4.1 Benefits and Problems of Buying an Existing SB

Buying out existing business has arguments both in favor and against. These may be seen:

Reasons for Buying	Reasons against Buying
1. Own a successful establishment with goodwill	1. Lines business may not conform to the buyer' s best judgement
2. Proven advantage of good location	2. Problem making employees may be inherited
3. Need not wait for profitable operation as is required in case of starting a new SB	3. Difficult to change the old customers even if they do not behave desirably
4. Can reap the fruits of established market & clientele	4. Unwelcome conventions of the past owner is hard to change
5. Getting all the infrastructural facilities i.e. building, equipment, inventory, and personnel in a functioning status	5. The personnel may be stagnant and have a poor production records
6. A product or service already produced and distributed	6. There may very high proportion of poor quality accounts receivable
7. Already have needful contacts with suppliers, bankers & others.	7. May require substantial BMRE investment in an attempt to modernise the plant
8. Resources & capabilities are already known	8. Lease terms entered into by the old owner may not be found justified and acceptable.
9. Financing is limited to one single purchase transaction	9. Nature of inventories may be of bad quality & slow- moving
10. May be enjoying the special benefits & concessions allowed by the Govt.	10. The old infrastructure facilities may be obsolete & defective
	11. The location may be bad
	12. There may be poor solvency & liquidity resulting in deteriorating relations with the old financiers

While it is difficult to discuss this subject intelligently without knowing the specific details of each situation, at least there are some generalizations which can be made both in favour and against buying an existing enterprise.

4.2 Evaluate All Opportunities

A buyer should evaluate all opportunities that are available. The old adage still applies, "Let the buyer be aware" It is assumed that the buyer has evaluated and investigated all the activities of the available opportunity. The final decision has supposedly been made after careful consideration and analysis of all actions and activities of that opportunity. The following may be used as a checklist in evaluating a business opportunity.

Many of the factors involved in choosing a business are personal ones. The desirability for any one business is particular to any given individual. The type and size of the business are sensitive personal factors, as well as being limited by available financing. In choosing a business, either as an existing business or as a franchisee, it is important to properly evaluate the business opportunity.

The evaluation of any business is the crucial stage prior to the actual opening of that business. The prospective owner faces the dilemma of determining fair costs associate with reasonable profitability for a particular business. Such an evaluation should cover the following points:

1. History of the business and its related industry. 2. Business profit, sales and expense figures; past and projected (five or more years back; one to three years in future) 3. Image and goodwill of the business under sale 4. The reason for the sale: a. Owner's health and age b. Owner's interest for another business c. Accept an extremely attractive employee position elsewhere d. Discouraged by labor troubles e. Discouraged by high rate of taxes f. Expiration of a vital patent./ Franchise g. Loss of customers. h. Owner's family i. Profitability j. Bankruptcy k. Moving to a better climate l. Location m. Obsolete merchandiser inventory. n. Poor management	5. Determine what is being bought; a. Assets b. Liabilities c. Replacement value 6. Other areas of concern a. Location b. Parking c. Licenses d. Merchandise line. e. Employees 7. Liquidation

The successful completion an analysis of these guidelines will require time and effort, but such an investment will highlight the danger and obstacles to becoming successful as a business owner.

4.3 Circumstances when to Buy?

1. When an entrepreneur has no firm business idea but has organizing and management ability.
2. When the business climate is poor, the economy is not favorable, and the costs of penetrating the market are too high..
3. When the interest rate is too high and most people prefer to leave money in the bank or buy second mortgage.
4. When there is a business for sale, as long as the entrepreneur can be sure that he or she is financially capable of undertaking the risk, and the reasons for the business being sold are generally caused by:

- The death of the proprietor
- Poor health
- Poor management
- Inability of the business
- Family problems
- The owner-managers retirement.
- Disagreement among partners.

4.4 Focus of Analysis while buying

Focus of analysis while buying on the specifics business you are considering for buying. There are a number of factors to be considered before an intelligent decision can be made. Those factors include:

- *The Business.* Do past financial statements show the potential for a legitimate return on investment within a reasonable amount of time? Do past financial statements show the potential for positive cash flow within a reasonable amount of time? Why does the current owner want to sell? (There are always hidden agendas.) Are the business's existing problems solvable or are they beyond repair?
- *The purchase price.* Is the price of the business low enough to allow a fair return on investment within a reasonable amount of time? Will the resulting debt choke you?
- *The terms.* The more owner financing, the better. That's because owner financing represents money that doesn't have to be borrowed from a bank and banks are always tougher on borrowers than ex-owners. Besides, ex-owners who still have a stake in the success of their old business can be an important asset to the new owners.
- *The previous owner.* How important to the success of the business is the previous owner? How badly will his or her skills be missed? Will the business lose important customers upon his or her departure? Will the previous owner remain with the business long enough to bring you up to speed?
- *You (the new owner).* Are you capable of filling the business's existing voids while you're plugging the holes created by the previous owner's departure? How much do you know about the industry? How much do you know about managing a business?

..Also, the longer the repayment period, the better. A short-term need to repay principal can result in a drain on cash, thereby restricting growth. Give yourself as much time as you can negotiate. A rule of thumb is that you should be able to buy back a business (repay its debt) in five years.

If these issues can be resolved to the benefit of the prospective new owner, buying an existing small business is usually preferable to starting a business from scratch. Here are several reasons for this.

- *Cash flow.* An existing small business is capable of generating positive cash flow from day one of new ownership not so for a start-up, however . . . it can take months, even years, for the flow of cash to come around.
- *Focus.* The entrepreneur can focus his or her energies on the nuts and bolts issues of the new business and not on those pain-in-the-posterior chores that are part of every start-up. Those details have already been done.
- *Credibility.* Customers, suppliers, and lenders are more likely to establish a relationship with an ongoing business than they are with a start-up.
- *Risk.* History is an excellent fortune teller; thus small businesses with existing track records are always more predicable, and less risky, than those without. Besides this crystal ball effect, the risk factor is also less because such things as a customer base, leases, and vendor agreements are already in place.
- *Less expensive.* It costs less money to buy an existing business than it does to start up one. This is because many of the organizational and start-up expenses have already been paid for and written off by the existing business. Also, many of the assets that are being purchased have been significantly depreciated. (Meanwhile, the startup business has to buy them new.)

Yes, all other things being equal, buying a business is better than starting one. But remember to involve the head and not the heart when structuring the deal, and beware of making emotional decisions.

Consider Other Factors.

A number of other factors in evaluating an existing business remain to be explored. Some of these are:

1. *Competition* – the prospective buyer should look into the extent, intensity, and location of competing businesses. In particular, the buyer should check to see whether the business in question is gaining or losing in the race with competitors.
2. *Legal commitments* – These may include contingent liabilities, unsettled lawsuits, delinquent tax payments, missed payrolls, overdue rent or installment payments, and mortgagees of record against any of the real property acquired.
3. *Market* – The adequacy of the market to maintain all competing business units, including the one to be purchased, should be determined. This entails market research, study of census data, and personal, on-the-spot observation at each competitor's place of business.
4. *Future community developments* – Examples of community developments planned for the future include:
   a. Changes in zoning ordinances already enacted but not yet in effect.
   b. Land condemnation suits for construction of a public building, a municipally operated parking lot, or a public park.
   c. Change from two-way traffic flow to one-way traffic.
   d. Discontinuance of bus routes that will eliminate public transportation for customers and employees.
5. *Union contracts* – The prospective buyer should determine what type of labor agreement, if any, is in force, as well as the quality of the firm's employee relations.
6. *Buildings* – The quality of the buildings housing the business, particularly the fire hazard involved, should be checked. In addition, the buyer should determine if there are restrictions on access to the building. For example, is there access to the building without crossing the property of another? If necessary, a right of way should be negotiated before the purchase contract is closed.
7. *Future national emergencies* – The buyer should determine what would be the impact of possible future national emergencies such as price and wage controls, energy shortages, human resources shortages, raw material shortages, and the like.
8. *Product prices* – The prospective owner should compare the prices of the seller's products with manufactures' or wholesalers' catalogs or prices of competing products in the locality. This is necessary to assure full and fair pricing of goods whose sales are reported on the seller's financial statements.

Check Tax Angles.

The purchase of an existing business also presents tax problems. Questions of this type are quite technical, so the prospective buyer should check all possible tax considerations with a tax expert.

Many other tax angles require checking by a tax expert. These include the following:

1. *Tax deductible items* – Interest expenses connected with installment purchase of business assets may be tax deductible. The same is true of payments made by the buyer to the seller in the return for the seller's agreement not to engage in direct competition for a specified period of time.
2. *Payment of property taxes* – Property taxes are the obligation of the titleholder of record at the time the tax is imposed. Therefore, the purchase agreement should require prorating of this tax between buyer and seller.
3. *Payment of dividends* – In buying capital stock and taking over a corporation intact, the buyer must pay taxes on future dividends paid from the accumulated surplus existing and acquired at the time of purchase.

4.5 Steps in Dealing the Buy out

There are, in all, 9 steps to cover in the process in order to complete the purchase deal of an existing small business. This may be gauged as under:

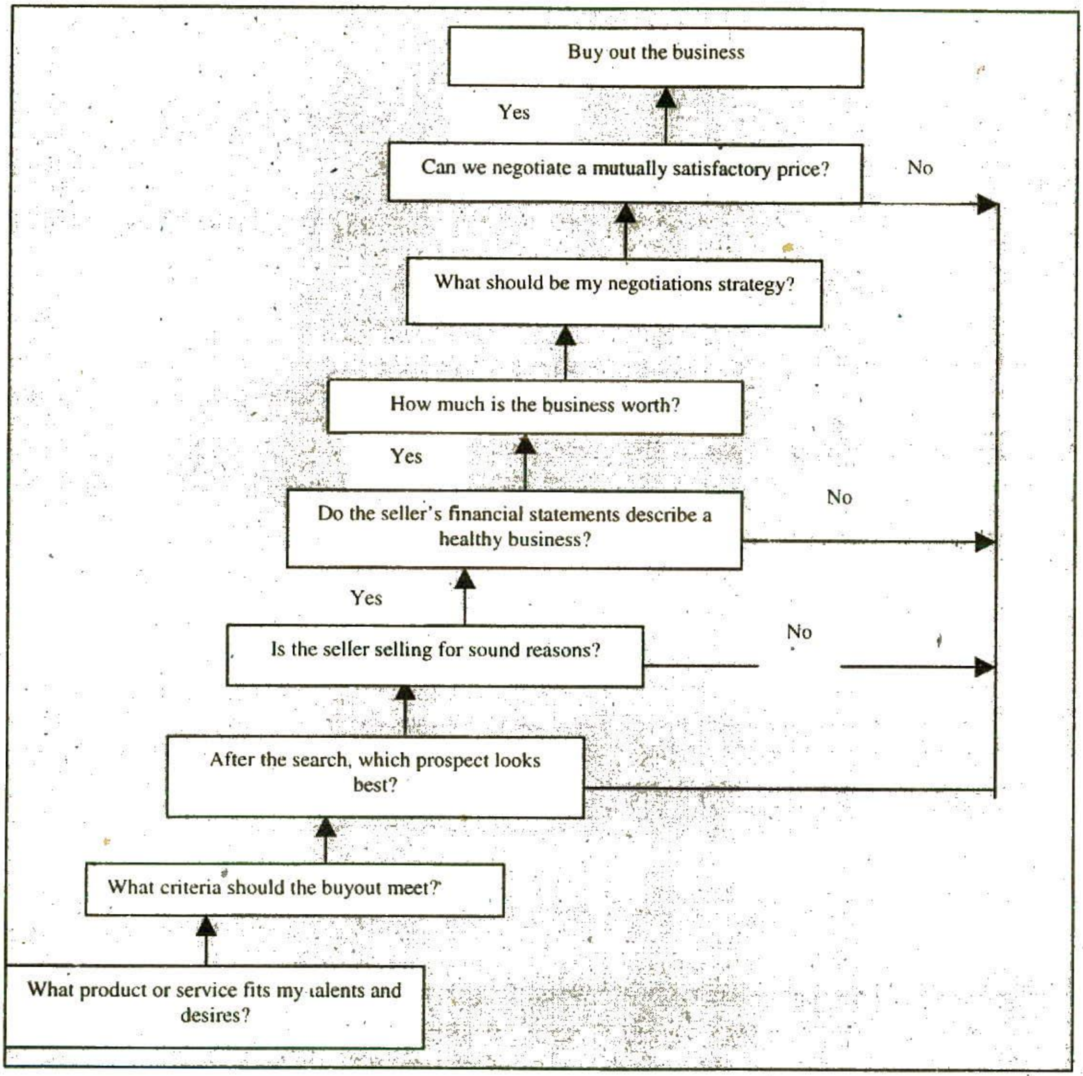

Figure – 4A: Showing the Steps in Dealing the Buy out

The potential buyer at first choose the line of activity in which he wants to be involved, then set a criteria in order to search for one unit of enterprise of his choice. He should know then the reasons for which the existing owner is offering the unit for sale. If the reasons are acceptable, the other steps i.e. financial heath and networth to be looked into before he starts negotiating to arrive at a final deal.

4.6 Items to be included in a complete buy/sale agreement

The agreement of buy out should contain all the essential items in order to avoid any lapses,for which the new owner may face problem in future. In order to be complete a buy / sale agreement should contain the items as under :

1. List the names of the individuals or business involve in the buy/sale agreement.
2. Indicate the method of purchase, such as, cross-purchase, stock-redemption or a combination of the two.
3. Explain from where money will come to purchase the departing owners portion of the business; business funds, insurance, notes, loans, or corporate funds.
4. Explain how to modify or terminate the buy/sale agreement, indicating the laws under which the buy/sell agreement is being made.
5. State whether for tax consideration, some thought should be given to using an installment purchase plan.
6. State whether the buy/sale agreement will have a required transfer of interest, a choice of a remaining owners, a choice of owner's estate or a right-of-first refusal inclusion.
7. Indicate if the buy/sale agreement will be contractual or optional.
8. List each partner as a particular portion of the business with a stipulation that no liens or incumbrances are or will be placed on his or her part of the business.
9. State the price and how to evaluate the price of the business,.
10. Name a trustee, if any.
11. State what item will be sold or transfer to the remaining partners or stockholders.
    As part of the succession plan, the buy / sell agreement is an aid in the smooth and continuous Operation of the business while it is being transferred from one owner to another.
12. Evaluating an existing Business

There are various outside experts who can aid the buyer in evaluating, negotiating, and closing a business purchase.

4.7 Price Setting Approaches

The buyer may arrive at the buying price following two approaches [i] Earning Approach or [ii] Asset Value Approach. Earning analysis should make a trend to project the future earnings if the unit remains with the present owner. Another such earning projection be made if the ownership is transferred to the buyer as a result of his new efforts in a changed conditions. This may be seen in the Chart provided:

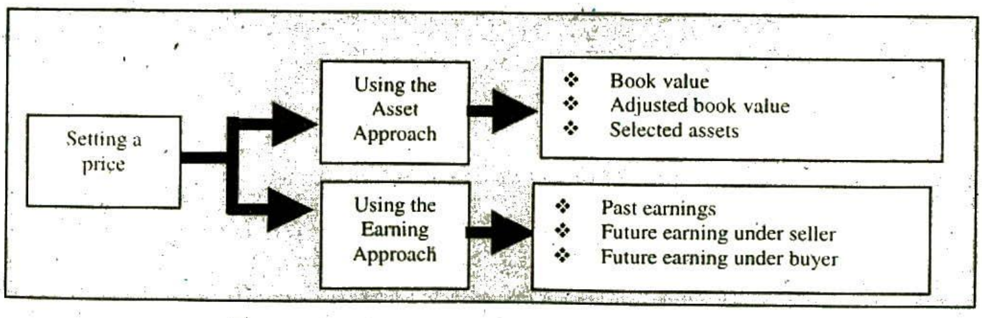

Figure- 4B: Showing the Price Setting Approaches

Traditional approaches for pricing a potential buyout. The buyer should price a potential buyout from both the buyer's and the seller's viewpoint.

4.8 Expected Positive Changes to be done by the Buyer

The issue in valuing a business is the reasons an entrepreneur's business is being acquired. The following are some of the most common positive changes that are likely to be done by a potential buyer:

- Integrating vertically, either backward or forward, by acquiring a firm that is supplier or distributor
- Reducing inventory levels by acquiring a firm that will allow elimination of duplicate operating costs (e.g., warehousing, distribution, etc.)
- Developing or improving customer service operations by acquiring a firm with an established service operation, as well as a customer service network that includes the company's products.
- Reducing operating leverage and increasing absorption of fixed cost by acquiring a firm that has a lower degree of operating leverage and can absorb the company's fixed costs.
- Reducing fixed costs by acquiring a firm that will permit elimination of duplicate fixed costs (e.g., corporate and staff functional groups) Increasing the number of customers by acquiring a firm whose current customers will broaden substantially the company's industry.
- Increasing market share by acquiring a firm in the company's industry
- Developing more growth-phase products by acquiring a firm that has developed new products in the company's industry.
- Using idle or excess plant capacity by acquiring a firm that can operate in the company's current plant facilities.
- Improving or changing distribution channels by acquiring a firm with recognized superiority in the company's current distribution channel.
- Expanding the product line by acquiring a firm whose products complement and complete the company's product line.

The potential buyer makes an exercise to gain if the unit is taken over by him. His own initial plan to earn profit after the acquisition is over. The likely changes in the selected areas of the enterprise whether can make the same profitable is an important exercise on the part of the buyer.

4.9 Closing the Deal

As in the purchase of real estate, the purchase of a business is closed at a specific time. The closing may be handled, for example, by a title company or an attorney.

Causes and dangers of inadequate investigation. Prospective entrepreneurs have been told many times by many different authorities on the need for adequate investigation before launching a new business. For a number of reasons, however, the investigations made are all too often inadequate. Some of the most common reasons are :

1. An impatience to get started.
2. Insufficient funds to carry on expensive market studies or even much personal observation.
3. Lack of training and skill to undertake an adequate business opportunity investigation.

The preliminary consequences of inadequate investigation and planning are :

a) Poor business location.
b) Unplanned or ill-planned distribution procedures.
c) Working capital shortage.
d) Inadequate sales potential.
e) Crushingly strong competition.

The ultimate consequence to be expected is business failure. Hence, we must reemphasize that a prospective entrepreneur must investigate adequately and carefully before inaugurating a new small business.

The buyer must be thorough about the industry to which the unit belong, its operational mechanisms, customers, employees etc. A lawyer who has previous experience of preparing such an agreement may help the buyer about the legal implications of the terms of agreement, especially on the financial implications. This apart, an experienced accountant may make study the assets & liabilities, earning ability & implications of the liabilities. As such, the buyer can be assisted in the deal as shown in the Chart presented:

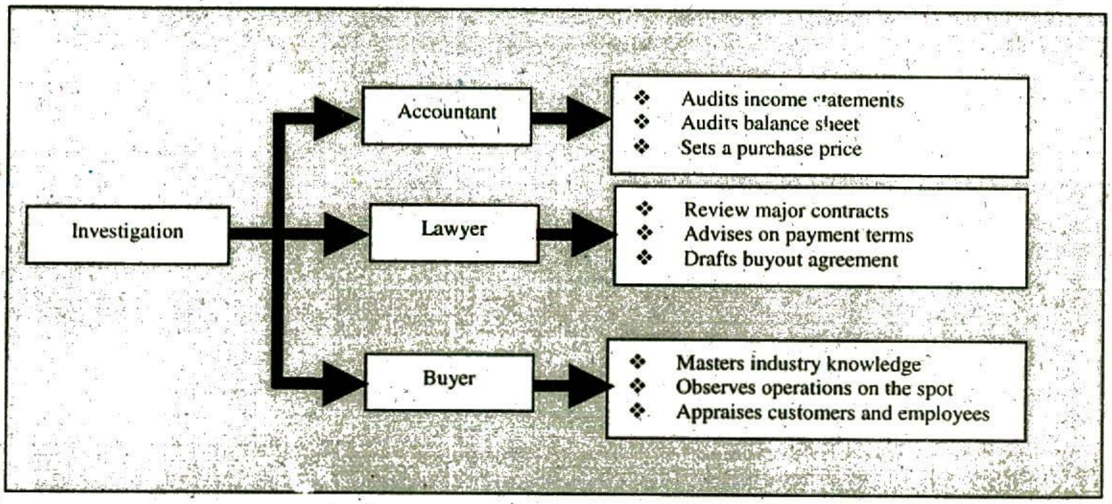

Figure – 4C: Showing the Involvement of the Buyer with Accountant & the Lawyer in Closing the Deal

Suggested procedure for investigating a potential buyout Investigation of a potential buyout should be a team effort, involving the buyer, a lawyer, and an accountant.

4.10 Summing Up

A prospective small entrepreneur while choosing a business, either as an existing unit or as a franchise, needs to properly evaluate the business opportunity. He should avoid buying a problem unit whose sickness, if any, is out of cure. The potential buyer of an existing business should:

i. Make a thorough evaluation of any business under sale in order to locate its strong as well as week points;
ii. The reasons for sale by the present owner be looked into;
iii. Earnings trend, assets- book value and market value, liabilities- current and long-term be investigated;
iv. Image of the business in the circles of the interested parties need be assessed;
v. Whether the prospective buyer has past experience of such a business and in what capacity, ability to manage such business under sale negotiation..
vi. The potential buyer must assess his financial ability whether adequate & enough to afford the business under sale and the possible additional sources manageable when need arises.
vii The prospective buyer must not attempt to negotiate business unit with obsolete & defective assets, poor production records, strained labor relations, excessive amount of "dead stock", high proportion of poor quality accounts receivable, unsuitable locations, liquidity crisis, large proportion of poor customers who are draining the assets of the firm and the like;

viii. The prospective buyer should look into the extent, intensity, and location of the competing businesses. In particular, the buyer should check to see whether the business in question is gaining or losing in the market race with competitors.

ix. The potential buyer should look into the possibility and extent of the contingent liabilities, unsettled lawsuits, delinquent tax payments, missed payrolls, overdue rent or installment payments, and mortgages of record against any of the real property acquired and shown as assets of the unit under sale;

x. The buying deal be carefully handled by competent persons or an organization, for example, by a title company or an attorney or at least one with ample legal knowledge with past experience of handling such types of contracts.

Model Questions

Broad Questions

1. What are the logical reasons for choosing to buy an existing business? Do you think the buying circumstances is better than starting a new business? –Evaluate.
2. What are the factors involved in choosing an existing business? Describe the reasons for and against buying an established small business.
3. How can you decide whether to buy out an existing business? Evaluation the available opportunities that a buyer should need.
4. How can you investigate the sellers reasons for selling?
5. What are the reasons for saying, "Buying an existing business increases the certainty of successful operation for the new owner" ? Is this necessarily always true?
6. Can time be saved by purchasing an existing firm, rather than by doing a thorough job of planning and establishing a new firm?
7. What reasons for buying an existing business, in contrast to starting from the scratch, appear most important?
8. What contractual arrangements can be made to prevent future competition by a seller of a business? Are these legally enforceable?
9. What are the advantages and disadvantages of buying out an existing business?
10. Outline the procedure that an entrepreneur can follow to decide whether to buy out an existing business.
11. Briefly describe the various ways of arriving at a purchase price for an existing business.
12. How important are nonfinancial considerations in negotiating the purchase price of an existing business? Explain.

Short Questions

1. What are the five important questions to be answered before buying an unit?
2. Delineate the parameters of an ideal business buy-out.
3. What steps are required to be followed in buying an existing small business?
4. What items to be included in a complete buy/sale agreement?
5. Why the investigations required to be made before buying, often, remain inadequate?
6. State reasons for selling a business.

Appendix A
Am I Capable of Running a Small Business?
-A Self Analysis

Are you a self-starter?
- ❑ I do things on my own. Nobody has to tell me to get going.
- ❑ If someone gets me started, I keep going all right.
- ❑ Easy does it. I don't put myself out until I have to.

How do you feel about other people?
- ❑ I like people, I can get along with just about anybody.
- ❑ I have plenty of friends- I don't need anyone else.
- ❑ Most people bug me.

Can you lead others?
- ❑ I can get most people to go along when I start something.
- ❑ I can give the orders if someone tells me what we should do.
- ❑ I let someone else get things moving. Then I go along if I feel like it.

Can you take responsibility?
- ❑ I like to take charge of things and see them through.
- ❑ I'll take over if I have to, but I'd rather let someone else be responsible.
- ❑ There are always some eager beavers around wanting to show how smart they are, I say let them.

How good on organizer are you?
- ❑ I like to have a plan before I start. I'm usually the one to get things lined up when the gang wants to do something.
- ❑ I do all right unless get too goofed up. Then I cop out.
- ❑ You get aii set and then something comes along and blows the whole bag. So I just take things as they come.

How good a worker are you?
- ❑ I can keep going as long as I need to. I don't mind working hard of something I want.
- ❑ I'll work hard for a while, but when I've had enough, that's it!
- ❑ I can't see that hard work gets you anywhere.

Can you make decision?
- ❑ I can make up my mind in a hurry if I have to. It usually turns out O.K., too.
- ❑ I can if I have plenty of time. If I have to make up my mind fast, I think later I should have decided the other way.
- ❑ I don't like to be the one who has to decide things. I'd probably blow it.

Can people trust what you say?
- ❑ You bet they can. I don't say things I don't mean.
- ❑ I try to be on the level most of the time, but sometimes I just say what's easiest.
- ❑ What's the sweat if the other person doesn't know the difference?

Can you stick with it?
- ❑ If I make up my mind to do something, I don't let anything stop me.
- ❑ I usually finish what I start – if it doesn't get fouled up.
- ❑ If it doesn't go right a way, I turn off. Why beat your brains out?

How good is your health?

- ❑ I never run down!
- ❑ I have enough energy for most things I want to do.
- ❑ I run out of juice sooner than most of my friends seem to.

Now count the checks you made.

How many checks are there beside the first answer to each question? -------------

How many checks are there beside the second answer to each question? ------------

How many checks are there beside the third answer to each question? ------------

If most of your checks are beside the first answers, you probably have what it takes to run a business. If not, you're likely to have more trouble than you can handle by yourself. Better find a partner who is strong on your weak points. If many checks are beside the third answer, not even a good partner will be able to shore you up.

Locate in haste, repent in leisure.
- Jeffery Davidson

Real opportunities lie within a person, not outside. What lies behind you and what lies before you are tiny matters compared to what lies within you.
- Ralph Waldo Emerson

All laws, written and unwritten, have need of interpretation.
- Thomas Hobbes