WOMEN'S ENTERPRISE CENTRE

Buying A Business

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1. Why Buy?

There are many reasons for buying a business. They all reduce, however, to two fundamental motives. People who are not in business may look to buying an existing operation rather than starting a new one. And people who are already in business may wish to acquire another business as a way of accelerating growth, making themselves more attractive to sources of additional capital, filling out a product line, adding to their existing capabilities or entering a new market.

2. An Alternative to Start-ups

If you are looking to go into business for the first time, there's a lot to be said for buying your way into an existing operation. Obviously you can get going a lot faster if you buy into a business that is already up and running. There is a track record, a defined product or service, employees, a market with real customers, a network of suppliers, an established distribution channel and an income. You need not have to figure out how to create any of this, as you would with a start-up. Instead, you can spend your energy on maintaining and (hopefully) improving it. Perhaps most appealing of all, you do not have to come up with a new product or service: you can buy into one that's already in place.

All of this may also make it far easier to get financing. Generally, bankers and investors are reluctant to put money into something new and untested. However, they are less hesitant about funding something that has been around for some time. The fact that there is some kind of established revenue stream and definable assets can be quite persuasive to those you are asking for financial support.

Before rushing to buy, however, remember that the very things that seem like advantages can also be serious disadvantages. The fact that everything is already in place may also mean that it is harder to change. Employees may resent a new owner. The existing plant, equipment, or processes may be outdated. The market for the existing product line may be shrinking. The location may no longer be appealing, which means you would have to change it. Existing suppliers or distributors may be ineffective or sub-optimal. There may even be skeletons in the closet – old liabilities or new regulatory requirements, a bad reputation or a poor public image - that you know nothing about.

If drastic changes are necessary, you may find that trying to reform something that is firmly entrenched may be a lot more difficult that starting from scratch. In fact, if the existing business is not doing very well, you may wind up buying someone else's headaches. And if you're really careless, you may also pay too much for the privilege of unscrambling the mess.

The only answer to buying a lemon is to take your time. Do not rush into anything. Shop around and look at different prospects. Investigate them thoroughly. Ask questions, call for detailed financial statements, and get references. Make sure not only to talk to the names you are given but also to anyone else who may know something about the business. If at any point you feel pressure to make a quick decision before you have all the facts, or there is a reluctance to provide full and detailed information, or if the deal just doesn't feel right, head for the nearest exit. Don't waste your time or jeopardize your future on a bad investment. There are many other businesses available.

3. Enhancing Existing Operations

If you already own a business, acquiring another can represent a significant strategic move. You may, for example, want to pursue rapid growth. Acquiring another business can be a way of doing this far more quickly than growing your existing operation. Essentially, you can buy a means of generating a revenue stream that you can immediately add to your own bottom line.

This can be crucial if you are looking for additional financing. You may be too small to interest venture capitalists that need deals of a certain size before they start making money. They may also require far more rapid growth than your company has shown to date. An acquisition may be the answer to both these problems.

Acquisitions also provide you with new resources and new capabilities. If you are careful in what you buy, you can add a whole new set of skills to what your employees currently know. You can secure new technology, physical assets, or innovative business processes. You can also secure the rights to products that give you a stronger position in the marketplace. Sometimes this involves using an acquisition to fill in gaps in a company's offerings. Sometimes it means generating the ability to create new and far more effective products. And sometimes it even means knocking inconvenient competitors out of the game by buying them out.

Buying an additional business is also a classic way of entering a new market. That is how many companies establish themselves in other parts of this country or in international markets. Instead of learning about a different culture or different market dynamics, the purchaser can acquire this expertise ready-made.

Even so, many of the same dangers buying facing a new entrepreneur buying a business would also face an established firm seeking to do the same. Taking your time, doing the research, and knowing what you are getting into are just as important to the established buyer as to the novice.

4. What to Buy

When it comes to deciding on what to buy, the challenge is somewhat easier for you if you are already in business. Your existing operations will help to define what you should be shopping for in terms of size and complementarily. If you are just starting out, the limits will be set by what you can afford, but also by your skills, interests and contacts.

One approach that both new and established entrepreneurs often take is to buy into a sub-optimal or even failing business at a bargain price and then turn it around. The strategy involves recognizing some unexploited value in the target business and developing a means of capitalizing on it. Success, however, depends on really knowing the business, having better ideas than its existing management, and having the means - both in terms of money and managerial skill – to implement the necessary changes. And turnarounds can be time-consuming, distracting you from your core business while to try to repair the new one.

5. Buying Assets

In buying a business, most people think of acquiring assets. The assets involved will depend on the type of business. They may but do not have to include: land, a building, physical equipment, inventory, a business name and reputation, a client or customer list, contractual arrangements with employees and suppliers, prepaid expenses, and intellectual property (business processes, technology, patent rights). Generally, the business owner seeking to sell a business will prepare an itemized list and assign a value, not only to the individual assets, but to the business as a whole.

As a prospective purchaser looking at these assets, your task is to ask the right questions about their condition and value. And beyond the physical assets, you need to do a thorough investigation of other aspects of the operation. For example:

- *Make sure that the list of assets prepared by the seller details all of the equipment and furniture involved.*

  You may need to know model numbers and dates of purchase.
- *Find out if any of the equipment is leased.*

  Is any of it still covered by warranties?
- *Will you have exclusive rights to the business name, trading style, logos, or other trademarks?*
- *What is the status of the business' reputation among customers and suppliers?*

  Do not rely on the seller for this information. Find out who the clients and customers are and talk to them directly.
- *Has the business entered into agreements that will affect the value of assets or limit your freedom of action?*

  For example, it may be leasing its current premises. How much time is left on the lease and will you be able to renew that lease on favorable terms? What about any long-term purchasing arrangement with suppliers, distribution agreements or contracts with employees? These agreements have a direct bearing on the value of the assets you are buying. Make sure you understand the agreements and what happens to them when the ownership changes.
- *Find out about all of the business' liabilities.*

  This may involve a lot more than payables to suppliers. For example, with the advent of a stronger environmental consciousness, many businesses have become liable for cleaning up their sites. If you purchase a site that was once a dumping ground for toxic waste, you could get stuck with the clean-up bill, even though the dumping occurred long before you ever got involved.

- *Find out about the regulations affecting the business.*

  Are regulations changing? Will pending changes affect the profitability of the business. Is that the reason the current owner is looking to sell. Regulatory changes can affect every type of business, from large industrial operations forced to adopt stricter environmental standards to family-owned restaurants that may be subject to stricter health inspections.

- *Find out about the seller's intentions.*

  If he or she turns around and establishes a competing business in the same market, your acquisition may quickly become valueless. You may need a non-competition clause in your purchase agreement to protect yourself against this.

Beyond these kinds of issues, you should look at broader changes in the marketplace or the technological environment to see how they may affect the business you is purchasing. For example, a small retailer may be offering up his business because he knows that a Wal-mart store is coming to town. Or a printer may be trying to sell his operation because he knows that a competitor has just purchased the latest, computer driven print-on-demand technology.

Developments like these need not scare you off purchasing these types of businesses, but you do need to know about them if you are going to put an appropriate valuation into your purchase offer, and if you are going to fashion an effective strategy to address such challenges. That strategy may also involve spending more money on refocusing the acquisition. In the case of the retail outlet, you may wish to reinvent the business as an upscale boutique. In the case of the print shop you may need to acquire matching technology.

6. Buying Shares

It is also possible to buy into a business by acquiring shares. The purchase agreement may include a provision by which you become directly involved in the management of the company.

This could be an effective way of easing into a business. You would not have to raise the entire purchase price of the operation and the existing ownership would continue to be involved to show you the ropes. You could test your aptitude for the business and see how successful it is before going further. Ultimately, you might buy out the remaining shares and become sole owner.

This option may be possible if the target business is publicly trade on a stock exchange and you can buy up a significant enough block of shares to exert an influence. If the business is privately held, buying a share in the business may not be possible if the owners want an outright sale.
There are also some risks in a strategy of sharing ownership, the chief of which is that you may not get along well with the existing ownership or you may have different strategic objectives and bickering or paralysis could be the outcome. Remember too that employees and suppliers may be more likely to look to the owners they know than to you for direction.

Another set of objectives to share purchase revolves around the fact that in buying shares, you become responsible for the existing liabilities of the business. You may be exposed to fewer of these liabilities if you simply purchase assets. And in purchasing shares you are bound by the existing depreciation schedules already in the business. If you purchase assets, you can depreciate those assets according to the purchase price.

7. Franchising

An alternative to the purchasing of shares is franchising. In fact, franchising has been so successful for both buyers and sellers that it now accounts for about a quarter of all purchases of a business. Franchises are probably best known in the fast-food industry but they are also common in other types of retail establishments and the hospitality industry.

Franchising involves the purchase of the right to set up a business according to a specific formula. The purchaser gets the right to use the franchise name, logo and public identity. In addition, the purchaser will likely also receive physical equipment, materials, advice, training, building plans, and marketing support from the franchise owner. In some cases, the franchiser may also provide assistance with financing. In return, the buyer may pay an initial purchase price plus monthly royalties based on sales. The buyer must also agree to various conditions governing the use of the franchise, maintenance of quality standards, contributions to and participation in marketing campaigns and possibly even an obligation to purchase materials exclusively from the franchiser.

There are both advantages and disadvantages to a franchise. On the plus side, a franchise offers participation in a proven business concept and this can greatly increase the chances of success. Where only about 20-30% of business start-ups survive the first few years, the survival rate of franchises is about 80%. The franchisee gets a complete range of support, advice, and assistance covering the entire spectrum of business needs. At the same time, an entrepreneur just starting out may find it easier to get financing from a bank or investor for a franchise than for a completely new business.

Franchises do have their limitations, however. They impose a business formula that must be strictly adhered to and a structure of fees and royalties that may be quite demanding. This may not be appealing for those who look to running their own business as a way of expressing their creative or innovative tendencies. Moreover franchises can be extremely demanding in terms of the work involved to conform to and maintain the franchiser's standards. The requirement that all materials must be purchased from the franchiser (often at a premium) may be regarded as excessively onerous. And there are too many restrictions on what can be done with a franchise to make it of interest to an existing business owner looking to purchase an additional operation in order to complement a product line or fuel rapid growth.

8. Where to Look

There are many places to look for an opportunity to buy a business. Perhaps the most obvious are real estate agents, some of whom specialize in the sale of businesses. The real estate listings in any larger city will usually include a section on businesses up for sale.

Business owners looking to sell may also advertise in the business or classified advertising section of the local newspaper, other types of business publication, a trade journal or the newsletter of a business association.

Remember, however, that sellers may be reluctant to use real estate listings or formal advertisements. The news that a business is up for sale may cause unease among employees or suppliers. Therefore may sellers will simply use their network of contacts to get the word out. That means you must use your own network of acquaintances, friends, business service providers (lawyers, bankers, accountants, & consultants), and association members. You can also approach suppliers or distributors active in the type of business in which you are interested. Let them all know you are in the market to buy a business and ask them if they know of any opportunities.

In some cases, you may know of a specific business that represents exactly what you are looking for. If you do, there is nothing to prevent you from approaching the owner directly and asking if he or she is interested in selling.

11. Valuation

Once you find a suitable prospect, your next step is to review exactly what is up for sale and determine what you should pay for it.

A first step is to determine exactly why the business is being sold. There may be a stated reason offered by the owner, but this may not represent the real reason driving the sale. Try to find out what is really happening by talking to others who are familiar with the business you are looking to buy. The price of a business is related to the ability of that business to generate revenue. This is determined, in large part, by the assets of the business. If you are purchasing assets, the seller will usually have a spec sheet prepared, listing the assets and offering an estimate of their value. The value may be calculated using various formulas including:

- Fair market value - the price of similar assets on the open market;
- Replacement value - what it would cost to replace the asset (i.e. from the original supplier);
- Liquidation value - what the asset would bring if the business were liquidated (as in a bankruptcy);
- Book value - based on the company's balance sheet.

In that list of assets, however, there will also be an item called goodwill, which represents the reputation and established customer base of the business. This is virtually impossible to value objectively. It depends more on instinct and gut feeling rather than a strict accounting formula.
The aggregated value of individual assets, however, tells only part of the story. The real value of the business depends on the income that it generates. This may not be directly related to the value of the assets. You may wish to look at the company's income history over a period of years (at least three is usual) to determine what its gross revenues, costs and profit were. You are really buying that annual profit and one way of looking at the purchase price is in terms of a return on your investment.

In attempting to arrive at an appropriate value for the target business, you should not restrict yourself to the seller's spec sheet or to his or her ideas about how to set a value on the business' assets. Start your own investigation by asking for the most recent three years of financial data. Who prepared this data? Is it part of a formal audit. Even if the statements are audited, remember that auditors depend on the paper they are given. There may be a lot hidden under formal statements certified by an accountant.

You can do your own audit by asking the seller for permission to see the actual records of the enterprise: deposit books, invoices, repair bills, payroll slips, sales slips etc. will tell you far more about the condition of a business than will an audited statement. You may have to sign a nondisclosure agreement to get access to this type of information, but it give you a clear picture of the quality of the records and the controls in place to manage the business. If records are scanty and poorly kept, you will know how much work will be involved in cleaning up the operation if you actually take it over. Adjust your offer accordingly.

As an additional form of verification, you may even want to sit in on the business for a period of time. There is no substitute for seeing how the business operates on a daily basis, in order to gain some sense of how efficient it is.

12. Financing

Once you have a value in mind for the target business, your next step is to determine if you can afford it. Few businesses are purchased for a lump cash payment, though many sellers may prefer that. In most cases, some kind of financing is involved.

There are, of course, many sources of capital and many financing vehicles that can be used in the purchase of a business. Because you are buying something that already exists and has a track record, you may find this financing easier to obtain than if you were starting from scratch. Family, friends, business associates and banks are the usual first sources for small business financing. If the transaction is somewhat larger (say above a million dollars), private investors and venture capitalists might even get involved.

One thing to consider, however, is that if all is said and done, you still do not have access to enough cash for the purchase, ask the seller to finance part of the transaction. For example, the seller could carry a promissory note for some part of the purchase price. You could ask the seller to issue a mortgage that you would repay on regular terms. Or you might lease rather than buy a portion of the assets. All of these options provide the seller with a steady source of revenue instead of a lump sum payment. They also mean that the seller does not immediately face a tax liability on any capital gains associated with selling the business.

To make this kind of offer more appealing to the seller, you may have to offer a rate of interest above the current market, and you will have to provide reasonable security that you will make the payments. For example, the purchased business itself may become part of the collateral. If you are contemplating this route, make sure you can carry the note and that the terms you agree to do not cripple the business you are buying. You may even be able to get the seller to agree to tie repayments to the performance of the business.

13. Making an Offer

When buying a business, you must make sure that you have the right kind of help. If you are an established business owner, you already have developed relationships with a banker, an accountant and a lawyer. If you are just starting out, you will need to develop a relationship with the providers of these services. In either case, the help they bring is vital to protecting your interests.

Your accountant can help you review and evaluate financial statements to determine the extent to which they are accurate and reflective of the whole story. An accountant can also advise you on the tax implications of the purchase in terms of what can be depreciated and at what rates. Your lawyer can advise you on the terms of the sale and draw up the contract as well as any other documentation. And your banker will be involved if you need financing. All three can also provide you with leads and referrals to people who might be interested in selling their business and they can also use word of mouth to let their own networks know that you are interested in buying.

Before you make a formal offer of purchase, find out everything you can about the seller and the seller's motivations. As part of this process, verify all of the target firm's titles, deeds, leases, contracts, licenses, mortgages, patents, copyrights, liabilities etc. to make sure you know exactly what you are getting into. Remember too that while this is happening, the seller is finding out about you and your interests.

After both parties have exercised this kind of due diligence, and you've held some preliminary discussions with the owner, you will be ready to make an offer of purchase and get down to negotiations. Sellers are reluctant to waste time with people who are not serious so do not be surprised if you are asked to accompany your offer with a non-refundable deposit, as is done in real estate transaction. At that point, you are ready to negotiate.

Typically in a negotiation the parties start at opposite extremes and work toward the middle. You should have a price and terms in mind that you are willing to settle for, but you may wish to start low in order to give yourself room to maneuver. Expect that the seller will counter your first offer with a price and terms that you consider excessive. That is all part of bargaining. If you are serious about buying, work toward the terms you are prepared to accept.

Keep within your limits, however. Once you reach a price you think is realistic, stick too it, even if the seller tries to pull you above it. And resist pressure tactics or unnecessarily short deadlines. If a seller says that the deal absolutely must be concluded within a few days, something may be wrong with the deal and you should be suspicious. At the other extreme, dragging out negotiations can also be a tactic to wear you down and agree to the seller's terms, just to save the time devoted to negotiations or the money you have spent on credit checks or contacting references. Losing that time, however, is preferable to losing your shirt on a bad venture. Be prepared to walk away from any deal that doesn't seem right to you, regardless of how much time and effort you have already put into it. At the other end of the spectrum, be wary of any offer that seems to good to be true. It is worthless if the underlying business is on the verge of collapse.

In some cases, you may ask the seller to help you finance the deal by taking a mortgage or accepting a promissory note for part of the purchase price, with the business itself as security. You may also ask to lease rather than buy the land or other physical assets, if you do not have enough cash for outright purchase. This kind of arrangement will give the seller a steady income rather than a lump sum payment, but that may be exactly what the seller is looking for.

The danger to you in such an arrangement is that the terms of the seller's financing may turn out to be quite onerous for the business. Rather than agreeing to payments at a set level, you may be better off negotiating terms in which payments on the loan are tied to the performance of the business. Such terms will keep the seller involved in the business, if only to keep an eye on how its doing.

If you already own a business that is publicly traded, you may wish to pay for part or all of the acquisition in shares. The seller may accept this if there is an active market for the shares and they can be liquidated relatively easily. If you company is privately held, however, shares in it will be hard to liquidate and the seller is unlikely to accept them as part of your offer.

14. The Contract

Ultimately the sale of a business involves a combination of final price, other terms and overall risk. You may be prepared to pay a higher price as long as other conditions (i.e. the seller agrees to take a mortgage on easy terms) are suitable. Or you may opt for a lower price in which you assume more of the risks of the transaction. The precise mix will vary in accordance with the nature of the business and the inclinations of the individuals involved. Once you have arrived at the terms, the details should be spelled out in a contract that itemizes all aspects of the sale. The following is a summary of some standard items that are usually found in such a contract:

- a definition of what is being transferred, from whom to whom, and at what price; this should include an itemized breakdown of costs so that you have a record of the value of each asset, both those you can claim for depreciation and those you cannot;
- details of any leases or liabilities that you are assuming in making the purchase;
- the method of payment (in cash, by cheque, in shares in another company, in bonds), on what date, by what means;
- any adjustments to the price to cover financial transactions occurring between the moment the offer is signed and the closing date (this could include sale of inventory, equipment purchases, tax payments, etc.);
- guarantees by the seller of the truthfulness of information supplied and provisions for any penalties in the event that information is not accurate; a description of the seller's obligations in operating the business up to closing, implementing the transfer of ownership, and performing any post-sale duties or services;
- how to deal with any losses or damages that might occur to the business between signing the agreement and the closing date;
- a clause restricting the ability of the seller to compete with the business once the sale is closed, or limiting the seller's freedom to start up similar ventures;
- any conditions that should be met prior to closing (such as validation of deeds, liabilities, or agreements entered into by the business);
- details of closing including the date, time, place, and individuals effecting the transfer;
- compensation to be paid by the seller to the buyer as damages or compensation if information is to be found to be false;
- the amount of the security deposit you put up as purchaser and held in escrow for a period of time as a guarantee that all terms and conditions have been satisfied;
- who would decide the case in the event of a dispute.

15. Final Comments

Buying a business can take time and it certainly involves new risk. In making the purchase you are assuming new responsibilities toward those who helped you finance the deal, toward any employees working for the business, to its suppliers and to its clients. Beyond that, if you already own a business, you will have to commit a significant amount of management time toward integrating the new acquisition into your existing operations. And be prepared for the possibility that the acquisition may even change the balance and direction of your current business activities. In the short term, that may pose a real challenge. Over the longer term, it may turn into a profitable opportunity.