# Before you buy a nursery

## Prospective purchasers must know what they're getting before they commit

BY RYAN KUENZI

WHEN IT COMES to buying or selling businesses, buyers typically have the benefit of experience at the outset of a deal — at least more so than sellers.

But a number of issues can still catch eager buyers unaware.

In the nursery business (and agribusiness, more generally), both private equity buyers and strategic buyers should be asking many of the same questions and examining similar issues, spanning everything from tax and transaction structure to bench strength in a management team. Let's look at a few of these in detail.

### Asset sales versus stock sales

How you structure a deal — whether as an asset or stock transaction — has two important consequences: first, the tax attributes achieved from the transaction and second, your exposure to any of the seller's liabilities you may be assuming.

On both fronts, an asset sale is the best deal for the buyer (except in a few exceptional circumstances) due to the step-up in the tax basis of the acquired assets. Stock deals can be given asset treatment if the buyer is willing to make the appropriate tax elections and certain criteria are met; however, doing so leads to additional hurdles that typically create more complexity and an increased possibility of the deal falling through.

Still, at times, a buyer's only option is a stock transaction. This happens when the seller has significant negotiating power; for example, significant intellectual property, market penetration or another competitive advantage a buyer must get its hands on at almost any cost.

### Liability

An asset deal helps mitigate the buyer's exposure to any outstanding debts, lawsuits or other liabilities incurred by previous owners, including outstanding liens or missing filings.

However, asset deals don't automatically protect you from all successor liability risk, so have your due diligence team keep an eye on liabilities around payroll taxes, sales and use taxes, etc., and make sure appropriate indemnifications are included in any deal documents.

With nurseries, it's often environmental issues that come back to haunt subsequent owners. Take buried diesel tanks, for example.

If a seller installed buried tanks 40 years ago and they started leaking 25 years ago, a buyer could be looking »

at significant cleanup and remediation costs. Chemical containment issues can also be another significant issue that pops up during due diligence. Well-written indemnification clauses are a must, no matter how a deal is structured.

**Tax considerations**

On the tax side, there are two important reasons buyers prefer to purchase a seller's assets rather than its equity.

First, assets are depreciable based on their allocated purchase price after the transaction is complete. With the accelerated tax depreciation benefits available in recent years, many sellers have already depreciated their assets down to $0 for tax purposes.

If you purchase the company's stock, you likely won't be able to depreciate those assets further. If you purchase the assets, you step up the tax basis of the assets to the price you paid for them and can begin depreciating them all over again.

Unlike buyers, sellers typically favor a stock sale because their gain is more likely to be capital in nature than treated ordinary income, so it's taxed at a lower rate. A stock sale is also beneficial to sellers structured as C corporations because it eliminates the double tax on the sale of assets. (A stock sale is taxed at only the shareholder level, rather than at both the corporate and shareholder levels.)

**Allocating purchase price**

While we're talking about the tax consequences of a transaction, allocation of purchase price is another key consideration. In an asset sale, buyer and seller must agree on how the purchase price breaks down into inventory, fixed assets, goodwill and other categories.

This is a push and pull: What's best for buyers typically isn't great for sellers and vice versa. As a buyer, you want to allocate as much as you can to assets with the shortest tax lives, such as inventory or equipment.

Buyers should seek to minimize the amount allocated to goodwill and other intangibles, which are amortizable over a 15-year period. Non-depreciable assets, such as land, need to be carefully considered for purchase price allocation purposes as well.

To illustrate, say a buyer purchases a nursery for $1 million, which includes the net pool of all assets transferred via the sale. If $100,000 is allocated to inventory (now its cost basis) and the buyer can sell the inventory for $125,000 a year later, selling it generates $25,000 of taxable income. If only $50,000 had been allocated to inventory but the buyer still manages to sell it for $125,000, the buyer in this case must recognize the difference between the inventory cost basis and the sale price ($75,000) as ordinary income,

which means heftier taxes shortly after the transaction closes.

Equipment is typically the second-best allocation category for a buyer. Say the same nursery owns five tractors with a market value of $210,000, all of which is allocated to those tractors for purchase price allocation purposes.

Tractors depreciate over the course of seven years, giving the buyer a potential deduction of $30,000 per year. If only $70,000 had been allocated to the tractors, the buyer would be looking at a depreciation deduction of $10,000 per year instead.

**Tax surprises**

In any transaction, expect some issues. Two tax hot buttons for nurseries today relate to accounting methods and multistate taxes.

Though strategic buyers are often on the cash method of accounting, private equity buyers often don't realize how different a company's financial statements can look under the accrual method.

Returning to our earlier example, let's assume the seller has written off the costs of producing existing inventory, as is permitted under the cash method of accounting. On its internal books, nothing may be recorded for inventory, because the owners have expensed it: they won't recognize the income until it's sold.

Buyers on the accrual method are used to allocating costs into inventory, which produces accurate costing and makes it easier to understand profit margins embedded within inventory. The cash basis also doesn't often reveal the quality of accounts receivable.

In short, make sure if you're looking at an unfamiliar accounting method that you understand what exactly you're buying — or not buying!

Second, multistate tax issues can rear their heads unexpectedly in a transaction. Nursery owners shipping their products into other states often don't realize they've potentially created a nexus for state sales and use and business and occupation taxes.

Examine a target's exposure early »

in the process to keep these matters from creating unnecessary hiccups during the deal life cycle.

### Inventory

It isn't uncommon for nursery businesses to lack strong inventory controls or to have a mismatch between what's on the books and what's in their fields. Buyers should do inventory observations and field tours to understand whether the numbers a seller gives are reasonable.

The same goes for plant mortality rates and other key operating metrics provided by a seller. Make sure to spend adequate time in the field reviewing these items during due diligence.

On an even more fundamental level, examine whether the inventory you're purchasing makes sense for your business model. Does it complement or strengthen your product line? Does it extend your selling season?

If it doesn't fit strategically with your business, including labor demands and customer needs, then purchasing inventory may not be the best and highest use for your cash.

Next, look at demand. Customer preferences can change from year to year and throughout housing cycles. Given the years it can take to grow a shade tree for sale, make sure your target's inventory aligns with demand and you're happy with what you're getting.

### Management

Though evaluating management sounds like the softer side of a transaction, it too has financial implications.

From a private equity buyer's perspective, a solid management team with a succession plan is part of the innate value of a business. As a strategic buyer, the management team may be less important (assuming the buyer intends to eliminate some redundancies), but loyalty to existing owners can impact the nursery's workforce, especially its relationships with its migrant workers.

In both cases, ascribe a value to the target company's leadership. Even if you intend to retain much of the existing management team, there's always some attrition associated with a transaction. Understand what key personnel would cost to replace as well as what kind of value they bring to their operations.

### The big picture

Finally, don't forget about the big picture. When considering a transaction with any seller, ask:

- Does the seller know where its risks and opportunities are?
- Is there a clear vision for the business moving forward?
- Has the business given appropriate attention to management succession?
- Are the financial statements and other financial documents clean, and do they tell an accurate story of the business?
- Do the business' numbers make sense and indicate a thoughtful approach to its operations?

Not all sellers are perfect, and issues are bound to come up before or during due diligence. No one thing ought to be enough to derail a transaction, but be wary of trends; for instance, consistently misaligned numbers or a scattershot business strategy.

As tempting as a deal may seem, step back to understand what it is you're buying before you make a move, because buyer's remorse is expensive. Your checkbook — and your business — will thank you.

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