Buying An Existing Business

Key Questions to Consider *Before* Buying a Business

- Is the right type of business for sale in the market in which you want to operate?
- What experience do you have in this particular business and the industry in which it operates?
- How critical is experience in the business to your ultimate success?
- What price and payment method are reasonable for you and acceptable to the seller?

Key Questions to Consider *Before* Buying a Business

(continued)

- **Should you start the business and build it from the ground up rather than buy an existing one?**
- **What is the company's potential for success?**
- **What changes will you have to make – and how extensive will they have to be – to realize the business's full potential?**
- **Will the company generate sufficient cash flow to pay for itself and leave you with a suitable return on your investment?**

Advantages of Buying A Business

- It may continue to be successful
- It may already have the best location
- Employees and suppliers are established
- Equipment is already installed
- Inventory is in place and trade credit is established

Advantages of Buying A Business

(continued)

- You can "hit the ground running"
- You can use the previous owner's experience
- Easier financing
- It's a bargain

Disadvantages of Buying A Business

- “It’s a loser”
- Previous owner may have created ill will
- “Inherited” employees may be unsuitable
- Location may have become unsatisfactory
- Equipment may be obsolete

Disadvantages of Buying A Business

(continued)

- **Changes can be difficult to implement**
- **Inventory may be stale**
- **Accounts receivable may be worth less than face value**
- **It may be overpriced**

Acquiring a Business

- Analyze your skills, abilities, and interest.
- Prepare a list of potential candidates (Remember the "hidden market.")
- Investigate and evaluate candidate businesses and select the best one.
- Explore financing options.
- Ensure a smooth transition.

Five Critical Areas for Analyzing an Existing Business

1. **Why does the owner want to sell.... the *real* reason?**
2. **What is the physical condition of the business?**
3. **What is the potential for the company's products or services?**
   - **Customer characteristics and composition.**
   - **Competitor analysis.**
4. **What legal aspects must I consider?**
5. **Is the business financially sound?**

The Legal Aspects of Buying a Business

- **Lien – creditors' claims against an asset.**
- **Bulk transfer – protects business buyer from the claims unpaid creditors might have against a company's assets.**
- **Contract assignment – buyer's ability to assume rights under seller's existing contracts.**

The Legal Aspects of Buying a Business

(continued)

- **Restrictive covenant** – contract in which a business seller agrees not to compete with the buyer within a specific time and geographic area.
- **Ongoing legal liabilities** – physical premises, product liability, and labor relations.

Figure 5.1 The Acquisition Process

1. Identify and approach candidate

2. Sign nondisclosure statement

3. Sign letter of intent

4. Buyer's due diligence investigation

5. Draft the purchase agreement

6. Close the final deal

7. Begin the transition

Negotiations

1. Approach the candidate. If a business is advertised for sale, the proper approach is through the channel defined in the ad. Sometimes, buyers will contact business brokers to help them locate potential target companies. If you have targeted a company in the "hidden market," an introduction from a banker, accountant, or lawyer often is the best approach. During this phase, the seller checks out the buyer's qualifications, and the buyer begins to judge the quality of the company.

2. *Sign a nondisclosure document.* If the buyer and the seller are satisfied with the results of their preliminary research, they are ready to begin serious negotiations. Throughout the negotiation process, the seller expects the buyer to maintain strict confidentiality of all of the records, documents, and information he receives during the investigation and negotiation process. The nondisclosure document is a legally binding contract that ensures the secrecy of the parties' negotiations.

3. Sign a letter of intent. Before a buyer makes a legal offer to buy the company, he typically will ask the seller to sign a letter of intent. The letter of intent is a non-binding document that says that the buyer and the seller have reached a sufficient "meeting of the minds" to justify the time and expense of negotiating a final agreement. The letter should state clearly that it is non-binding, giving either party the right to walk away from the deal. It should also contain a clause calling for "good faith negotiations" between the parties. A typical letter of intent addresses terms such as price, payment terms, categories of assets to be sold, and a deadline for closing the final deal.

4. Buyer's Due Diligence. While negotiations are continuing, the buyer is busy studying the business and evaluating its strengths and weaknesses. In short, the buyer must "do his homework" to make sure that the business is a good value.

5. Draft the Purchase Agreement. The purchase agreement spells out the parties' final deal! It sets forth all of of the details of the agreement and is the final product of the negotiation process.

6. Close the final deal. Once the parties have drafted the purchase agreement, all that remains to making the deal "official" is the closing. Both buyer and seller sign the necessary documents to make the sale final. The buyer delivers the required money, and the seller turns the company over to the buyer.

7. Begin the Transition. For the buyer, the real challenge now begins: Making the transition to a successful business owner!

Sources: Adapted from *Buying and Selling: A Company Handbook*, Price Waterhouse,(New York: 1993) pp.38-42;Charles F. Claeys, "The Intent to Buy," *Small Business Reports*, May 1994, pp.44-47.

Determining the Value of a Business

- Balance Sheet Technique
  - Variation: Adjusted Balance Sheet Technique
- Earnings Approach
  - Variation 1: Excess Earnings Approach
  - Variation 2: Capitalized Earnings Approach
  - Variation 3: Discounted Future Earnings Approach
- Market Approach

Balance Sheet Techniques

Book Value of Net Worth = Total Assets - Total Liabilities

= $266,091 - $114,325

= <u>$151,766</u>

Variation: Adjusted Balance Sheet Technique:

Adjusted Net Worth = $274,638 - $114,325

= <u>$160,313</u>

Earnings Approaches

Variation 1: Excess Earnings Method

Step 1: Compute adjusted tangible net worth:

Adjusted Net Worth = $274,638 - $114,325 = $160,313

Step 2: Calculate opportunity costs of investing:

Investment	$160,313 x 25% =	$40,078
Salary		+ $25,000
	Total	$65,078

Step 3: Project earnings for next year:

$74,000

Excess Earnings Method

(continued)

Step 4: Compute extra earning power (EEP):

EEP = Projected Net Earnings - Total Opportunity Costs

= \$74,000 - 65,078 = \$8,922

Step 5: Estimate the value of the intangibles ("goodwill"):

Intangibles = Extra Earning Power x "Years of Profit" Figure*

= 8,922 x 3 = \$26,766

* Years of Profit Figure ranges from 1 to 7; for a normal risk business, it is 3 or 4.

Excess Earnings Method

(concluded)

Step 6: Determine the value of the business:

Value = Tangible Net Worth + Value of Intangibles

= \$160,313 + 26,766 = \$187,079

Estimated Value of the Business = \$187,079

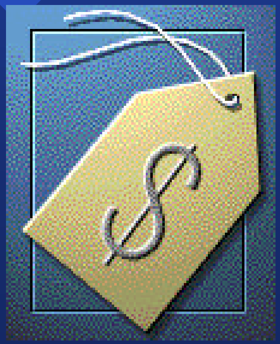
Earnings Approaches

Variation 2: Capitalized Earnings Method:

$$\text{Value} = \frac{\text{Net Earnings (}\textit{After}\text{ Deducting Owner's Salary)}}{\text{Rate of Return*}}$$

*** Rate of return reflects what could be earned on a similar-risk investment.**

$$\text{Value} = \frac{\$74{,}000 - \$25{,}000}{25\%} = \$196{,}000$$



Earnings Approaches

Variation 3: Discounted Future Earnings Method:

<u>Step 1</u>: Project earnings five years into the future:

<u>3 Forecasts:</u>
Pessimistic
Most Likely
Optimistic

Compute a *weighted average* of the earnings:

$$\frac{\text{Pessimistic} + (4 \times \text{Most Likely}) + \text{Optimistic}}{6}$$

Discounted Future Earnings Method

(continued)

Step 1: Project earnings five years into the future:

Year	Pess	ML	Opt	Weighted Average
1	$65,000	$74,000	$92,000	$75,500
2	$74,000	$90,000	$101,000	$89,167
3	$82,000	$100,000	$112,000	$99,000
4	$88,000	$109,000	$120,000	$107,333
5	$88,000	$115,000	$122,000	$111,667

Discounted Future Earnings Method

(continued)

<u>Step 2</u>: Discount weighted average of future earnings at the appropriate present value rate:

$$\text{Present Value Factor} = \frac{1}{(1+k)^{t}}$$

where...

k = Rate of return on a similar risk investment

t = Time period (Year - 1, 2, 3...n)

Discounted Future Earnings Method

(continued)

Step 2: Discount weighted average of future earnings at the appropriate present value rate:

Year	Weighted Average	x	PV Factor	=	Present Value
1	$75,500		.8000		$60,400
2	$89,167		.6400		$57,067
3	$99,000		.5120		$50,688
4	$107,333		.4096		$43,964
5	$111,667		.3277		$36,593
			Total		$248,712

Discounted Future Earnings Method

(continued)

<u>Step 3</u>: Estimate the earnings stream beyond five years:

Weighted Average Earnings in Year 5 x $\dfrac{1}{\text{Rate of Return}}$

$$= \quad \$111{,}667 \ \times \ \frac{1}{25\%}$$

<u>Step 4</u>: Discount this estimate using the present value factor for year 6:

\$446,668 x .2622 = <u>\$117,116</u>

Discounted Future Earnings Method

(concluded)

Step 5: Compute the value of the business:

Value = Discounted earnings in years 1 through 5 + Discounted earnings in years 6 through ?

= $248,712 + $117,116 = $365,828

Estimated Value of Business = $365,828

Market Approach

Step 1: Compute the average Price-Earnings (P-E) Ratio for as many similar businesses as possible:

Company	P-E Ratio
1	3.3
2	3.8
3	4.7
4	4.1

Average P-E Ratio = 3.975

Step 2: Multiply the average P-E Ratio by next year's forecasted earnings:

Estimated Value = 3.975 x $74,000 = $294,150

Understanding the Seller's Side

Exit Strategies:

- Straight business sale
- Form a family-limited partnership
- Sell a controlling interest
- Restructure the company
- Sell to an international buyer
- Use a two-step sale
- Establish an ESOP

The Five P's of Negotiating

Preparation - Examine the needs of both parties and all of the relevant external factors affecting the negotiation before you sit down to talk.

Poise - Remain calm during the negotiation. Never raise your voice or lose your temper, even if the situation gets difficult or emotional. It's better to walk away and calm down than to blow up and blow the deal.

Patience - Don't be in such a hurry to close the deal that you end up giving up much of what you hoped to get. Impatience is a major weakness in a negotiation.

Persuasiveness - Know what your most important positions are, articulate them, and offer support for your position.

Persistence - Don't give in at the first sign of resistance to your position, especially if it is an issue that ranks high in your list of priorities.