Chapter

5 Buying an Existing Business

Goodwill, like a good name, is gotten by many actions, and lost by one.

—Lord Jeffrey

Experience is what you get looking for something else.

—Mary Pettibone Poole

LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

1. **UNDERSTAND** the advantages and disadvantages of buying an existing business.
2. **DEFINE** the steps involved in the *right* way to buy a business.
3. **EXPLAIN** the process of evaluating an existing business.
4. **DESCRIBE** the various techniques for determining the value of a business.
5. **UNDERSTAND** the seller's side of the buyout decision and how to structure the deal.
6. **UNDERSTAND** how the negotiation process works and identify the factors that affect the negotiation process.

Each year, more than 500,000 businesses are bought and sold. Many entrepreneurs don't start new businesses but instead focus their attention on finding an existing business that has potential but is poorly managed and can be bought at "the right price." Each circumstance is unique, but the process of evaluating a potential acquisition is not. The importance of the analysis and evaluation process cannot be underestimated. A business that looks good on the surface may have flaws at its core. The "due diligence" process in analyzing and evaluating an existing business is just as time consuming as the development of a comprehensive business plan for a start-up. The due diligence process will uncover the negative as well as the positive components of any business. This process takes time and a lot of homework to verify all the facts and figures. Be patient and, as the process implies, be diligent. Be sure that you know the answers to the following fundamental questions:

- Is the right type of business for sale in a 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? Where should such a business be located?
- What price and payment method are reasonable for you and acceptable to the seller?
- Should you start the business and build it from the ground up or should you shop around to buy an existing company?
- What is this company's potential for success?
- What changes will you have to make—and how extensive will they be—to realize the business's full potential?
- Will the company generate sufficient cash to pay for itself and leave you with a suitable rate of return on your investment?

BUYING AN EXISTING BUSINESS

1-A. Understand the advantages of buying an existing business.

Advantages of Buying an Existing Business

A SUCCESSFUL EXISTING BUSINESS MAY CONTINUE TO BE SUCCESSFUL. Purchasing a thriving business at an acceptable price increases the likelihood of success. The previous management already has established a customer base, built supplier relationships, and set up a business system. The new owner's objective should be to make those modifications that will attract new customers while retaining the firm's existing customers. Maintaining the proper balance of old and new is not an easy task, however. The customer base inherited in a business purchase can carry an entrepreneur while he studies how the business has become successful and how he can build on that success. Time spent learning about the business and its customers before introducing changes will increase the probability that any changes made will be successful.

AN EXISTING BUSINESS MAY ALREADY HAVE THE BEST LOCATION. When the location of the business is critical to its success (as is often the case in retailing), it may be wise to purchase a business that is already in the right place. Opening in a second-choice location and hoping to draw customers may prove fruitless. In fact, an existing business's biggest asset may be its location. If this advantage cannot be matched by other locations, an entrepreneur may have little choice but to buy instead of build. As part of its expansion plans, one fast-food chain recently purchased a smaller chain, not so much for its customer base or other assets but for its prime store locations.

EMPLOYEES AND SUPPLIERS ARE ESTABLISHED. An existing business already has experienced employees, so there are fewer problems associated with the transition phase. Experienced employees can help the company earn money while a new owner learns the business. Many new owners find it valuable to ask the employees what ideas they might have that would increase sales or reduce cost. In many cases, the previous owner may not have involved the employees in this fashion and never gained the advantages found in the wisdom of employees. Few people know a job better than those who are performing it.

In addition, an existing business has an established set of suppliers with a history of business dealings. Those vendors can continue to supply the business while the new owner investigates the products and services of other suppliers. Often the new owner is not pressured to choose a supplier quickly without thorough investigation. However, a supplier may want to ensure that the new owners are competent to run the business.

A Company Example

Reid Chase and Scott Semel purchased ***Cole-Kramer Imports****, a high-end candy company, that distributed Swiss candies. The Swiss supplier worked with the new owners who aggressively expanded the product offerings and grew the sales from $600,000 in 1994 to $40 million in 2001.*[1]

EQUIPMENT IS INSTALLED AND PRODUCTIVE CAPACITY IS KNOWN. Acquiring and installing new equipment exerts a tremendous strain on a fledgling company's financial resources. In an existing business, a potential buyer can determine the condition of the plant and equipment and its capacity before buying. The previous owner may have established an efficient production operation through trial and error, although the new owner may need to make modifications to improve it. In many cases, entrepreneurs can purchase physical facilities and equipment at prices significantly below their replacement costs.

INVENTORY IS IN PLACE AND TRADE CREDIT IS ESTABLISHED. The proper amount of inventory is essential to both cost control and sales volume. If a business has too little inventory, it will not have the quantity and variety of products to satisfy customer demand. But if a business has too much inventory, it is tying up excessive capital, thereby increasing costs and reducing profitability. Owners of successful, established businesses have learned the proper balance between these extremes. Previous owners have established trade credit relationships that can benefit the new owner. No supplier wants to lose a good customer.

THE NEW BUSINESS OWNER HITS THE GROUND RUNNING. The entrepreneur who purchases an existing business saves the time, costs, and energy required to launch a new business. The day she takes over the ongoing business is the day her revenues begin. Entrepreneurs who buy an existing *successful* business do not have to invest a lifetime in building a company to enjoy success.

THE NEW OWNER CAN USE THE EXPERIENCE OF THE PREVIOUS OWNER. Even if the previous owner is not around after the sale, new owners will have access to all of the business's records that they reviewed during the due diligence process, which can guide them until they become acclimated to the business and the local market. They can trace the impact on costs and revenues of the major decisions that the previous owner made and can learn from his mistakes and profit from his achievements. In many cases, the previous owner spends time in an orientation period with the new owner, giving the new manager the opportunity to learn about the policies and procedures in place and the reasons for them. Previous owners also can be extremely helpful in unmasking the unwritten rules of business in the area, critically important intangibles, and whom you can and cannot trust. After all, owners who sell out want to see the buyer succeed in carrying on their businesses.

EASIER FINANCING. Attracting financing to purchase an existing business often is easier than finding the money to launch a company from scratch. Many existing businesses already have established relationships with lenders, which may open the door to financing through traditional sources such as banks. As we will see later in this chapter, many business buyers also have access to another important source of financing: the seller.

IT'S A BARGAIN. Some existing businesses may be real bargains. The current owners may need to sell on short notice, which may lead to them selling the business at a low price. Many small companies operate in profitable but tiny niches, making it easy for potential buyers to overlook them. The more specialized the business is, the greater the likelihood is that a bargain might be found. If special skills or training is required to operate the business, the number of potential buyers will be significantly smaller. If the owner wants a substantial down payment or the entire selling price in cash, few buyers may qualify; however, those who do may be able to negotiate a good deal.

Disadvantages of Buying an Existing Business

1-B. Understand the disadvantages of buying an existing business.

"IT'S A LOSER." A business may be for sale because it has never been profitable. Such a situation may be disguised; owners can employ various creative accounting techniques that make a firm's financial picture appear much brighter than it really is. The reason that a business is for sale will seldom be stated honestly as "It's losing money." If there is an area of business where the maxim "let the buyer beware" still prevails, it is in the sale of a business. Any buyer unprepared to do a complete and thorough analysis of the business may be stuck with a real loser.

Although buying a money-losing business is risky, it is not necessarily taboo. If your analysis of a company shows that it is poorly managed or suffering from neglect, you may be able to turn it around. However, if you do not have a well-defined plan for improving a struggling business, do *not* consider buying it!

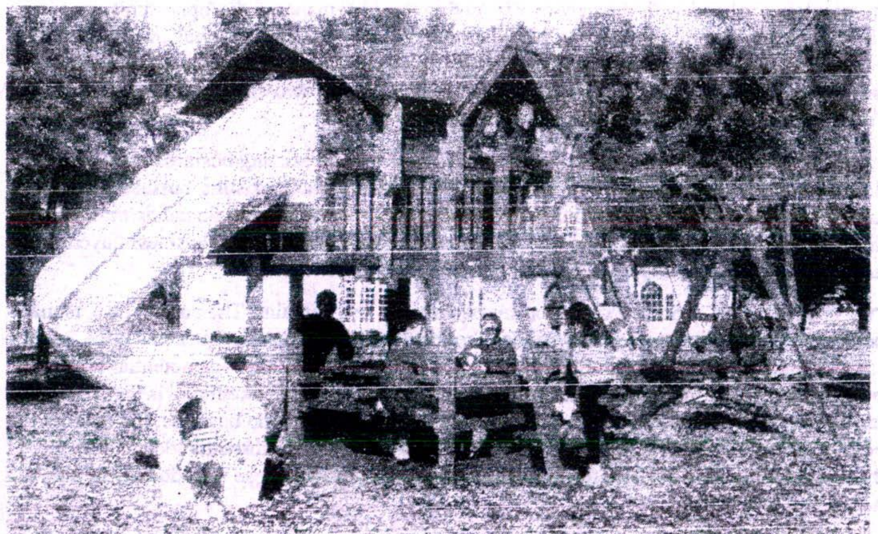
A Company Example

After deciding to become entrepreneurs by buying a business, Jim Sally and Tom Marenyi established the criteria their acquisition must meet: a quality product, a good name, market potential, and a solid formula they could improve upon. They soon discovered **Woodplay**, *a small company that manufactured wooden playsets for the residential market. Although the company was known for its outstanding line of well-made redwood products and had good name recognition in an attractive niche, Woodplay had fallen on hard times and was in bankruptcy. Looking beyond the company's immediate financial problems, Sally and Marenyi recognized that Woodplay had great potential. They purchased the company's assets and invested several hundred thousand dollars of their own money in working capital. "The first thing we had to do was stabilize the business," says Marenyi. They quickly eliminated Woodplay's two weakest product lines, added two new ones, and began building a network of national dealers. Within two years, Sally and Marenyi found themselves turning down orders because they could not keep up with the demand for their products! Today, Woodplay is thriving, and in addition to expanding their dealer network, Sally and Marenyi are working to build retail locations to sell their state-of-the-art product line.*[2]

THE PREVIOUS OWNER MAY HAVE CREATED ILL WILL. Just as ethical, socially responsible business dealings create goodwill for a company, improper business behavior creates ill will. The due diligence process may reveal that customers, suppliers, creditors, or employees have extremely negative feelings about the behavior of the previous owner. Business relations may have begun to deteriorate, but their long-term effects may not yet appear in the business's financial statements. Ill will can permeate a business for years.

EMPLOYEES INHERITED WITH THE BUSINESS MAY NOT BE SUITABLE. Previous managers may have kept marginal employees because they were close friends or because they started off with the company. The new owner, therefore, may have to make some very unpopular

Courtesy of WoodPlay.



termination decisions. For this reason, employees often do not welcome a new owner because they feel threatened. If the new owner plans to make changes in the business, its current employees may not suit her needs. Others may not be able to adapt to the new owner's management style, and a culture clash results. A successful new operating strategy can seldom be effectively implemented by incompetent employees. If your due diligence efforts uncovered that the current employees are a significant cause of the problems the business faces, you must have a preemptive plan to correct this weakness or your new strategic efforts may fail miserably.

THE BUSINESS LOCATION MAY HAVE BECOME UNSATISFACTORY. What was once an ideal location may have become obsolete as market and demographic trends changed. Large shopping malls, new competitors, or highway reroutings can spell disaster for small retail shops. Prospective buyers should always evaluate the existing market in the area surrounding an established business as well as its potential for expansion. Remember, you are buying the future, not the past. A location in decline may never recover. If business success is tied to location, do not acquire a business where the demographic trends are turning negative. The value of the business will erode faster than the neighborhood.

EQUIPMENT AND FACILITIES MAY BE OBSOLETE OR INEFFICIENT. Potential buyers sometimes neglect to have an expert evaluate a firm's facilities and equipment before they purchase it. Only later do they discover that the equipment is obsolete and inefficient, and consequently the business may suffer losses from excessively high operating costs. The equipment may have been well suited to the business they purchased but not to the business they want to build. Modernizing equipment and facilities is seldom inexpensive.

CHANGE AND INNOVATION ARE DIFFICULT TO IMPLEMENT. It is easier to plan for change than it is to implement it. Methods previously used in a business may have established precedents that are hard to modify. For example, if the previous owner allowed a 10 percent discount to customers purchasing a hundred or more units in a single order, it may be almost impossible to eliminate the discount practice without losing some of those customers. The previous owner's policies, even if proven unwise, still affect the changes a new owner can make. Reversing a downward slide in sales can be just as difficult. Implementing changes to bring in new business and convince former clients to return can be an expensive and laborious process. Never underestimate the effort, time, and expense it takes to change the negative momentum of a business in trouble. Before a business can go forward, it must stop going backward.

INVENTORY MAY BE OUTDATED OR OBSOLETE. Inventory is valuable only if it is salable. Smart buyers know better than to trust the inventory valuation on a firm's balance sheet. Some of it may actually appreciate in value in periods of rapid inflation, but more likely it has depreciated. A prospective buyer must judge inventory on the basis of its market value, not its book value.

TABLE 5.1

Valuing Accounts Receivable

A prospective buyer asked the current owner of a business about the value of her accounts receivable. The owner's business records showed $101,000 in receivables. But when the prospective buyer aged the accounts and multiplied them by his estimated collection probabilities, he discovered their *real* value.

Age of Accounts	Amount	Collection Probability	Value
0–30 days	$ 40,000	95%	$ 38,000
31–60 days	25,000	88%	22,000
61–90 days	14,000	70%	9,800
91–120 days	10,000	40%	4,000
121–150 days	7,000	25%	1,750
151-plus days	5,000	10%	500
Total	$101,000		$76,050

Had he blindly accepted the seller's book value of these accounts receivable, this prospective buyer would have overpaid nearly $25,000 for them!

A Company Example

For example, generations of customers have enjoyed shopping at a Clemson, South Carolina, landmark, ***Judge Kellers General Store.*** *Inventory can be traced back to the founder, three generations ago. Excellent service and friendly and honest owners made shopping a delight, but if you were to evaluate its inventory you might discover some items that were outdated.*

ACCOUNTS RECEIVABLE MAY BE WORTH LESS THAN FACE VALUE. Like inventory, accounts receivables rarely are worth their face value. The prospective buyer should age the accounts receivable (a breakdown of accounts 30, 60, 90, and 120 days old and beyond) to determine their collectibility. The older the receivables are, the less likely they are to be collected and, consequently, the lower their value is. Table 5.1 shows a simple but effective method of evaluating accounts receivable once they have been aged.

When one buyer was considering purchasing an existing business, his research showed that a substantial volume of accounts receivable was well past due. Further investigation revealed that the company and its largest customer were locked in a nasty fight over these outstanding accounts. The buyer decided to withdraw his preliminary offer.[3]

THE BUSINESS MAY BE OVERPRICED. Each year, many people purchase businesses at prices far in excess of their value, which can impair the companies' ability to earn a profit and generate a positive cash flow. If a buyer accurately values a business's accounts receivable, inventories, and other assets, she will be in a better position to negotiate a price that will allow the business to be profitable. Making payments on a business that was overpriced is a millstone around the new owner's neck, making it difficult to carry this excess weight and keep the business afloat.

Although most buyers do not realize it, the price they pay for a company typically is not as crucial to its continued success as the terms on which they make the purchase. Of course, wise business buyers will try to negotiate a fair and reasonable price, but they are often equally interested in the more specific terms of the deal—for instance, how much cash they must pay out and when, how much of the price the seller is willing to finance and for how long, the interest rate at which the deal is financed, and other such terms. Their primary concern is making sure that the deal does not endanger the company's future financial health and that it preserves the company's cash flow.

Learning Objective

2. Define the steps involved in the *right* way to buy a business.

THE STEPS IN ACQUIRING A BUSINESS

Buying an existing business can be risky if approached haphazardly. Studies show that more than 50 percent of all business acquisitions fail to meet the buyer's expectations. To avoid costly mistakes, an entrepreneur-to-be should follow a logical, methodical approach:[4]

- Analyze your skills, abilities, and interests to determine what kind(s) of businesses you should consider.
- Prepare a list of potential candidates.
- Investigate those candidates and evaluate the best one(s).
- Explore financing options.
- Ensure a smooth transition.

Analyze Your Skills, Abilities, and Interests

The first step in buying a business is *not* searching out potential acquisition candidates. Every entrepreneur considering buying a business should begin by conducting a self-audit to determine the ideal business for him or her. The primary focus is to identify the type of business *you* will be happiest and most successful owning. Consider, for example, the following questions:

- What business activities do you enjoy most? Least? Why?
- Which industries or markets offer the greatest potential for growth?
- Which industries interest you most? Least? Why?
- What kind of business do you want to buy?
- What kinds of businesses do you want to *avoid*?
- What do you expect to get out of the business?
- How much time, energy, and money can you put into the business?

- What business skills and experience do you have? Which ones do you lack?
- How easily can you transfer your skills and experience to other types of businesses? In what kinds of businesses would that transfer be easiest?
- How much risk are you willing to take?
- Are you willing and able to turn around a struggling business?
- What size company do you want to buy?
- Is there a particular geographic location you desire?

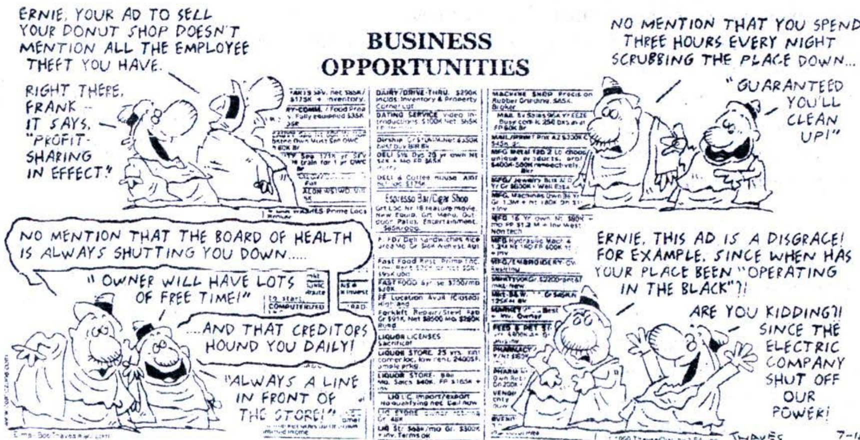
Answering these and other questions beforehand will allow you to develop a list of precise criteria a company must meet before it becomes a purchase candidate. Addressing these issues early in the process will also save a great deal of time, trouble, and confusion as you wade through a multitude of business opportunities. The better you know yourself—your skills, competencies, and interests—the more likely you will be to find and manage a successful business.

Prepare a List of Potential Candidates

Once you know what your goals are for acquiring a business, you can begin your search. Do *not* limit yourself to only those businesses that are advertised as being "for sale." In fact, the **hidden market** of companies that might be for sale but are not advertised as such is one of the richest sources of top-quality businesses. Many businesses that can be purchased are not publicly advertised but are available through business brokers and other professionals. Although they maintain a low profile, these hidden businesses represent some of the most attractive purchase targets a prospective buyer may find. How can you tap into this hidden market of potential acquisitions? Typical sources include the following:

hidden market—*low-profile companies that might be for sale but are not advertised as such.*

- Business brokers
- Bankers
- Accountants
- Investment bankers
- Industry contacts—suppliers, distributors, customers, insurance brokers, and others
- Networking—social and business contacts with friends and relatives
- Knocking on the doors of businesses you'd like to buy (even if they're not advertised as being for sale)
- Trade associations
- Newspapers and trade journals listing businesses for sale



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In recent years, the World Wide Web also has become an important tool for entrepreneurs looking to buy businesses. In the past, the market for businesses was highly fragmented and unstructured, making it difficult for entrepreneurs to conduct an organized, thorough search for companies that might meet their purchase criteria. Today, hundreds of business brokers have established Web sites that list thousands of companies for sale in practically every industry imaginable, enabling entrepreneurs to search the entire country for that perfect business from the comfort of their own homes. Using the Web, potential buyers can eliminate the companies that do not suit them and can conduct preliminary research on those that look most promising. The more opportunities entrepreneurs have to find and evaluate potential acquisitions, the greater the likelihood of finding a match that meets their criteria.

INVESTIGATE AND EVALUATE CANDIDATE BUSINESSES AND EVALUATE THE BEST ONE. Finding the right company requires patience. Although some buyers find a company after only a few months of looking, the typical search takes much longer, as much as two or three years. Once you have a list of prospective candidates, it is time to do your homework. The next step is to investigate the candidates in more detail:

- What are the company's strengths? Weaknesses?
- Is the company profitable? What is its overall financial condition?
- What is its cash flow cycle? How much cash will the company generate?
- Who are its major competitors?
- How large is the customer base? Is it growing or shrinking?
- Are the current employees suitable? Will they stay?
- What is the physical condition of the business, its equipment, and its inventory?
- What new skills must you learn to be able to manage this business successfully?

Determining the answers to these (and other questions addressed in this chapter) will allow a prospective buyer to develop a list of the most attractive prospects and to prioritize them in descending order of attractiveness. This process also will make the task of valuing the business much easier.

Explore Financing Options

Placing a value on an existing business (a topic we will discuss later in this chapter) represents a major hurdle for many would-be entrepreneurs. The next challenging task in closing a successful deal is financing the purchase. Although financing the purchase of an existing business usually is easier than financing a new one, some traditional lenders shy away from deals involving the purchase of an existing business. Those who are willing to finance business purchases normally lend only a portion of the value of the assets, so buyers often find themselves searching for alternative sources of funds. Fortunately, most business buyers have access to a ready source of financing: the seller. Once a seller finds a suitable buyer, she typically will agree to finance anywhere from 30 percent to 80 percent of the purchase price. Usually, a deal is structured so that the buyer makes a down payment to the seller, who then finances a note for the balance. The buyer makes regular principal and interest payments over time—perhaps with a larger balloon payment at the end—until the note is paid off. The terms and conditions of such a loan are a vital concern to both buyer and seller. They cannot be so burdensome that they threaten the company's continued existence; that is, the buyer must be able to make the payments to the seller out of the company's cash flow. At the same time, the deal must give the seller the financial security she is seeking from the sale. Defining reasonable terms is the result of the negotiation process between the buyer and the seller.

Ensure a Smooth Transition

Once the parties strike a deal, the challenge of making a smooth transition immediately arises. No matter how well planned the sale is, there are *always* surprises. For instance, the new owner may have ideas for changing the business—sometimes radically—that cause a great deal of stress and anxiety among employees and the previous owner. Charged with such emotion and uncertainty, the transition phase is always difficult and frustrating—and sometimes painful. To avoid a bumpy transition, a business buyer should do the following:

- Concentrate on communicating with employees. Business sales are fraught with uncertainty and anxiety, and employees need reassurance.
- Be honest with employees. Avoid telling them only what they want to hear. Share with the employees your vision for the business with the intent of generating a heightened level of motivation and support.
- Listen to employees. They have intimate knowledge of the business and its strengths and weaknesses and usually can offer valuable suggestions.
- Consider asking the seller to serve as a consultant until the transition is complete. The previous owner can be a valuable resource, especially to an inexperienced buyer.

Table 5.2 describes 15 steps potential buyers should take to increase the probability that the businesses they buy are the right ones for them.

EVALUATING AN EXISTING BUSINESS—THE DUE DILIGENCE PROCESS

Learning Objective

3. Explain the process of evaluating an existing business.

When evaluating an existing business, a lone buyer quickly feels overwhelmed by the tremendous number and complexity of the issues involved. Therefore, a smart buyer will assemble a team of specialists to help in investigating the potential business opportunity. This team is usually composed of a banker, an accountant familiar with the particular industry, an attorney, and perhaps a small business consultant or a business broker. The cost of such a team can range from $3,000 to $20,000, but most buyers agree that using a team significantly lowers the likelihood of making a bad buy. Because making a bad purchase will cost many times the expense of a team of experts, most buyers see it as a wise investment. It is important for a buyer to trust the members of the business evaluation team. With this team assembled, the potential buyer is ready to explore the business opportunity by examining five critical areas.

TABLE 5.2

15 Steps to Buying the Company That's Right for You

1. *Make sure you shouldn't be starting a company instead.* You should have solid reasons for buying a company rather than starting one—and you should know what they are.
2. *Determine the kind of business you want—and whether you're capable of running it.* This requires an unflinching assessment of your own strengths, weaknesses, personality, and goals.
3. *Consider the lifestyle you want.* What are you expecting from the business? Money? Freedom? Flexibility?
4. *Consider the location you want.* What part of the country (or world) do you want to live in?
5. *Reconsider lifestyle.* You may own this business for a long, long time; it had better be one you enjoy.
6. *Cozy up to lenders in advance.* Visit potential lenders long before you need to borrow any money. Develop a rapport with them.
7. *Prepare to sell yourself to the sellers.* You're buying their "baby," and they'll want to make sure you're the right person for the job!
8. *Once you've defined the kind of business you're after, find the right company.* Three major sources of potential candidates are: (1) the network of businesspeople and advisers in the area, (2) business brokers specializing in companies of the size or type you want to buy, and (3) businesses that technically are not for sale (but are very attractive).
9. *Choose the right seller.* Is she honest? What's the *real* reason she's selling the business?
10. *Do your research before agreeing to a price.* Ask lots of questions and get the facts to help you estimate the company's value.
11. *Make sure your letter of intent is specific.* It should establish deadlines, escape clauses, payment terms, confidentiality, and many other key issues.
12. *Don't skimp on due diligence.* Don't believe everything you see and hear; a relentless investigation will show whether the seller is telling the truth. Not all of them will.
13. *Be skeptical.* Don't fall in love with the deal; look for reasons *not* to buy the company.
14. *Don't forget to assess the employees.* You're not just buying a company; you're also buying the people who go with it.
15. *Make sure the final price reflects the company's real value.* Don't lower your chances of success by paying too much for the business.

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YOU Be the Consultant . . .

Is This Any Way to Buy a Business?

After reading dozens of entrepreneurial success stories in the press, stockbroker David Clausen decided that he wanted to own a company of his own. He figured that the best way to get into business for himself was to buy an existing company. Clausen did not know where to start, so he called a broker he found listed in the Yellow Pages and began looking at companies. "I had no industry in mind, and I looked at 30 companies," he says.

Looking back, Clausen realizes that he went about buying a business the wrong way. He had no idea what kind of business he wanted to buy, he did not conduct a systematic search for prospects, and he was in a hurry. "I was so eager to get my hands on a business," Clausen admits. "But, I was naïve. I ran into a lot of obstacles I didn't expect."

Ultimately, it was a friend at church who told Clausen about the company he ultimately purchased, Barclay Maps, a 40-year-old map-publishing business whose owner had just died. He contacted the former owner's attorney and learned that the asking price was $200,000. Interested, Clausen strolled through the business. He estimated that the equipment he saw was worth about $25,000, added another $15,000 for goodwill, and made an offer of $40,000. To his surprise, the previous owner's family accepted his offer. With just $7,000 of his own money available, he asked the family if he could pay the balance over two years. Again, Clausen was surprised when the family accepted his proposal.

Suddenly a business owner, Clausen was counting heavily on one major asset to keep the company going while he learned the business: a nine-month backlog of orders. "Even if I made no new sales, I had nine months of work to sink or swim," he reasoned. Unfortunately, Clausen soon discovered a host of problems, including a shrinking customer base and woefully outdated equipment, facing Barclay Maps that thorough research before the sale would have uncovered. Clausen figured that the obsolete computers and cartography equipment in the company posed the greatest problem, so he tackled it first. He replaced all of the old machinery with state-of-the-art technology, which not only improved productivity but also enabled Barclay Maps to create digital mapping systems on CDs. Clausen quickly realized that the ability to develop digital maps essentially created a new product line that his short and shrinking list of customers was keenly interested in. He began marketing the digital maps to existing customers before securing new accounts. Despite his shaky start in business, Clausen has managed to increase sales at Barclay Maps from just $190,000 to more than $1 million and has transformed the company into one of the nation's largest suppliers of high-end digital geographic data. Looking back on his purchase of Barclay Maps, Clausen says, "If I were doing this again, I would go about the whole process differently—much smarter."

1. Evaluate the way in which David Clausen went about finding a business to buy, assessing it, and searching for financing. What did he do right? What did he do wrong?

2. What should Clausen have done differently?

Source: Adapted from Gianna Jacobson, "Blind Ambition," *Success*, October 1997, p. 65.

1. Why does the owner want to sell?
2. What is the physical condition of the business?
3. What is the potential for the company's products or services?
4. What legal aspects should you consider?
5. Is the business financially sound?

Why Is the Business for Sale?

WHY DOES THE OWNER WANT TO SELL? Every prospective business buyer should investigate the *real* reason the business owner wants to sell. A study by the Geneva Corporation found that the most common reasons that owners of small and medium-sized businesses gave for selling were boredom and burnout.[5] Others decided to cash in their business investments and diversify into other types of assets.

Smart business buyers know that the biggest and most unpleasant surprises can crop up outside the company's financial records and may never appear on the spreadsheets designed to analyze a company's financial position. For instance, a business owner might be looking to sell his business because a powerful new competitor is about to move into the market, a major highway rerouting will cause customer traffic to evaporate, the lease agreement on the ideal location is about to expire, or the primary customer base is declining. Every prospective buyer should investigate thoroughly any reason a seller gives for wanting to sell a business.

Businesses do not last forever, and smart entrepreneurs know when the time has come to sell. Some owners consider their behavior ethical only if they do not make false or misleading

statements. Never expect to get a full disclose of the whole story. In most business sales, the buyer bears the responsibility of determining whether the business is a good value. The best way to do that is to get out into the local community, talk to people, and ask a lot of questions. Visiting local business owners may reveal general patterns about the area and its overall vitality. The local Chamber of Commerce also may have useful information. Suppliers, customers, and even competitors may be able to shed light on why a business is up for sale. By combining this information with an analysis of the company's financial records, the potential buyer should be able to develop a clearer picture of the business and its real value.

The Condition of the Business

WHAT IS THE PHYSICAL CONDITION OF THE BUSINESS? A prospective buyer should evaluate the business's assets to determine their value. Are they reasonably priced? Are they obsolete? Will they need to be replaced soon? Do they operate efficiently? The potential buyer should check the condition of both the equipment and the building. It may be necessary to hire a professional to evaluate the major components of the building—its structure and its plumbing, electrical, and heating and cooling systems. Unexpected renovations are rarely inexpensive or simple and can punch a gaping hole in a buyer's financial plans.

How fresh is the firm's inventory? Is it consistent with the image the new owner wants to project? How much of it would the buyer have to sell at a loss? A potential buyer may need to get an independent appraisal to determine the value of the firm's inventory and other assets because the current owner may have priced them far above their actual value. These items typically comprise the largest portion of a business's value, and a potential buyer should not accept the seller's asking price blindly. Remember: *Book value is not the same as market value.* Usually, a buyer can purchase equipment and fixtures at substantially lower prices than book value. Value is determined in the market, not on a balance sheet.

Other important factors that the potential buyer should investigate include the following:

ACCOUNTS RECEIVABLE. If the sale includes accounts receivable, the buyer should check their quality before purchasing them. How creditworthy are the accounts? What portion of them is past due? How likely are you to be able to collect them? By aging the accounts receivable, a buyer can judge their quality and determine their value. (Refer to Table 5.1.)

LEASE ARRANGEMENTS. Is the lease included in the sale? When does it expire? What restrictions does it have on renovation or expansion? The buyer should determine *beforehand* what restrictions the landlord has placed on the lease and negotiate any changes prior to purchasing the business.

BUSINESS RECORDS. Well-kept business records can be a valuable source of information and can tell a prospective buyer a lot about the company's pattern of success (or lack of it). Unfortunately, many business owners are sloppy recordkeepers. Consequently, the potential buyer and his team may have to reconstruct some critical records. It is important to verify as much information about the business as possible. For instance, does the owner have customer or mailing lists? These lists can be a valuable marketing tool for a new business owner.

INTANGIBLE ASSETS. Does the sale include any intangible assets such as trademarks, patents, copyrights, or goodwill? How long do patents have left to run? Is the trademark threatened by lawsuits for infringement? Does the company have logos or slogans that are unique or widely recognized? Determining the value of such intangibles is much more difficult than computing the value of the tangible assets.

LOCATION AND APPEARANCE. The location and the overall appearance of the building are important factors for a prospective buyer to consider. What had been an outstanding location in the past may be totally unacceptable today. Even if the building and equipment are in good condition and are fairly priced, the business may be located in a declining area. What kinds of businesses are in the area? Every buyer should consider the location's suitability several years into the future.

The potential buyer should also check local zoning laws to ensure that any changes he wants to make are legal. In some areas, zoning laws are very difficult to change and, as a result, can restrict the business's growth.

Table 5.3 offers a checklist of items every business buyer should investigate before closing a deal.

TABLE 5.3

A Business Buyer's Checklist

Sources: Adapted from "Look Before You Buy," Business Resale Network, www.br.network.com/features/bybl.html; "Making an in-Depth Evaluation," Business Resale Network, www.br.network.com/features/bybl.html; Norm Brodsky, "Caveat Emptor," *Inc.*, August 1998, pp. 31–32; "Basics of Buying a Business," American Express Small Business Exchange, home3.americanexpress.com/smallbusiness/resources/starting/buybiz.shtml

Buildings, furnishings, and fixtures. **Every buyer should get a list of all of the fixed assets included in the purchase and then determine their condition, age, usefulness, and value.**

Inventory. Inventory may be the biggest part of a business sale, and it can be one of the trickiest parts of the deal. What inventory is on hand? What is its condition? How salable is it? What is its value? (Remember not to confuse *book value* with *market value*.) What is the company's merchandise return policy? How high is its return rate?

Financial statements. Although small business owners are notoriously poor recordkeepers, a business buyer must have access to a company's financial statements for the past five years. This is the only way a buyer can judge the earning power of a company. The most reliable financial statements are those that have been audited by a certified public accountant. Comparing financial ratios against industry standards found in reports from Robert Morris & Associates and Dun & Bradstreet can reveal important patterns.

Tax returns. A good accountant should be able to reconcile the owner's or company's tax returns with its financial statements.

Sales records. A prospective buyer should determine sales patterns by getting a monthly breakdown by product categories, sales representatives, cash versus credit, and any other significant factor for the company for three years. It is also a good idea to identify the company's top 10 customers and review their purchases over the past three years. For what percentage of total sales did these 10 customers account?

Accounts receivable. Age the company's accounts receivable to see how many are current and how many are past due. Identify the top 10 accounts and check their credit ratings.

Accounts payable. Conduct an analysis similar to the one for accounts receivable for the company's accounts payable. Past-due accounts are an indication that a business is experiencing cash flow difficulties.

Legal documents. A prospective buyer should investigate all significant contracts (especially long-term ones) a company has with vendors, suppliers, distributors, lenders, employees, unions, customers, landlords, and others. Can the current owner assign the rights and obligations of these existing contracts to the buyer? If the company is incorporated, it is wise to check the articles of incorporation (or its articles of organization and operating agreement if it is a limited liability company).

Patents, trademarks, and copyrights. Reviewing the documentation for any patents, trademarks, and copyrights the company holds is vital.

Lawsuits. Is the company facing any lawsuits, either current or pending?

Liabilities. It is essential that the seller provide the buyer with a complete list of liabilities that are outstanding against the company, including accounts and notes payable, loans, liens by creditors against business assets, lawsuits, and others.

Advertising and sales literature. A business buyer should study the company's advertising and sales literature to get an idea of the image it is projecting to its customers and the community. Talking to customers, suppliers, bankers, attorneys, and other local business owners will provide clues about the company's reputation.

Organization chart. Current employees can be a vital asset to a business buyer (if they are willing to stay after the sale). Ask the seller to develop an organization chart, showing the company's chain of command, and get copies of employees' job descriptions so you can understand who is responsible for which duties.

Insurance coverage. Evaluate the types and amounts of insurance coverage the company currently has, including workers' compensation. Is it sufficient? If not, will you be able to obtain the necessary coverage at a reasonable price?

Products and Services

WHAT IS THE POTENTIAL FOR THE COMPANY'S PRODUCTS OR SERVICES? No one wants to buy a business with a shrinking customer base. A thorough market analysis can lead to an accurate and realistic sales forecast for an existing business. This research will tell a buyer whether or not he should consider buying a particular business and will help spot trends in the business's sales and customer base.

CUSTOMER CHARACTERISTICS AND COMPOSITION. Before purchasing an existing business, a buyer should analyze both existing and potential customers. Discovering why customers buy from the business and developing a profile of the entire customer base can help the buyer identify a company's strengths and weaknesses. The entrepreneur should determine the answers to the following questions:

- Who are my customers in terms of race, age, gender, and income level? What is their demographic profile?
- Why do they buy?
- What do the customers want the business to do for them? What needs are they satisfying?

- How often do customers buy? Do they buy in seasonal patterns?
- How loyal are my present customers?
- Is it practical or even possible to attract new customers? If so, are the new customers significantly different from existing customers?
- Does the business have a well-defined customer base? Is it growing? Do these customers come from a large geographical area or do they all live near the business?

Analyzing the answers to these questions can help a potential buyer create and implement a more powerful marketing plan. Most likely he will try to keep the business attractive to existing customers, while changing some features of its marketing plan to attract new customers.

COMPETITOR ANALYSIS. A potential buyer must identify the company's direct competition—those businesses in the immediate area that sell similar products or services. The potential profitability and survival of the business may well depend on the behavior of these competitors. An important factor to consider is the trend in the competition. How many competitors have opened in recent years? How many have closed in the past five years? What caused these failures? Has the market already reached the saturation point? Being a latecomer in an already saturated market is not the path to long-term success.

When evaluating the competitive environment, a prospective buyer should address other questions:

- Which competitors have survived, and what characteristics have led to their success?
- How do competitors' sales volumes compare with those of the business under consideration?
- What unique services do competitors offer?
- How well organized and coordinated are the marketing efforts of competitors?
- What are the competitors' reputations?
- What are the strengths and weaknesses of the competition? Which competitor is strongest?
- What competitive edge does each competitor have?
- How can you gain market share in this competitive environment?

Legal Aspects

WHAT LEGAL ASPECTS SHOULD YOU CONSIDER? Business buyers must be careful to avoid several legal pitfalls as they negotiate the final deal. The biggest potential traps include liens, bulk transfers, contract assignments, covenants not to compete, and ongoing legal liabilities.

LIENS. The key legal issue in the sale of any asset is typically the proper transfer of good title from seller to buyer. However, because most business sales involve a collection of assorted assets, the transfer of a good title is more complex. Some business assets may have **liens** (creditors' claims) against them and, unless they are satisfied before the sale, the buyer must assume them and is financially responsible for them. One way to reduce this potential problem is to include a clause in the sales contract stating that any liability not shown on the balance sheet at the time of sale remains the responsibility of the seller. A prospective buyer should have an attorney thoroughly investigate all of the assets for sale and their lien status before buying any business.

lien—*a creditor's claim against an asset.*

BULK TRANSFERS. To protect against surprise claims from the seller's creditors after purchasing a business, the buyer should meet the requirements of a **bulk transfer** under Section 6 of the Uniform Commercial Code. Suppose that an owner owing many creditors sells his business to a buyer. The seller, however, does not use the proceeds of the sale to pay his debts to business creditors. Instead, he pockets them to use for his own benefit. Without the protection of a bulk transfer, those creditors could make claim to the assets that the buyer purchased in order to satisfy the previous owner's debts (within six months). To be effective, a bulk transfer must meet the following criteria:

bulk transfer—*protects the buyer of a business's assets from the claims unpaid creditors might have against those assets.*

- The seller must give the buyer a signed, sworn list of existing creditors.
- The buyer and the seller must prepare a list of the property included in the sale.
- The buyer must keep the list of creditors and the list of property for six months.
- The buyer must give written notice of the sale to each creditor at least 10 days before he takes possession of the goods or pays for them (whichever is first).

By meeting these criteria, a buyer acquires free and clear title to the assets purchased, which are not subject to prior claims from the seller's creditors. Because Section 6 can create quite a burden on a business buyer, 16 states have repealed it, and more may follow. About a half-dozen states have revised Section 6 to make it easier for buyers to notify creditors. Under the revised rule, if a business has more than 200 creditors, the buyer may notify them by public notice rather than by contacting them individually.

CONTRACT ASSIGNMENTS. A buyer must investigate the rights and the obligations he would assume under existing contracts with suppliers, customers, employees, lessors, and others. To continue the smooth operation of the business, the buyer must assume the rights of the seller under many existing contracts. Assuming these rights and obligations means having the seller assign existing contracts to the new owner. For example, the current owner may have four years left on a 10-year lease and will need to assign this contract to the buyer. To protect her interest, the buyer (who is the assignee) should notify the other party involved in the contract of the assignment. In the previous example, the business buyer should notify the landlord promptly of the lease assignment from the previous owner.

Generally, the seller can assign any contractual right to the buyer, unless the contract specifically prohibits the assignment or the contract is personal in nature. For instance, loan contracts sometimes prohibit assignments with **due-on-sale clauses.** These clauses require the buyer to pay the full amount of the remaining loan balance or to finance the balance at prevailing interest rates. Thus, the buyer cannot assume the seller's loan (at a lower interest rate). Also, a seller usually cannot assign his credit arrangements with suppliers to the buyer because they are based on the seller's business reputation and are personal in nature. If such contracts are crucial to the business operation and cannot be assigned, the buyer must renegotiate new contracts. A prospective buyer also should evaluate the terms of any other unique contracts the seller has, including patent, trademark, or copyright registrations, exclusive agent or distributor contracts, real estate leases, financing and loan arrangements, and union contracts.

due-on-sale clause—*loan contract provision that prohibits a seller from assigning a loan arrangement to the buyer. Instead, the buyer is required to finance the remaining loan balance at prevailing interest rates.*

COVENANTS NOT TO COMPETE. One of the most important and most often overlooked legal considerations for a prospective buyer is negotiating a **covenant not to compete** (or a **restrictive covenant**) with the seller. Under a restrictive covenant, the seller agrees not to open a new competing business within a specific time period and geographic area. (The covenant should be negotiated with the *owner*, not with the corporation, because if the corporation signs the agreement, the owner may not be bound.) However, the covenant must be a part of a business sale and must be reasonable in scope in order to be enforceable. Although some states place limitations on the enforceability of restrictive covenants, business buyers should insist on the seller signing one. Without this protection, a buyer may find his new business eroding beneath his feet. For example, Bob purchases a tire business from Alexandra, whose reputation in town for selling tires is unequaled. If Bob fails to negotiate a restrictive covenant, nothing can stop Alexandra from opening a new shop next to her old one and keeping all of her customers, thereby driving Bob out of business. A reasonable covenant in this case might restrict Alexandra from opening a tire store within a three-mile radius for three years. Every business buyer should negotiate a covenant not to compete with the seller.

covenant not to compete (or restrictive covenant)—*an agreement between a buyer and a seller in which the seller agrees not to compete with the buyer within a specific time period and geographic area.*

ONGOING LEGAL LIABILITIES. Finally, a buyer must look for any potential legal liabilities the purchase might expose. These typically arise from three sources: (1) physical premises, (2) product liability claims, and (3) labor relations. First, the buyer must examine the physical premises for safety. Are employees at risk because of asbestos or some other hazardous material? If a manufacturing environment is involved, does it meet Occupational Safety and Health Administration (OSHA) and other regulatory agency requirements?

A Company Example

One entrepreneur who purchased a retail business located in a building that once housed a gasoline service station was quite surprised when the Environmental Protection Agency informed him that he would have to pay for cleaning up the results of an old, leaking gas tank that still sat beneath the property. Even though he had no part in running the old gas station and did not know the leaking tank was there, he was responsible for the cost of the cleanup! Removing the tank and cleaning up the site cost him several thousand dollars that he had not budgeted.

Second, the buyer must consider whether existing products contain defects that could result in **product liability lawsuits,** which claim that a company is liable for damages and injuries caused by the products or services it makes or sells. Existing lawsuits might be an omen of more to follow. In addition, the buyer must explore products that the company has discontinued because he

might be liable for them if they prove to be defective. The final bargain between the parties should require the seller to guarantee that the company is not involved in any product liability lawsuits.

product liability lawsuits—*lawsuits that claim a company is liable for damages and injuries caused by the products it makes or sells.*

Third, what is the relationship between management and employees? Does a union contract exist? The time to discover sour management–labor relations is before the purchase, not after.

If the buyer's investigation reveals such potential liabilities, it does not necessarily eliminate the business from consideration. Insurance coverage can shift such risks from the potential buyer, but the buyer should check to see whether the insurance will cover lawsuits resulting from actions predating the purchase.

Financial Soundness of the Business

IS THE BUSINESS FINANCIALLY SOUND? A prospective buyer must analyze the financial records of a target business to determine its condition. He shouldn't be afraid to ask an accountant for help. Accounting systems and methods can vary tremendously from one type of business to another and can be quite confusing to a novice. Current profits can be inflated by changes in the accounting procedure or in the method for recording sales. For the buyer, the most dependable financial records are audited statements, those prepared by a CPA firm in accordance with generally accepted accounting principles (GAAP). Unfortunately, audited records do not exist in many small companies that are for sale. In some cases, a potential buyer has to hire an accountant to construct reliable financial statements because the owner's accounting and recordkeeping is so sloppy.

When evaluating the financial status of any business prospect, a buyer must remember that any investment in a company should produce a reasonable salary for her, an attractive return on the money she invests, and enough to cover the amount she must borrow to make the purchase. Otherwise, it makes no sense to purchase the business. Because most investors know that they can earn at least 8 to 10 percent a year by investing wisely in the stock market, they expect any business they buy to earn at least that amount plus an extra return that reflects the additional risk of buying a business. Many owners expect to earn a return of at least 15 percent to 30 percent on the amount invested in their businesses.

A buyer also must remember that she is purchasing the future profit potential of an existing business. To evaluate the firm's profit potential, she should review past sales, operating expenses, and profits as well as the assets used to generate those profits. She must compare current balance sheets and income statements with previous ones and then develop pro forma statements for the next two or three years. Sales tax records, income tax returns, and financial statements are valuable sources of information.

Are profits consistent over the years, or are they erratic? Is this pattern typical in the industry, or is it a result of unique circumstances or poor management? Can the business survive with such a serious fluctuation in revenues, costs, and profits? If these fluctuations are caused by poor management, can a new manager turn the business around?

Some of the financial records that a potential buyer should examine include the following:

INCOME STATEMENTS AND BALANCE SHEETS FOR THE PAST THREE TO FIVE YEARS. It is important to review data from several years because creative accounting techniques can distort financial data in any single year. Even though buyers are purchasing the future profits of a business, they must remember that many businesses intentionally show low profits in order to minimize the owners' tax bills. Low profits should prompt a buyer to investigate their causes.

INCOME TAX RETURNS FOR THE PAST THREE TO FIVE YEARS. Comparing basic financial statements with tax returns can reveal discrepancies of which the buyer should be aware. Some small business owners **skim** from their businesses—take money from sales without reporting it as income. Owners who skim will claim their businesses are more profitable than their tax returns show. Although such underreporting is illegal and unethical, it is surprisingly common. Do *not* pay for undocumented, "phantom" profits the seller claims exist. In fact, you should consider whether you want to buy a business from someone who admits to doing business unethically.

skimming—*taking money from sales without reporting it as income.*

OWNER'S COMPENSATION (AND THAT OF RELATIVES). The owner's compensation is especially important in small companies; and the smaller the company is, the more important it will be. Although many companies do not pay their owners what they are worth, others compensate their owners lavishly. The buyer must consider the impact of fringe benefits—company cars, insurance contracts, country club memberships, and the like. It is important to adjust the company's income statements for the salary and fringe benefits that the seller has paid himself and others.

CASH FLOW. Most buyers understand the importance of evaluating a company's profitability, but fewer recognize the necessity of analyzing its cash flow. They assume that if profits are adequate, there will be sufficient cash to pay all of the bills and to fund an attractive salary for themselves. *That is not necessarily the case!* Before you agree to a deal, you should sit down with an accountant and convert the target company's financial statements into a cash flow forecast. Not only must this forecast take into account existing debts and obligations but also any modifications the buyer would make in the business. It must also reflect the repayment of any financing the buyer arranges to purchase the company. Will the company generate enough cash to be self-supporting? How much cash will it generate for you?

A potential buyer must look for suspicious deviations from normal (in either direction) for sales, expenses, profits, cash flow, assets, and liabilities. Have sales been increasing or decreasing? Is the equipment really as valuable as it is listed on the balance sheet? Are advertising expenses unusually high or low? How is depreciation reflected in the financial statements?

This financial information gives a buyer the opportunity to verify the seller's claims about the business's performance. Sometimes, however, an owner will take short-term actions that produce a healthy financial statement but weaken the firm's long-term health and profit potential. For example, a seller might lower costs by gradually eliminating equipment maintenance or boost sales by selling to marginal businesses that will never pay their bills. Such techniques can artificially inflate assets and profits, but a well-prepared buyer should be able to see through them.

YOU Be the Consultant . . .

Escaping a High-Tech World for a Low-Tech One

Mike and Nancy Lusby knew that it was time for a change in their lives. Mike, the director of operations for a high-tech company in Silicon Valley, had just learned that his $70,000-a-year job was being eliminated. Nancy was the manager of the finance department at a high-tech lab in Silicon Valley, and, although she enjoyed her work, she had grown weary of office politics and the three-hour round-trip commutes to work and back. The Lusbys decided that it was time to realize their dream of becoming entrepreneurs.

Rather than start their own company from scratch, however, the Lusbys wanted to buy a business. They knew that they did not want to own a high-tech company and that they did want a business that included living quarters. The couple spent a considerable amount of time scouring advertisements for businesses in magazines and newspapers, ultimately narrowing their choices to three: hardware stores, bed-and-breakfast inns, and general stores. "I've always loved hardware stores," says Mike, but they don't usually come with a place to live. B&Bs provide you housing, but you're on call 24 hours a day." The couple decided to focus on general stores.

Mike contacted a dozen general stores and visited them but ultimately rejected them all because they were either "boring" or they were too far from good schools for the couple's young daughters. The prospects of finding a suitable general store were fading. "We were down to our last $1,000 in my severance pay, and I spent it on a plane tickets to fly to New Hampshire," Mike says. There he visited the Brick Store, which is listed on the Interior Department's National Register of Historic Places as the oldest continuously operated general store in the United States. Mike immediately recognized the Brick Store's drawing power and marketing potential; he also fell in love with the business, which was started in 1790. The brick building that houses the store today was built in 1804 after a fire destroyed the original location. The two-story, Federal-style building came complete with large white columns and an inviting porch. Its old-world charm was hard for the Lusbys—and for customers—to resist. Plus, there was plenty of room upstairs for the family to live. The Ammonoosuc River flowed by just beyond the Brick Store, and the town of Bath was filled with picturesque, calendar-like scenes of New England. Nearby was the longest covered bridge in New Hampshire.

The Lusbys were ready to buy the Brick Store. The asking price was $390,000 but the owner accepted the Lusbys' offer of $300,000. The Lusbys took much of their savings and a gift from Nancy's parents to make a down payment of $140,000 and borrowed the balance from a local bank. Although their previous business experience came in handy when they set up a mail-order business to keep revenue coming in during the off-season (January through April), the Lusbys knew they had a lot to learn about retailing. Product lines run into the hundreds—from pocketknives and jellies to weathervanes and worms—all with profit margins as varied as the products themselves. They discovered that the store's tourist traffic arrives in May, swells throughout the summer, and blossoms in September and October. In fact, the Brick House brings in 40 percent of its annual sales in just six weeks during September and October. After that, business slows to a trickle. Fortunately for the Lusbys, three long-time employees agreed to stay on to teach the New England newcomers the daily details of running the store.

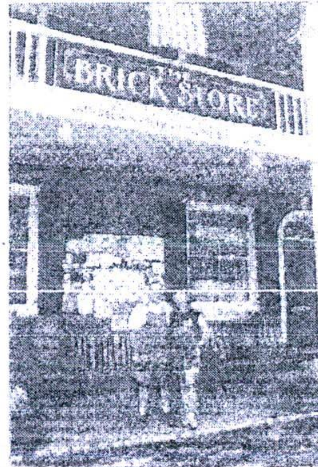
After the Lusbys took over the Brick Store, they discovered several problems that caused them so much concern that they actually returned to California for a brief time. They learned that in the future a new highway will divert approximately 20 percent of the store's traffic. In addition, the Lusbys' early experience in the store did not measure up to the expectations that the previous owner's rather

spotty financial records had created. Fortunately, the business broker, whom the Lusbys did not know before buying the store, became a friend and was able to show them that the store could generate enough profits to support itself and them. The Lusbys also discovered how much they enjoyed their new lifestyle and location. "One winter day, [we] sat down and figured out how much we'd have to earn at other jobs to support this kind of life," says Mike. "It came to $75,000 a year." The Lusbys not only are making a comfortable living running the Brick Store, but their commute to work is now much shorter. A short stroll down the steps from the living quarters puts them at work in a beautiful, 200-year-old general store with a tremendous sense of history.

1. Suppose that the Lusbys came to you for advice on buying the Brick Store. What would you have told them?

2. Should the Lusbys have done anything differently in their quest to buy a business? Explain.

Source: Adapted from Lee Smith, "From High Tech . . . to Low Tech," *Fortune*, November 9, 1998, pp. 228[A]–228[D].



Source: Courtesy of The Brick Store.

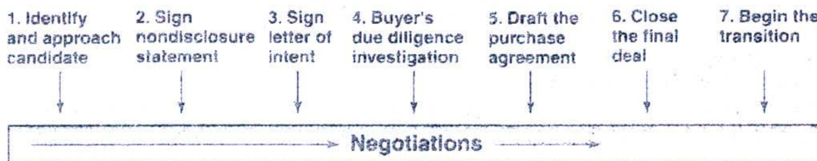


FIGURE 5.1

The Acquisition Process

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.

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 the records, documents, and information he or she 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 or she typically will ask the seller to sign a letter of intent. The letter of intent is a nonbinding 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 nonbinding, 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, 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 or her 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 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!

Finally, a potential buyer should walk away from a deal—no matter how good it may appear on the surface—if the present owner refuses to disclose his company's financial records.

Buying an existing business is a process filled with potential missteps along the way. The expression "Let the buyer beware" should govern your thoughts and actions throughout the entire process. However, by following the due diligence procedure just discussed, a buyer can dramatically lower the probability of getting "burned" with a business that does not suit her personality or one that is in on the verge of failure. Figure 5.1 illustrates the sequence of events leading up to a successful negotiation with a seller.

Learning Objectives
4. Describe the various techniques for determining the value of a business.

METHODS FOR DETERMINING THE VALUE OF A BUSINESS

Business valuation is partly an art and partly a science. Part of what makes establishing a reasonable price for a privately held business so difficult is the wide variety of factors that influence its value: the nature of the business itself, its position in the market or industry, the outlook for the market or industry, the company's financial status, its earning capacity, any intangible assets it may own (e.g., patents, trademarks, or copyrights), the value of other similar publicly held companies, and many other factors.

Computing the value of the company's tangible assets normally poses no major problem, but assigning a price to the intangibles, such as goodwill, almost always creates controversy. The seller expects goodwill to reflect the hard work and long hours invested in building the business. The buyer, however, is willing to pay extra only for those intangible assets that produce exceptional income. So, how can the buyer and the seller arrive at a fair price? There are few hard-and-fast rules in establishing the value of a business, but the following guidelines are helpful:

- The wisest approach is to compute a company's value using several techniques and then to choose the one that makes the most sense.
- The deal must be financially feasible for both parties. The seller must be satisfied with the price received for the business, but the buyer cannot pay an excessively high price.
- The potential buyer must have access to the business records.
- Valuations should be based on facts, not fiction.
- No surprise is the best surprise. Both parties should commit to dealing with one another honestly and in good faith.

The main reason that buyers purchase existing businesses is to get their future earning potential. The second most common reason is to obtain an established asset base; it is much easier to buy assets than to build them. Although evaluation methods should take these characteristics into consideration, too many business sellers and buyers depend on rules of thumb that ignore the unique features of small companies. Often these rules of thumb are based on multiples of a company's net earnings or sales and vary by industry.

The next section describes three basic techniques and several variations on them for determining the value of a hypothetical business, Lewis Electronics.

Basic Balance Sheet Methods: Net Worth = Assets – Liabilities

balance sheet technique—*a method of valuing a business based on the value of the company's net worth (net worth = total assets – total liabilities).*

BALANCE SHEET TECHNIQUE. The **balance sheet technique** is one of the most commonly used methods of evaluating a business although it is not highly recommended because it oversimplifies the valuation process. This method computes the company's net worth or owner's equity (net worth = total assets – total liabilities) and uses this figure as the value. The problem with this technique is that it fails to recognize reality: Most small businesses have market values that exceed their reported book values.

The first step is to determine which assets are included in the sale. In most cases, the owner has some personal assets that he does not want to sell. Professional business brokers can help the buyer and the seller arrive at a reasonable value for the collection of assets included in the deal. Remember that net worth on a financial statement will likely differ significantly from actual net worth in the market. Figure 5.2 shows the balance sheet for Lewis Electronics. Based on this balance sheet, the company's net worth is \$266,091 – \$114,325 = \$151,766.

Lewis Electronics Balance Sheet June 30, 200x			
Assets			
Current Assets:			
Cash		$11,655	
Accounts Receivable		15,876	
Inventory		56,523	
Supplies		8,574	
Prepaid Insurance		3,587	
Total Current Assets			$ 96,215
Fixed Assets:			
Land		$24,000	
Buildings	$141,000		
less accumulated depreciation	51,500	89,500	
Office Equipment	$ 12,760		
less accumulated depreciation	7,159	5,601	
Factory Equipment	$ 59,085		
less accumulated depreciation	27,850	31,235	
Trucks and Autos	$ 28,730		
less accumulated depreciation	11,190	17,540	
Total Fixed Assets			$167,876
Total Assets			$266,091
Liabilities			
Current Liabilities:			
Accounts Payable		$19,497	
Mortgage Payable (current portion)		5,215	
Salaries Payable		3,671	
Note Payable		10,000	
Total Current Liabilities			$ 38,383
Long-Term Liabilities:			
Mortgage Payable		$54,542	
Note Payable		21,400	
Total Long-Term Liabilities			$ 75,942
Total Liabilities			$114,325
Owners' Equity			
Owners' Equity			$151,766
Total Liabilities and Owners' Equity			$266,091

FIGURE 5.2 Balance Sheet for Lewis Electronics

VARIATION: ADJUSTED BALANCE SHEET TECHNIQUE. A more realistic method for determining a company's value is to adjust the book value of net worth to reflect *actual* market value. The values reported on a company's books may either overstate or understate the true value of assets and liabilities. Typical assets in a business sale include notes and accounts receivable, inventories, supplies, and fixtures. If a buyer purchases notes and accounts receivable, he should estimate the likelihood of their collection and adjust their value accordingly.

adjusted balance sheet technique—*a method of valuing a business based on the market value of the company's net worth (net worth = total assets – total liabilities).*

In manufacturing, wholesale, and retail businesses, inventory is usually the largest single asset in the sale. Taking a physical inventory count is the best way to determine accurately the quantity of goods to be transferred. The sale may include three types of inventory, each having its own method of valuation: raw materials, work-in-process, and finished goods. The buyer and the seller must arrive at a method for evaluating the inventory. First-in, first-out (FIFO), last-in, first-out (LIFO), and average costing are three frequently used techniques, but the most common methods use the cost of last purchase and the replacement value of the inventory. Before accepting any inventory value, the buyer should evaluate the condition of the goods.

A Company Example

One young couple purchased a lumber yard without sufficiently examining the inventory. After completing the sale, they discovered that most of the lumber in a warehouse they had neglected to inspect was warped and was of little value as building material. The bargain price they paid for the business turned out not to be the good deal they had expected.

To avoid such problems, some buyers insist on having a knowledgeable representative on an inventory team to count the inventory and check its condition. Nearly every sale involves merchandise that cannot be sold, but by taking this precaution, a buyer minimizes the chance of being stuck with worthless inventory. Fixed assets transferred in a sale might include land, buildings, equipment, and fixtures. Business owners frequently carry real estate and buildings at prices well below their actual market value. Equipment and fixtures, depending on their condition and usefulness, may increase or decrease the true value of the business. Appraisals of these assets on insurance policies are helpful guidelines for establishing market value. Also, business brokers can be useful in determining the current market value of fixed assets. Some

FIGURE 5.3 Balance Sheet for Lewis Electronics Adjusted to Reflect Market Value

Lewis Electronics
Adjusted Balance Sheet
June 30, 200x

Assets			
Current Assets:			
Cash		$ 11,655	
Accounts Receivable		10,051	
Inventory		39,261	
Supplies		7,492	
Prepaid Insurance		5,587	
Total Current Assets			$ 74,046
Fixed Assets:			
Land		$ 39,900	
Buildings	$177,000		
less accumulated depreciation	51,500	125,500	
Office Equipment	$ 11,645		
less accumulated depreciation	7,159	4,486	
Factory Equipment	$ 50,196		
less accumulated depreciation	27,850	22,346	
Trucks and Autos	$ 22,550		
less accumulated depreciation	11,190	11,360	
Total Fixed Assets			$200,592
Total Assets			$274,638
Liabilities			
Current Liabilities:			
Accounts Payable		$ 19,497	
Mortgage Payable (current portion)		5,215	
Salaries Payable		3,671	
Note Payable		10,000	
Total Current Liabilities			$ 38,383
Long-Term Liabilities:			
Mortgage Payable		$ 54,542	
Note Payable		21,400	
Total Long-Term Liabilities			$ 75,942
Total Liabilities			$114,325
Owners' Equity			
Owners' Equity			$160,313
Total Liabilities and Owners' Equity			$274,638

brokers use an estimate of what it would cost to replace a company's physical assets (less a reasonable allowance for depreciation) to determine value. For Lewis Electronics, the adjusted net worth is $274,638 – $114,325 = $160,313 (see the adjusted balance sheet in Figure 5.3), indicating that some of the entries in its books did not accurately reflect true market value.

Business evaluations based on balance sheet methods suffer one major drawback: They do not consider the future earning potential of the business. These techniques value assets at current prices and do not consider them as tools for creating future profits. The next method for computing the value of a business is based on its expected future earnings.

EARNINGS APPROACH. The buyer of an existing business is essentially purchasing its future income. The **earnings approach** focuses on the future income potential of a business and assumes that a company's value depends on its ability to generate consistent profits over time. There are three variations of the earnings approach.

earnings approach—*a method of valuing a business that recognizes that a buyer is purchasing the future income (earnings) potential of a business.*

VARIATION 1: EXCESS EARNINGS METHOD. This method combines both the value of a business's existing assets (minus its liabilities) and an estimate of its future earnings potential to determine its selling price. One advantage of this technique is that it offers an estimate of goodwill. **Goodwill** is an intangible asset that often creates problems in a business sale. In fact, the most common method of valuing a business is to compute its tangible net worth and then to add an often arbitrary adjustment for goodwill. In essence, goodwill is the difference between an established, successful business and one that has yet to prove itself. It is based on the company's reputation and its ability to attract customers. A buyer should not accept blindly the seller's arbitrary adjustment for goodwill because it is likely to be inflated. The *real* value of a company's goodwill lies in its financial value to the buyer, not in its emotional value to the seller.

goodwill—*an intangible asset that reflects the value of a company's reputation, its established customer and supplier contacts, name recognition, and other factors.*

The excess earnings method provides a consistent and realistic approach for determining the value of goodwill. It measures goodwill by the amount of profit the business earns above that of the average firm in the same industry. It also assumes that the owner is entitled to a reasonable return on the firm's adjusted tangible net worth.

Step 1. *Compute adjusted tangible net worth.* Using the adjusted balance sheet method of valuation, the buyer should compute the firm's adjusted tangible net worth. Total tangible assets (adjusted for market value) minus total liabilities yields adjusted tangible net worth. In the Lewis Electronics example, adjusted tangible net worth is $274,638 – $114,325 = $160,313 (refer to Figure 5.3).

Step 2. *Calculate the opportunity costs of investing in the business.* **Opportunity cost** represents the cost of forgoing a choice. If a buyer chooses to purchase the assets of a business, he cannot invest his money elsewhere. Therefore, the opportunity cost of the purchase would be the amount that the buyer could earn by investing the same amount *in a similar-risk investment.*

There are three components in the rate of return used to value a business: (1) the basic, risk-free return, (2) an inflation premium, and (3) the risk allowance for investing in the particular business. The basic, risk-free return and the inflation premium are reflected in investments such as U.S. treasury bonds. To determine the appropriate rate of return for investing in a business, the buyer must add to this base rate a factor reflecting the risk of purchasing the company. The greater the risk is, the higher the rate of return will be. A normal-risk business typically indicates a 25 percent rate of return. In the Lewis Electronics example, the opportunity cost of the investment is $160,313 × 25% = $40,078.

The second part of the buyer's opportunity cost is the salary that she could earn working for someone else. For the Lewis Electronics example, if the buyer purchases the business, she must forgo the $25,000 salary that she could earn working elsewhere. Adding these amounts together yields a total opportunity cost of $65,078.

opportunity cost—*the cost of the next best alternative choice; the cost of giving up one alternative to get another.*

Step 3. *Project net earnings.* The buyer must estimate the company's net earnings for the upcoming year before subtracting the owner's salary. Averages can be misleading, so the buyer must be sure to investigate the trend of net earnings. Have they risen steadily over the past five years, dropped significantly, remained relatively constant, or fluctuated wildly? Past income statements provide useful guidelines for estimating earnings. In the Lewis Electronics example, the buyer and his accountant project net earnings for the upcoming year to be $74,000.

Step 4. *Compute extra earning power.* A company's extra earning power is the difference between forecasted earnings (step 3) and total opportunity costs (step 2). Many small businesses that are for sale do not have extra earning power (i.e., excess earnings), and they show marginal or no profits. The extra earning power of Lewis Electronics is $74,000 – $65,000 = $8,922.

Step 5. *Estimate the value of intangibles.* The owner can use the extra earning power of the business to estimate the value of its intangible assets—that is, its goodwill. Multiplying the extra earning power by a years-of-profit figure yields an estimate of the intangible assets' value. The years-of-profit figure for a normal-risk business ranges from 3 to 4. A very high-risk business may have a years-of-profit figure of 1, whereas a well-established firm might use a figure of 7. For Lewis Electronics, the value of intangibles (assuming normal risk) would be $8,922 × 3 = $26,766.

Step 6. *Determine the value of the business.* To determine the value of the business, the buyer simply adds together the adjusted tangible net worth (step 1) and the value of the intangibles (step 5). Using this method, the value of Lewis Electronics is $160,313 + $26,766 = $187,079.

The buyer and the seller should consider the tax implications of including in the purchase the value of goodwill and the value of a covenant not to compete. Because the *buyer* can amortize both the cost of goodwill and a covenant over 15 years, the tax treatment of either would be the same for him or her. However, the *seller* would prefer to have the amount of the purchase price in excess of the value of the assets allocated to goodwill, which is a capital asset. The gain on the capital asset would be taxed at the lower capital gains rates. If that same amount were allocated to a restrictive covenant (which is negotiated with the seller personally, not the business), the seller must treat it as ordinary income, which would be taxed at regular rates that are higher than the capital gains rates.

VARIATION 2: CAPITALIZED EARNINGS APPROACH. Another earnings approach capitalizes expected net earnings to determine the value of a business. The buyer should prepare his own pro forma income statement and should ask the seller to prepare one also. Many appraisers use a five-year weighted average of past sales (with the greatest weights assigned to the most recent years) to estimate sales for the upcoming year.

Once again, the buyer must evaluate the risk of purchasing the business to determine the appropriate rate of return on the investment. The greater the perceived risk, the higher the return that the buyer requires. Risk determination is always somewhat subjective, but it is necessary for proper evaluation.

capitalized earnings approach—*a method of valuing a business that divides estimated earnings by the rate of return the buyer could earn on a similar-risk investment.*

The **capitalized earnings approach** divides estimated net earnings (*after* subtracting the owner's reasonable salary) by the rate of return that reflects the risk level. For Lewis Electronics, the capitalized value (assuming a reasonable salary of $25,000) is:

$$\frac{\text{Net earnings (after deducting owner's salary)}}{\text{Rate of return}} = \frac{\$74,000 - \$25,000}{25\%} = \$196,000$$

Clearly, firms with lower risk factors are more valuable (a 10 percent rate of return would yield a value of $499,000 for Lewis Electronics) than are those with higher risk factors (a 50 percent rate of return would yield a value of $99,800). Most normal-risk businesses use a rate-of-return factor ranging from 25 to 30 percent. The lowest risk factor that most buyers would accept for any business ranges from 15 to 20 percent.

discounted future earnings approach—*a method of valuing a business that forecasts a company's earnings several years into the future and then discounts them back to their present value.*

VARIATION 3: DISCOUNTED FUTURE EARNINGS APPROACH. This variation of the earnings approach assumes that a dollar earned in the future is worth less than that same dollar today. Therefore, using this approach, the buyer estimates the company's net income for several years into the future and then discounts these future earnings back to their present value. The resulting present value is an estimate of the company's worth.

The reduced value of future dollars represents the cost of the buyer's giving up the opportunity to earn a reasonable rate of return by receiving income in the future instead of today, a concept known as the time value of money. To illustrate the importance of the time value of money, consider two $1 million sweepstake winners. Rob wins $1 million in a sweepstakes, but he receives it in $50,000 installments over 20 years. If Rob invested every installment at 15 percent interest, he would have accumulated $5,890,505.98 at the end of 20 years. Lisa wins $1 million in another sweepstakes, but she collects her winnings in one lump sum. If Lisa invested her $1 million today at 15 percent, she would have accumulated $16,366,537.39 at the end of 20 years. The difference in their wealth is the result of the time value of money.

DISCOUNTED FUTURE EARNINGS APPROACH. The **discounted future earnings approach** has five steps:

Step 1. *Project future earnings for five years into the future.* One way is to assume that earnings will grow by a constant amount over the next five years. Perhaps a better method is to develop three forecasts—an optimistic, a pessimistic, and a most likely—for each year and then find a weighted average using the following formula:

$$\text{Forecasted earnings for year } i = \frac{(\text{Optimistic earnings for year } i) + (\text{Most likely forecast for year } i \times 4) + (\text{Pessimistic forecast for year } i)}{6}$$

For Lewis Electronics, the buyer's forecasts are:

Year	Pessimistic	Most Likely	Optimistic	Weighted Average
XXX1	65,000	74,000	92,000	75,500
XXX2	74,000	90,000	101,000	89,167
XXX3	82,000	100,000	112,000	99,000
XXX4	88,000	109,000	120,000	107,333
XXX5	88,000	115,000	122,000	111,667

Buyers must remember that the farther into the future they forecast, the less reliable their estimates will be.

Step 2. *Discount these future earnings at the appropriate present value rate.* The rate that the buyer selects should reflect the rate he could earn on a similar-risk investment. Because Lewis Electronics is a normal-risk business, the buyer chooses a present value rate of 25 percent.

Year	Income Forecast (Weighted Average)	Present Value Factor (at 25%)*	Net Present Value
XXX1	75,500	.8000	60,400
XXX2	89,167	.6400	57,067
XXX3	99,000	.5120	50,688
XXX4	107,333	.4096	43,964
XXX5	111,667	.3277	36,593
		Total	248,712

* The appropriate present value factor can be found by looking in published present value tables, by using modern calculators or computers, or by solving this formula:

$$\text{Present value factor} = \frac{1}{(1+k)^t}$$

where k = rate of retur
t = year(t = 1, 2, 3 …, n).

Step 3. *Estimate the income stream beyond five years.* One technique suggests multiplying the fifth-year income by 1/rate of return. For Lewis Electronics, the estimate is:

$$\text{Income beyond year 5} = \$111,667 \times \frac{1}{25\%} = \$446,668$$

Step 4. *Discount the income estimate beyond five years using the present value factor for the sixth year.* For Lewis Electronics:

Present value of income beyond year 5 = $446,668 × 0.2622 = $117,116

Step 5. *Compute the total value of the business.* Add the present value of the company's estimated earnings for years 1 through 5 (step 2) and the present value of its earnings from years 6 on (step 4):

$$\text{Total value} = \$248{,}712 + \$117{,}116 = \$365{,}828$$

The primary advantage of this technique is that it evaluates a business solely on the basis of its future earning potential, but its reliability depends on making forecasts of future earnings and on choosing a realistic present value rate. In other words, a company's present value is tied to its future performance, which is not always easy to project. The discounted cash flow technique is especially well suited for valuing service businesses (whose asset bases are often very thin) and for companies experiencing high growth rates.

market approach—*a method of valuing a business that uses the price/earnings (P/E) ratio of similar, publicly held companies to determine value.*

MARKET APPROACH. The **market** (or price/earnings) **approach** uses the price/earnings ratios of similar businesses to establish the value of a company. According to one valuation expert, among professional appraisers, the most widely recognized and applied standard of value is 'fair market value,' as defined by the Internal Revenue Service: the price at which property would change hands between a willing buyer and a willing seller, neither under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.[6] The buyer must use businesses whose stocks are publicly traded in order to get a meaningful comparison. A company's price/earnings ratio (or P/E ratio) is the price of one share of its common stock in the market divided by its earnings per share (after deducting preferred stock dividends). To get a representative P/E ratio, the buyer should average the P/E ratios of as many similar businesses as possible.

To compute the company's value, the buyer multiplies the average price/earnings ratio by the private company's estimated earnings. For example, suppose that the buyer found four companies comparable to Lewis Electronics whose stocks are publicly traded. Their price/earnings ratios are:

Company 1	3.3
Company 2	3.8
Company 3	4.7
Company 4	4.1
Average P/E ratio	3.975

Using this average P/E ratio produces a value of $294,150:

$$\text{Value} = \text{Average P/E ratio} \times \text{Estimated net earnings} = 3.975 \times \$74{,}000 = \$294{,}150$$

The biggest advantage of the market approach is its simplicity. But this method does have several disadvantages, including the following:

- *Necessary comparisons between publicly traded and privately owned companies.* Because the stock of privately owned companies is illiquid, the P/E ratio used is often subjective and lower than that of publicly held companies.
- *Unrepresentative earnings estimates.* The private company's net earnings may not realistically reflect its true earning potential. To minimize taxes, owners usually attempt to keep profits low and rely on fringe benefits to make up the difference.
- *Finding similar companies for comparison.* Often it is extremely difficult for a buyer to find comparable publicly held companies when estimating the appropriate P/E ratio.
- *Applying the after-tax earnings of a private company to determine its value.* If a prospective buyer is using an after-tax P/E ratio from a public company, he also must use the after-tax earnings from the private company.

Despite its drawbacks, the market approach is useful as a general guideline to establishing a company's value.

Which of these methods is best for determining the value of a small business? Simply stated, there is no single best method. Valuing a business is partly an art and partly a science. Using these techniques, a range of values will emerge. Buyers should look for values that might cluster together and then use their best judgment to determine their offering price. Table 5.4 summarizes the valuation techniques covered in this chapter.

TABLE 5.4

What's It Worth? A Summary of Business Valuation Techniques

Source: "Cashing Out and Maintaining Control" by Peter Collins, Small Business reports, Dec. 1989, p. 28. Reprinted by permission of JBS and Emerald, www.emeraldinsight.com.

BALANCE SHEET TECHNIQUE

Book value of net worth = Total assets − Total liabilities
= $266,091 − $114,325 = $151,766

Variation: Adjusted Balance Sheet Technique

Net worth adjusted to reflect market value = $274,638 − $114,325 = $160,313

EARNINGS APPROACH

Variation 1: Excess Earnings Method

Step 1: Adjusted tangible net worth = $274,638 − $114,325 = $160,313

Step 2: Opportunity costs = Opportunity cost of investing + Salary forgone
= $160,313 × 25% + $25,000 = $65,078

Step 3: Estimated net earnings = $74,000

Step 4: Extra earning power = Estimated net earning − Total opportunity costs
= $74,000 − $65,078
= $8,922

Step 5: Value of intangibles (goodwill) = Extra earning power × Years-of-profit figure
= $8,922 × 3
= $26,766

Step 6: Value of business = Tangible net worth + Value of intangibles
= $160,313 + 26,766
= $187,079

Variation 2: Capitalized Earnings Approach

$$\text{Value} = \frac{\text{Net earnings (after deducting owner's salary)}}{\text{Rate of return on a similar risk investment}}$$

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

Variation 3: Discounted Future Earnings Approach

Step 1: Project future earnings.

Year	Pessimistic	Most Likely	Optimistic	Weighted Average*
XXX1	$65,000	$ 74,000	$ 94,000	$ 75,500
XXX2	74,000	90,000	101,000	89,167
XXX3	82,000	100,000	112,000	99,000
XXX4	88,000	109,000	120,000	107,333
XXX5	88,000	115,000	122,000	111,667

$$^{*}\ \text{Weighted average} = \frac{P + 4 \times ML + O}{6}$$

Step 2: Discount future earnings using the appropriate present value factor.

Year	Forecasted Earnings	Present Value Factor	Net Present Value
XXX1	$ 75,500	.8000	$ 60,400
XXX2	89,167	.6400	57,067
XXX3	99,000	.5120	50,688
XXX4	107,333	.4096	43,964
XXX5	111,667	.3277	36,593
Total			$248,712

Step 3: Estimate income stream beyond five years.

$$\text{Income stream} = \text{Fifth-year forecasted income} \times \frac{1}{\text{Rate of return}}$$

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

$$= \$446{,}668$$

(continued on the next page)

TABLE 5.4 (continued)

Step 4: Discount income stream beyond five years (using sixth-year present value factor).

Present value of income stream = $446,668 × .2622 = $117,116

Compute total value.

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

MARKET APPROACH

Value = Estimated earnings × Average price/earnings ratio of representative companies
= $74,000 × 3.975 = $294,150

Which value is correct? Remember: There is no best method of valuing a business. These techniques provide only estimates of a company's worth. The particular method used depends on the unique qualities of the business and the special circumstances surrounding the sale.

Learning Objectives

5. Understand the seller's side of the buyout decision and how to structure the deal.

UNDERSTANDING THE SELLER'S SIDE

Few events are more anticipated—and more emotional—for entrepreneurs than selling a business. It often produces vast personal wealth and a completely new lifestyle, and this newly gained wealth offers freedom and the opportunity to catch up on all the things the owners missed out on while building the business. Yet, many entrepreneurs who sell out experience a tremendous void in their lives. We might call this difficulty "separation anxiety" because for many owners their entire lives have been linked to their businesses. The businesses they owned were the focal point in their lives in the communities in which they lived and a part of their identities. In many cases the values that an owner exhibited through the business are an overwhelming concern at the time of sale. Will the new owner display the same values in managing the business I built?

Gary Hirshberg, who was the founder and CEO of Stonyfield Farms, a Londonderry, New Hampshire, yogurt producer, ran the business in compliance with his values regarding social responsibility. When negotiations with the French firm, Groupe Danone, began, Hirshberg made a condition of the sale that the acquirer must retain all of the company's employees. This condition was similar to the terms in the Ben & Jerry's Homemade sale to Cenilever.[7]

Selling a business involves developing a plan that maximizes the value of the business. Before selling her business, an entrepreneur must ask herself some important questions: Do you want to walk away from the business completely, or do you plan to stay on after the sale? If you decide to stay on, how involved do you want to be in running the company? How much can you realistically expect to get for the business? Is this amount of money sufficient to maintain your desired lifestyle? Rather than sell the business to an outsider, should you be transferring ownership to your kids or to your employees? Who are the professionals—business brokers, accountants, attorneys, tax advisors—you will need to help you close the sale successfully? How do you expect the buyer to pay for the company? Are you willing to finance at least some of the purchase price?

A seller who has answered these fundamental questions is prepared to move forward in an organized and professional fashion.

Structuring the Deal

Next to picking the right buyer, planning the structure of the deal is one of the most important decisions a seller can make. Entrepreneurs who sell their companies without considering the tax implications of the deal can wind up paying the IRS as much as 70 percent of the proceeds in the form of capital gains and other taxes![8] A skilled tax advisor or financial planner can help business sellers legally minimize the bite various taxes take out of the proceeds of the sale.

Exit Strategy Options

STRAIGHT BUSINESS SALE. A straight business sale may be best for those entrepreneurs who want to step down and turn over the reins of the company to someone else.

A Company Example

For instance, Richie Stachowski recently sold his toy company, **Short Stack Inc.**, *to Wild Planet Toys of San Francisco because the business had grown so rapidly that Richie wanted more time to focus on other activities. The success of his three-year-old company, which sold worldwide more than 1 million water toys such as the Water Talkie (a device that allows swimmers to communicate underwater) and the Bin-Aqua-Lar (underwater binoculars), had won Richie several national awards and an appearance on* The David Letterman Show. *But he wanted time to pursue more normal activities—those suited for a 13-year-old boy! (Richie started Short Stack when he was just 10.) The sale of the company to Wild Planet Toys will net Richie an estimated $1 million per year for the next several years.*[9]

An initial question that owners need to answer is whether they want to sell the stock in the business or the assets of the business. Which choice is best for the seller and the buyer depends on the form of ownership. In an S corporation, the seller does not care if stock or assets are sold because the tax considerations are the same. Owners of C corporations are far better off selling stock rather than selling assets. Buyers will generally prefer to acquire the "hard" assets of the business, thus avoiding any potential hidden liabilities.[10] Despite these concerns, more than 90 percent of sales involve stock.

In every case, an intelligent entrepreneur always consults an attorney or tax advisor to obtain advice as to what form of sales will best suit their unique situation and personal desires. Know in advance what options you would prefer and which purchase options you would not accept. For example, although selling the business outright is the cleanest exit path for an entrepreneur, it may have negative tax consequences, and it often excludes the option of "staying on" and exiting gradually.

FORM A FAMILY LIMITED PARTNERSHIP. An entrepreneur could transfer her business to her children but still maintain control over it by forming a family limited partnership. The entrepreneur would take the role of the general partner with the children becoming limited partners in the business. The general partner keeps just 1 percent of the company, but the partnership agreement gives her total control over the business. The children own 99 percent of the company but have little or no say over how to run the business. Until the founder decides to step down and turn over the reins of the company to the next generation, she continues to run the business and sets up significant tax savings for the ultimate transfer of power.

SELL A CONTROLLING INTEREST. Sometimes business owners sell the majority interest in their companies to investors, competitors, suppliers, or large companies with an agreement that they will stay on after the sale as managers or consultants.

A Company Example

For instance, Leon and Pam Seidman sold 55 percent of **Cosmic Pet Products**, *a catnip business Leon started while in college, to Four Paws Pet Products, a much larger company. Four Paws gives the Seidmans the autonomy to run the business as they did before the sale, although the Seidmans do work with Four Paws on strategic planning and pricing issues. For both the Seidmans and Four Paws, the sale has produced positive outcomes. The Seidmans still get to run the day-to-day operations of the business they love without having to worry about the financial struggles of keeping a small company going. With the Seidmans' help, Four Paws has improved Cosmic Pet Products' distribution and pricing and built it into the largest catnip company in the country, commanding 60 percent of the market!*[11]

RESTRUCTURE THE COMPANY. Another way for business owners to cash out gradually is to replace the existing corporation with a new one, formed with other investors. The owner essentially is performing a leveraged buyout of his own company. For example, assume that you own

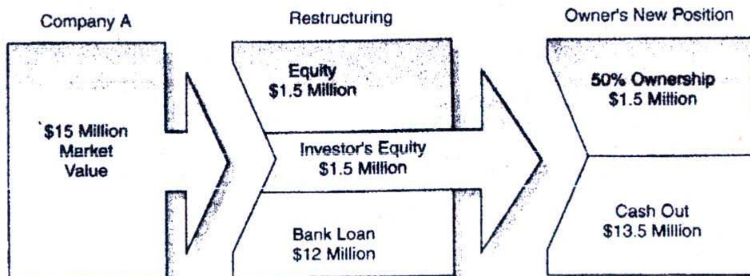


FIGURE 5.4 Restructuring a Business for Sale

Source: Peter Collins, "Cashing Out and Maintaining Control," *Small Business Reports*, December 1989, p. 28.

a company worth $15 million. You form a new corporation with $12 million borrowed from a bank and $3 million in equity: $1.5 million of your own equity and $1.5 million in equity from an investor who wants you to stay on with the business. The new company buys your company for $15 million. You net $13.5 in cash ($15 million – your $1.5 million equity investment) and still own 50 percent of the new leveraged business (see Figure 5.4).[12]

SELL TO AN INTERNATIONAL BUYER. In an increasingly global marketplace, small U.S. businesses have become attractive buyout targets for foreign companies. Foreign buyers—mostly European—buy more than 1,000 U.S. businesses each year. Despite the publicity that Japanese buyouts get, England leads the list of nations acquiring U.S. companies. Small business owners are receptive to international offers.

A Company Example

Consider the opportunity presented to Jim Dolce, founder of ***Redstone Communications***, *by the German firm, Siemens, that paid Dolce $500 million for his 18-month-old telecommunications business and then hired him to stay on and run the company.*[13]

In today's global economic environment, it is not unprecedented to find buyers for a business, viewed as having great financial potential, from around the world. In many instances, foreign companies buy U.S. businesses to gain access to a lucrative, growing market. They look for a team of capable managers, whom they typically retain for a given time period. They also want companies that are profitable, stable, and growing.

Selling to foreign buyers can have disadvantages, however. They typically purchase 100 percent of a company, thereby making the previous owner merely an employee. Relationships with foreign owners also can be difficult to manage.

USE A TWO-STEP SALE. For owners wanting the security of a sales contract now but not wanting to step down from the company's helm for several years, a two-step sale may be ideal. The buyer purchases the business in two phases—getting 20 to 70 percent today and agreeing to buy the remainder within a specific time period. Until the final transaction takes place, the entrepreneur retains at least partial control of the company.

employee stock ownership plan (ESOP)—*an employee benefit plan in which a trust created for employees purchases stock in their employer's company.*

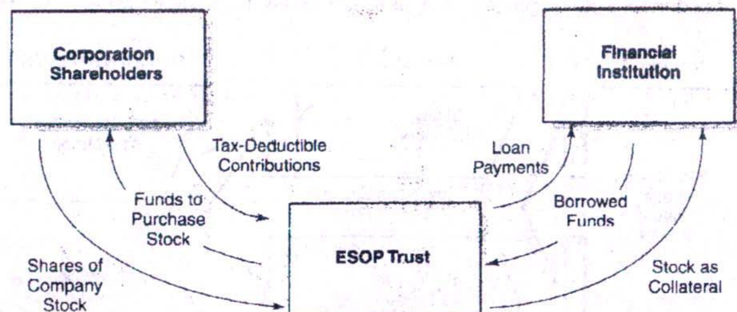
ESTABLISH AN EMPLOYEE STOCK OWNERSHIP PLAN (ESOP). Some owners cash out by selling to their employees through an **employee stock ownership plan (ESOP)**. An ESOP is a form of employee benefit plan in which a trust created for employees purchases their employer's stock. Here's how an ESOP works: The company transfers shares of its stock to the ESOP trust, and the trust uses the stock as collateral to borrow enough money to purchase the shares from the company. The company guarantees payment of the loan principal and interest and makes tax-deductible contributions to the trust to repay the loan (see Figure 5.5). The company then distributes the stock to employees' accounts based on a predetermined formula. In addition to the tax benefits an ESOP offers, the plan permits the owner to transfer all or part of the company to employees as gradually or as suddenly as preferred.

To use an ESOP successfully, a small business should be profitable (with pretax profits exceeding $100,000) and should have a payroll of more than $500,000 a year. Generally, companies with fewer than 15 to 20 employees do not find ESOPs beneficial. For companies that prepare properly, however, ESOPs offer significant financial and managerial benefits. An owner has great flexibility to set her retirement pace. An ESOP allows all parties to benefit and the transfer of ownership can be timed to meet the goals of the entrepreneur.

FIGURE 5.5

A Typical Employee Stock Ownership Plan (ESOP)

Source: From Sharing Ownership with Employees by Corey Rosen, Small Business Reports, Dec. 1990, p. 63. Reprinted by permission of JBS and Emerald, www.emeraldinsight.com.



YOU Be the Consultant . . .

A Seller's Tale

Joseph Grassadonia loves the ocean so much that he planned his life around it, including starting businesses that would allow him to have both the time and the money to enjoy the sun and surf of California's beaches. Over the years, Grassadonia launched six magazines, including his most recent, *Dive Travel*. He compares the thrill and challenge of starting and managing a magazine to surfing and catching the ultimate wave. "When you're surfing and you're totally in control of the wave, and the equipment is right and everything is working, it's exhilarating," he says. After five years of running *Dive Travel*, however, Grassadonia says he got to the point where it wasn't fun anymore. "That's when I knew I had to sell," he recalls.

Actually, Grassadonia knew he would eventually sell *Dive Travel* from the day he started it. Managing and growing a magazine is "not my forte," he says. He began shopping for a business broker and settled on a local company to help him sell the company. The first order of business was to put a price tag on *Dive Travel*, something that proved to be a more emotional experience for Grassadonia than he had imagined. Although he knew that a company's value depends on the cash it can generate, he couldn't help but recall all of the energy, time, and talent he had invested in building the magazine from nothing to its current level. "This business is a chunk of my life. How do you put a value on that?" he asks philosophically.

Grassadonia had built *Dive Travel* into a successful publication. "We do business with just about every major advertiser in the marketplace," he says. "It would be very expensive to try and [re]create that." Using *Dive Travel's* sales of $324,000 and earnings of $50,000, the broker suggested an asking price of $500,000. For the next year, the business attracted very few leads—not an unusual pattern in selling a business. Ads in industry trade journals produced only a few nibbles but no serious buyers. Waiting to sell was wearing on Grassadonia, so he and the broker reduced the price to $450,000. Several more months slipped by with no interest from buyers, and Grassadonia was beginning to wonder if *anyone* wanted to buy *Dive Travel*.

Finally, Susan Wilmink and Thomas Schneck contacted Grassadonia's broker about *Dive Travel*. The couple was living in Germany, where Wilmink worked for a large international magazine publisher and Schneck owned a software company. The only problem was that Wilmink and Schneck couldn't afford to buy *Dive Travel* outright. They proposed that Grassadonia sell them a controlling interest in the company and stay on as a consultant for three years. Grassadonia hesitated at first but then agreed to stay on as long as Wilmink and Schneck took over the day-to-day operations of running the business. A major factor in his decision was Wilmink's presentation on how she and Schneck planned to run the company—from adding a World Wide Web site to repositioning the magazine. "Susan came in with a vision," says Grassadonia.

Negotiating the final deal took another six months, and at times the discussions became heated. At one such emotional moment, Barkley, Grassadonia's 13-year-old golden retriever, walked over to Wilmink's chair, jumped up, and licked her face. That broke the tension, everyone started laughing, and Wilmink decided to name the new business Barkley Publishing. The final price the parties agreed on was $215,000 for the 51 percent controlling interest Wilmink and Schneck got. Wilmink became the new president and publisher, and Grassadonia agreed to stay on as a paid consultant for three years. At the end of that time, he would sell his stock, with Wilmink and Schneck getting the right of first refusal. In addition, Grassadonia got a percentage of the company's revenues over the three years.

The deal has worked to everyone's satisfaction. Grassadonia has the freedom to surf whenever he pleases, and Wilmink and Schneck have the company they wanted. *Dive Travel's* circulation has more than doubled, revenues have nearly doubled, and profits are up.

1. Why is the process of valuing a business so difficult for the entrepreneur who founded it?

2. Which method(s) of valuing a business do you think would be most appropriate in placing a realistic value on *Dive Travel*? Explain.

3. Evaluate the final deal the parties struck from both the buyers' and the seller's perspectives. Do you think the deal was fair?

Source: Inc., Adapted from Christopher Caggiano, "The Seller," June 1996, pp. 54–56.

NEGOTIATING THE DEAL

6. Understand how the negotiation process works and identify the factors that affect the negotiation process.

Although determining the value of a business for sale is an important step in the buying process, it is not the final one. The buyer must sit down with the seller to negotiate the actual selling price for the business and, more importantly, the terms of the deal. The final deal the buyer strikes depends, in large part, on her negotiating skills. The first rule of negotiating a deal is to avoid confusing price with value. Value is what the business is actually worth; price is what the buyer agrees to pay. In a business sale, the party who is the better bargainer usually comes out on top. The seller is looking to:

- get the highest price possible for the business.
- sever all responsibility for the company's liabilities.

- avoid unreasonable contract terms that might limit his future opportunities.
- maximize the cash he gets from the deal.
- minimize the tax burden from the sale.
- make sure the buyer will be able to make all future payments.

The buyer seeks to:

- get the business at the lowest possible price.
- negotiate favorable payment terms, preferably over time.
- get assurances that he is buying the business he thinks he is getting.
- avoid putting the seller in a position to open a competing business.
- minimize the amount of cash paid up front.

FACTORS AFFECTING THE NEGOTIATION PROCESS. Before beginning negotiations, a buyer should take stock of some basic issues. How strong is the seller's desire to sell? Is the seller willing to finance part of the purchase price? What terms does the buyer suggest? Which ones are most important to him? Is it urgent that the seller close the deal quickly? What deal structure best suits your needs? What are the tax consequences for both parties? Will the seller sign a restrictive covenant? Is the seller willing to stay on with the company for a time as a consultant? What general economic conditions exist in the industry at the time of the sale? Sellers tend to have the upper hand in good economic times, and buyers will have an advantage during recessionary periods in an industry.

The Negotiation Process

On the surface, the negotiation process appears to be strictly adversarial. Although each party may be trying to accomplish objectives that are at odds with those of the opposing party, the negotiation process does not have to turn into a nasty battle of wits with overtones of "If you win, then I lose." The negotiation process will go much more smoothly and much faster if both parties work to establish a cooperative relationship based on honesty and trust from the outset. A successful deal requires both parties to examine and articulate their respective positions while trying to understand the other party's position. Recognizing that neither of them will benefit without a deal, both parties must work to achieve their objectives while making certain concessions to keep the negotiations alive.

To avoid a stalled deal, a buyer should go into the negotiation with a list of objectives ranked in order of priority. Once she has developed her own list of priorities, it is useful to develop what she perceives to be the seller's list. That requires learning as much as possible about the seller. Knowing which terms are most important (and which are least important) to her and to the seller enables a buyer to make concessions without "giving away the farm" and without getting bogged down in "nit-picking," which often leads to a stalemate. If, for instance, the seller insists on a term that the buyer cannot agree to, she can explain why and then offer to give up something in exchange. The buyer also should identify the one concrete objective that sits at the top of that list, the one thing she absolutely must come away from the negotiations with. The final stage of preparing for the actual negotiation is to study her list and the one she has developed based on her perceptions of the seller to determine where the two mesh and where they conflict. The key to a successful negotiation is to use this analysis to look for areas of mutual benefit and to use them as the foundation for the negotiation.

Figure 5.6 offers five tips on making the negotiation process a successful one.

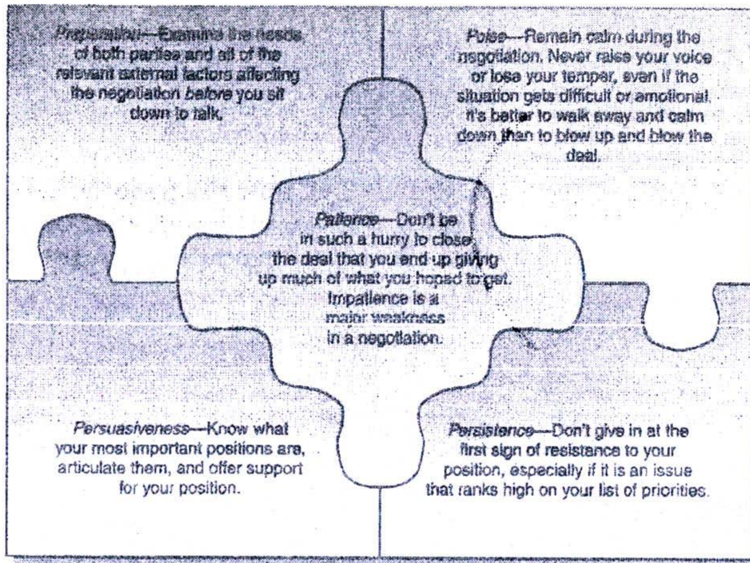


FIGURE 5.6 The Five Ps of Negotiating

Source: Adapted from Right Associates, Philadelphia, PA.

CHAPTER SUMMARY

1. Understand the advantages and disadvantages of buying an existing business.

The *advantages* of buying an existing business: A successful business may continue to be successful; the business may already have the best location; employees and suppliers are already established; equipment is installed and its productive capacity known; inventory is in place and trade credit established; the owner hits the ground running; the buyer can use the expertise of the previous owner; and the business may be a bargain.

The *disadvantages* of buying an existing business: An existing business may be for sale because it is deteriorating; the previous owner may have created ill will; employees inherited with the business may not be suitable; its location may have become unsuitable; equipment and facilities may be obsolete; change and innovation are hard to implement; inventory may be outdated; accounts receivable may be worth less than face value; and the business may be overpriced.

2. Define the steps involved in the *right* way to buy a business.

Buying a business can be a treacherous experience unless the buyer is well prepared. The right way to buy a business is to analyze your skills, abilities, and interests to determine the ideal business for you; prepare a list of potential candidates, including those that might be in the hidden market; investigate and evaluate candidate businesses and evaluate the best one; explore financing options before you actually need the money; and, finally, ensure a smooth transition.

3. Explain the process of evaluating an existing business.

Rushing into a deal can be the biggest mistake a business buyer can make. Before closing a deal, every business buyer should investigate five critical areas: (1) Why does the owner wish to sell? Look for the *real* reason. (2) Determine the physical condition of the business. Consider both the building and its location. (3) Conduct a thorough analysis of the market for your products or services. Who are the present and potential customers? Conduct an equally thorough analysis of competitors, both direct and indirect. How do they operate and why do customers prefer them? (4) Consider all of the legal aspects that might constrain the expansion and growth of the business. Did you comply with the provisions of a bulk transfer? Negotiate a restrictive covenant? Consider ongoing legal liabilities? (5) Analyze the financial condition of the business, looking at financial statements, income tax returns, and especially cash flow.

4. Describe the various techniques for determining the value of a business.

Placing a value on a business is partly an art and partly a science. There is no single best method for determining the value of a business. The following techniques (with several variations) are useful: the balance sheet technique (adjusted balance sheet technique); the earnings approach (excess earnings method, capitalized earnings approach, and discounted future savings approach); and the market approach.

5. Understand the seller's side of the buyout decision and how to structure the deal.

Selling a business takes time, patience, and preparation to locate a suitable buyer, strike a deal, and make the transition. Sellers must always structure the deal with tax consequences in mind. Common exit strategies include a straight business sale, forming a family limited partnership, selling a controlling interest in the business, restructuring the company, selling to an international buyer, using a two-step sale, and establishing an employee stock ownership plan (ESOP).

6. Understand how the negotiation process works and identify the factors that affect the negotiation process.

The first rule of negotiating is never to confuse price with value. In a business sale, the party who is the better negotiator usually comes out on top. Before beginning negotiations, a buyer should identify the factors that are affecting the negotiations and then develop a negotiating strategy. The best deals are the result of a cooperative relationship between the parties based on trust.

DISCUSSION QUESTIONS

1. What advantages can an entrepreneur who buys a business gain over one who starts a business "from scratch"?
2. How would you go about determining the value of the assets of a business if you were unfamiliar with them?
3. Why do so many entrepreneurs run into trouble when they buy an existing business? Outline the steps involved in the *right* way to buy a business.
4. When evaluating an existing business that is for sale, what areas should an entrepreneur consider? Briefly summarize the key elements of each area.
5. How should a buyer evaluate a business's goodwill?
6. What is a restrictive covenant? Is it fair to ask the seller of a travel agency located in a small town to sign a restrictive covenant for one year covering a 20-square-mile area? Explain.
7. How much negative information can you expect the seller to give you about the business? How can a prospective buyer find out such information?
8. Why is it so difficult for buyers and sellers to agree on a price for a business?
9. Which method of valuing a business is best? Why?
10. Outline the different exit strategy options available to a seller.
11. Explain the five Ps of a successful negotiation process. What tips would you offer someone about to enter into negotiations to buy a business?
12. One entrepreneur who recently purchased a business advises buyers to expect some surprises in the deal no matter how well prepared they may be. He says that potential buyers must build some "wiggle room" into their plans to buy a company. What steps can buyers take to ensure that they have sufficient "wiggle room"?

THE BUSINESS DISC

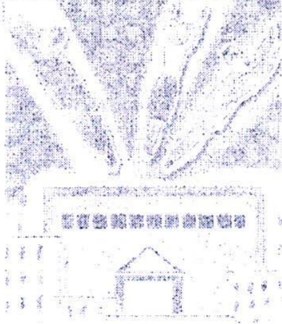
Launch *The Business Disc* and continue from where you left off until you have completed the Cash Flow projections for the full year. To understand how the program calculates and automatically fills numbers into some parts of the form see the Owner's Manual. From the Main Menu click Owner's Manual. Then scroll down to "Cash Flow Statement" at the bottom of page 5.

BUSINESS PLAN PRO

Business PlanPro

This chapter has dealt with the acquisition of an existing business. If you are developing a business plan for a company you plan to buy, go to the "Company Summary" section of the Business PlanPro and include the results of the due diligence process there. Be sure to include in the financial section income statements, balance sheets, and cash flow statements for the business for the past three years as well as forecasts for the next three years.

BEYOND THE CLASSROOM . . .



1. Ask several new owners who purchased existing businesses the following questions:

   a. How did you determine the value of the business?

   b. How close was the price paid for the business to the value assessed prior to purchase?

   c. What percentage of the accounts receivable was collectible?

   d. How accurate have the projections been concerning customers (sales volume and number of customers, especially)?

2. Visit a business broker and ask him how he brings a buyer and seller together. What does he do to facilitate the sale? What methods does he use to determine the value of a business?

3. Invite an attorney to speak to your class about the legal aspects of buying a business. How does the attorney recommend business buyers protect themselves legally in a business purchase?