetrated in corporate corridors across the country.”

On his corporate takeovers:

“The corporate world did not lack for poor managements and undervalued companies, so acquisitions would become a key part of our growth strategy.”

“The minnow trying to swallow a whale. But what we lacked in size, we would make up for in creativity and tenacity.”

General:

“Lynn and I decided to get married. Our parents wanted us to wait a few years, but we wouldn’t listen.”

“We rented a house for \$60 a month and sublet one room for \$40 (breakfast included) to a friend. And that, sports fans, is entrepreneurship.”

“I just don’t think I look at life the same way a lot of people do.”

“Be willing to make decisions. That’s the most important quality in a good leader. Don’t fall victim to what I call the ready-aim-aim-aim-aim syndrome. You must be willing to fire.”

“I’ve always believed that it’s important to show a new look periodically. Predictability can lead to failure.”

“Keep things informal. Talking is the natural way to do business. Writing is great for keeping records and putting down details, but talk generates ideas. Great things come from our luncheon

meetings which consist of a sandwich, a cup of soup, and a good idea or two. No martinis.”

“I believe the greatest opportunity lies in a free marketplace. There are powerful forces afoot trying to restrict that freedom in the interests of the vested and already wealthy. I am talking about a relatively small collection of corporate executives who would use the engine of American commerce for their own narrow ends.”

“Play every game for all you’re worth. But when it’s over, it’s over.”

“Asking people for money is the most essential skill for a young dealmaker.”

“... money has frequently been a motivating force in my life. It’s quite a thrill to make money.”

“I believed in good planning, and if I could accomplish as much in ten hours as someone else could in twenty, that really made me happy.”

“It looked like a cinch – and that should have scared the hell out of me. My experience today would have told me that there are no cinches in this business.”

“I had to adjust my dreams to fit reality – or could I somehow change reality to match my dreams?”

“Entrepreneurs need more capital than banks are willing to lend – to expand, to build new plants or just to get started – and they can find that capital by selling their ideas in the equity markets.”

“I have found that many CEOs could care less about the mechanics of a deal and depend almost totally on their lawyers and investment bankers. They don’t ask questions because they are afraid of looking stupid. I would rather look uninformed at thirty-six, than stupid forever after.”

“I felt that size was meaningless. Results were what mattered.”

“If you are a consistent moneymaker, you will be a good decision-maker. Sometimes the window of opportunity is open only briefly. Waiting isn’t a decision, although many people think it is.”

“The more objective and the less emotionally involved you are, the more successful you tend to be.”

“If I can borrow and get a good return on these funds, it’s more satisfying to me than getting a good return on equity. It’s like a bonus. On the other hand, if you are highly leveraged and lose, your losses are compounded.”

“(I don’t worry so much about the interest rate on borrowed money.) If one half of a percent is going to make a difference, then I shouldn’t be borrowing the money anyway. And I’m always confident that I can make several times what the money costs me.”

“I get concerned, but I don’t get nervous. You can’t make money consistently if you’re uptight. If you don’t watch out, you’ll spend twice as much time on the losers as you do on the winners. You shouldn’t take a risk in the first place if you can’t handle the loss, because you’re not always going to win.”

“I hate losing, but I know that an aggressive investor is going to take some losses.”

“Money is a report card.”

“It seems as if everything I do is geared to saving time.” □

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