

Buying An Existing Business

Important Factors to Consider

An essential requirement for the successful purchase of an existing firm is knowing how to assess and evaluate the operation. A number of basic factors must be considered in determining the value of the business to you. Some of these factors are more complex and involved than others but each must be carefully investigated and studied. This section will discuss the most important of these concerns one at a time.

1. Why is the Business for Sale?

You should have this question in mind at all times during the evaluation of a possible acquisition. When the owner of a business decides to dispose of it, the reason presented to the public may be somewhat different from the actual facts of the situation. There are a number of reasons that the owner may be quite willing to express for wanting to sell their business. For example, they may wish to retire, or want to move to another city, or, perhaps, illness is pressuring the owner to leave the business. In addition to these seemingly logical reasons for wanting to sell a business, there are a number of others, which the current owner may not be quite so likely to volunteer. For example, they may be experiencing some family pressures, or marital problems, or, perhaps see a better business opportunity somewhere else. In addition, the company may need more financing than the owner can raise or, the current market for the firm's products may be somewhat depressed. Other possible reasons might include competitive pressures such as competitors moving in with more effective

products or methods or the current plant and equipment may be worn out or obsolete and the firm is no longer able to compete successfully. As well, the firm may have to contend with new government regulations, which are creating some difficulties, or certain key employees may be leaving the firm to set up a business of their own.

As you can see, there are a number of possible contributing factors to explain why any business may be for sale. It is important that you retain a skeptical attitude because behind each of the offered explanations may be a number of hidden reasons for the seller wanting to dispose of the company. Such a skeptical attitude forces you to examine the situation from all angles and not necessarily accept everything you are told at face value. When the real reasons for selling are factors that may lead to the eventual collapse of the company, then the present owner may be hard-pressed to justify these reasons to you.

This is not to assume that all businesses are for sale due to negative opportunity factors. Many companies are sold to very plausible and honest reasons. However, to keep from losing your shirt as well as your savings, a detailed evaluation should be conducted in order to evaluate the true character of the business.

2. Financial Factors

An analysis of the financial statements of the firm, preferably with the help of a professional accountant, can help you assess the current health of the business. You should not fall into the trap, however, of necessarily accepting these statements as the absolute truth. Even though the statements may have been audited there are many accounting techniques that allow business owners to present a less than accurate picture of the financial situation of their company. You must be careful to ensure that the statements have not been biased in favor of the seller.

In performing this analysis there are a number of items you should check. The most important of these include:

a) The profit trend

A study of the records of the business will indicate whether sales volume and profits have been increasing or decreasing. If they have been going up, it is useful to know which departments within the business or products within the firm's product line have accounted for this increased sales and /or profitability.

If sales and profits are declining, the question may arise as to whether this is due to a failure by the firm to keep up with the competition, its inability to adjust to changing circumstances or, perhaps, simply due to a lack of selling effort. Some experience with this type of business situation plus a few directed to appropriate sources bring out an explanation for these circumstances.

3. Marketing Considerations

While the previous section deals with the internal aspects of the firm's profitability, these has been no discussion of the

external determinants of these internal conditions. You must be concerned with analyzing and understood. Studying maps, customers, competition, and various other aspects of its operating environment. You must carefully examine the company's current market situation. Each market segment served by the firm must be analyzed and understood Studying maps, customer lists, traffic patterns, and other factors can help you to determine the normal market size for the business. Once the market and its various segments are understood, the composition of these segments should be determined in order to identify the approximate number of customers in the total market. As a buyer, you should be concerned with:

1. The company's trading area
2. Population demographics
3. Trend and size of the market
4. Recent changes in the market
5. Prediction of future market patterns.

All these factors help in determining if the firm's market area is changing, if there is a declining relevant population, or if technological or other changes may be creating an obsolete operation.

Competition facing the business must also be evaluated and understood. Foremost, you should make sure that the present owner would not remain in competition with you. Very often an owner will dispose of his business and open up a similar operation to compete with the purchase of his old firm. For business that is largely based on the personality and contacts of the owner, you may be hard pressed to

maintain rapport with your present customers, suppliers, and financial sources. A legal agreement may be required in order to ensure that the vendor will not continue to compete with you.

Another aspect of competition deals with assessing the present competition faced by the firm. You should be aware of the business's major competitor's and what trends can be for-seen in the nature of their competition. Most of this information can be obtained either from direct observation or by talking with other people in the business.

Other aspects of the environment also should not be overlooked in trying to determine the future prospects of the company. You must be tuned in to developments in the economy, changes in technology, government policy and regulations, and trends in society at large that can affect your business situation. Your banker or other professionals may be able to tell you what the experts are saying about the future economic variables likely to affect your firm. Both national and regional economic factors must be studied in order to develop accurate projections as to the size of the market opportunity available to the business.

4. Human Factors

When a business is being purchased, manpower must be considered of equal importance with financial and marketing factors for it is usually desirable to retain certain key people in the business in order to provide some continuity. As a prospective buyer, you should assess the value of the company's personnel and try to become acquainted with the attitude of the present employees. For example, will key employees continue to work for the

firm under your management? If these key people will leave, you must anticipate the consequences.

Both the quality and quantity of trained personnel must be evaluated. The skill level of the employees has some bearing on the value of the business. Highly trained staff, for example, can increase the selling price. An inefficient and poorly trained staff, however, may suggest a lower purchase price with a long-term expense needed to be incurred in retraining or rehiring additional employees.

5. Other concerns

There are a number of other factors you will also have to take into account in assessing a business to buy. These include various legal considerations as well as past company policies. The legal aspects of doing business are becoming increasingly more complex and the use of a lawyer is practically a fact of business life. A lawyer can help you in such areas as deciding on an appropriate form of legal organization: the identification of real estate documents such as zoning restrictions.

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Checklist for Business Acquisition

Should you start a new business or buy an existing one? At this point in your deliberations, this is the critical question. The material in this questionnaire will aid you in making this choice.

If, after answering the questions in Part A, you decide to enter an established business rather than to start one of your own, then you should proceed to the questions in Part B. You may want to reproduce these pages and answer the same questions for several businesses you have in mind. Go through the questionnaire and answer the questions concerning each business as conscientiously as you can.

PART A

Before deciding whether you will purchase an established business, you need to give consideration to the positive and negative features of this alternative. You should rate each point in the questionnaire as you perceive the significance of the point and its importance to you.

1. How would you define the nature of the business you are interested in?

2. How important are each of the following factors to you in electing to buy an established business? Indicate the importance of each factor to you on a

scale ranging from 0 – not important at all, to 10 – extremely important.

a.) Having a business with a proven performance record in sales, reliability, service and profits. _____

b.) Avoiding the problems associated with assembling the composite resources – including location, building, equipment, material, and people. _____

c.) Avoiding the necessity of selecting and training a new work force. _____

d.) Having an established product line. _____

e.) Avoiding production problems typically associated with the start-up of a new business. _____

f.) Having an established channel of distribution to market your production. _____

g.) Having a basic accounting and control system already in place. _____

h.) Avoiding the difficulty of having to work out the “bugs” that commonly develop in the initial operation of a new business. _____

i.) Having established relationships with suppliers and financial institutions. _____

j.) May be able to acquire the assets of the business for less than their replacement value. _____

TOTAL _____

3. In checking back over the points covered in section 2, the closer your total score on all items is to 100, the more that purchasing an established business is likely to be of interest to you as a means of going into business for yourself.

PART B

The following is a set of considerations to be assessed in evaluating an established business. Your responses, information from the present owner, and other information concerning the status of the business should guide you to a comfortable decision as to whether this business is for you.

1. Why is the business for sale?

2. Financial Factors:

a.) Recent sales trend:

- Increasing substantially _____
- Increasing marginally _____
- Relatively stable _____
- Decreasing marginally _____
- Decreasing substantially _____

b.) Recent trend in net profit:

- Increasing substantially _____
- Increasing marginally _____
- Relatively stable _____
- Decreasing marginally _____
- Decreasing substantially _____

c.) Are the financial statements audited?

YES ___ NO ___

d.) Apparent validity of financial statements:

- Accurate _____
- Overstated _____
- Understated _____

-Check:

-Relationship of book value of fixed assets to market price or replacement cost.

-Average age of accounts receivable and percentage over 90 days

-Bad debts written off in the past 6 months, 12 months.

e.) Ratio Analysis:

Industry Standard	This Company		
	Year to Date	Last Year	Two Years Ago

- (1) Current Ratio
- (2) Quick Ratio
- (3) Debt to Net Worth Ratio
- (4) Gross Profit To Sales Ratio
- (5) Net Income to Sales Ratio
- (6) Return on Assets

3. Tangible Assets

a.) Are the land and buildings adequate for the business?

YES ___ NO ___

b.) Is the location acceptable?

YES ___ NO ___

c.) Is the machinery equipment worn or out of date?

YES ___ NO ___

d.) How does it compare with the latest available?

e.) What is the maintenance status of the plant and equipment?

Excellent ___ Good ___
Fair ___ Poor ___

f.) Is the plant of sufficient size and design to meet your current and projected requirements?

YES ___ NO ___

g.) Does the plant appear to be well laid out for the efficient use of people, machines, and material?

YES ___ NO ___

h.) What is the approximate value of the company's inventory?

Raw material \$ _____
Work-in-Process \$ _____
Finished Goods \$ _____
TOTAL \$ _____

i) Does the inventory contain a high proportion of obsolete or "dead" stock?

YES ___ NO ___

4. Intangible Assets

a.) Does the company name or any of its trade names have any value?

YES ___ NO ___

b.) What kind of reputation does the business have with its *customers*?

Positive ___ Neutral ___ Negative ___

c.) What kind of reputation does the business have with its *suppliers*?

Positive ___ Neutral ___ Negative ___

d.) Are any franchise, licensing or other rights part of the business?

YES ___ NO ___

e.) Are patents, copyrights or trademarks part of the business?

YES ___ NO ___

Are they included in the deal?

YES ___ NO ___

5. Marketing Factors

a.) Is the market for the firm's product/service?

Increasing ___ Stable ___ Declining ___

If *declining*, is this principally attributable to?

(1) decreasing demand due to lower popularity

(2) a changing neighborhood _____

(3) a declining population _____

(4) technological change _____

(5) lack of effort by present owner ___

(6) other factors _____

6. Human Factors

a. Is the present owner in good health?

YES ___ NO ___

b. Does the present owner plan to establish a new business or acquire another business that would put them in competition with you?

YES ___ NO ___

What are the intentions of the present owner?

c. How efficient are current personnel?

(1) What is the rate of labor turnover?

___ %

(2) What is the rate of absenteeism?

___ %

(3) What proportion of production is completed without rejects?

___ %

(4) Can you accurately determine the cost of producing an individual unit of production or service?

YES ___ NO ___

-How has this changed in the past year?

Increased ___ Stayed the same ___

Decreased ___

d. Has a union recently won an election to serve as a bargaining agent for the company's employees?

YES ___ NO ___

e. Will most of the key employees continue to work for the firm under your management?

YES ___ NO ___

f. Will you have to incur considerable costs in retraining or rehiring additional employees?

YES ___ NO ___

7. Other considerations

a. Are there any zoning restrictions or caveats on the property that may put you at a competitive disadvantage?

YES ___ NO ___

b. Can you satisfy all the federal and provincial licensing and permit requirements?

YES ___ NO ___

c. Have you considered what would be the most advantageous way of purchasing the company?

Buy shares ___ Buy Assets ___

Don't Know ___

d. Have you had a lawyer and an accountant review the material you received from the vendor and any other information you may have regarding the business?

Lawyer: YES ___ NO ___

Accountant: YES ___ NO ___

8. Your Evaluation of the Business

What you have determined to be the approximate value of the business based on:

a. Net Book Value

\$ _____

b. Modified Book Value

\$ _____

c. Liquidation Value

\$ _____

d. Capitalization of Past Earnings

\$ _____

e. Discounted Future Earnings

\$ _____

f. Discounted Cash Flow

\$ _____

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How to Determine an Appropriate Price to Pay for a Business

Buying an existing business is a serious involving a substantial financial and personal investment. A business bought at the wrong price, or at the wrong time, can cost you and your family much more than just the dollars you have invested and lost. After you have thoroughly investigated the opportunity represented by a business according to the factors in the previous section and weighed the wealth of information that you have gathered and decided that your expectations have been suitably fulfilled, a price must be agreed upon with the seller. Determining an appropriate price to pay to a business is a complex and technical process. If making this determination on your own you should have a sound knowledge of general accounting principals and evaluation techniques or use the services of a professional accountant.

Setting the purchase price for a going concern typically involves two different sets of valuations:

1. Evaluation of the firm's tangible net assets, and;
2. Evaluation of the firm's expected future earnings.

The tangible net assets or balance sheet methods for determining the value of a business are generally less reliant on estimates and forecasts than the earnings based methods. However, these balance sheet methods totally ignore the future earnings capability of the business.

1. Balance Sheet Methods

If the company has a balance sheet, the quickest means for determining a valuation figure is simply to look at its net worth as indicated by the balance sheet. You simply take the total assets as shown in the financial statement and subtract total liabilities. This is the "book value". The advantage of this method is that for most firms the numbers are readily available. Its drawbacks, however, are numerous. The company's accounting practices will have a big impact on its book value. Similarly, book value does not necessarily reflect the fair market value of the assets or the liabilities. For example, buildings and equipment shown on the balance sheet may be depreciated below their actual market value, or land may have appreciated above its original cost. These differences will not be reflected on the company's balance sheet. Despite these drawbacks however, book value may be useful in establishing a reference point when considering the asset valuation of a business. This approach is illustrated in Table 3 based on the balance sheet for the Appleton Company presented in Table 1.

To correct for any differences from the real situation, you may wish to make some modifications to create a "modified book value". This modified book value is simply the book value adjusted for major differences between the stated book value and the fair market value of the company's fixed assets and

liabilities. This refinement of plain book value approach still has a number of drawbacks, but does, however, give a more accurate representation of the value of the company's assets at current market value than does book value. The application of this method is also illustrated in Table 3.

A third approach is to go beyond the books of the company to get a more detailed evaluation of specific assets. Generally this involves determining the "liquidation value" of the assets or how much the seller could get for the business or part of it if it were suddenly thrown onto the market. This liquidation approach, indicating what the assets would fetch if the business were wound up, is ordinarily a highly conservative evaluation and, as such, is frequently useful in determining the lowest valuation in a range of values to be considered. (See table 3)

2. Earnings Methods

In most cases, however, a going concern is much more than the sum of its physical assets. While the cost of reproducing or liquidating these assets can be closely determined, the cost of duplicating the firm's experience, management, technical know-how, and reputation is not so easily determined. These intangible factors will be reflected in the firm's past and expected future earnings.

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The Advantages and Disadvantages Of Buying and Existing Business

The case for buying an existing firm against setting up a new one of your own is not clear-cut either way. Each situation must be decided on its merits. There are distinct advantages and disadvantages to each course of action. You must consider how well your personal preferences fit into each of these options.

1. Reasons for Buying an Established Business.

- a. Buying an existing business can reduce the risk factor. The existing business is already a proven entity. It is often easier to obtain financing for an established operation rather than a new one.
- b. Acquiring a going concern with a good past history increases the likelihood of a successful operation for the new owner.
- c. The established business has a proven location for successful operation.
- d. The established firm already has a product or service that is presently being produced, distributed, and sold.
- e. A clientele has already been developed for the product or service of the existing company.
- f. Financial relationships have already been established with

banks, trade creditors, and other sources of financial support.

- g. The equipment needed for production is already available and its limitations and capabilities are known in advance.
- h. An existing firm can often be acquired at a good price. The owner may be forced to sell the operation at a low price relative to the value of the assets in the business.

2. Disadvantages of Buying an Established Business.

- a. The physical facilities (the building and equipment) and product line may be old and obsolete.
- b. Union/management relationship may be poor.
- c. Present personnel may be unproductive and have a poor track record.
- d. The inventory may contain a large amount of “dead stock”.
- e. A high percentage of the assets may be in poor – quality accounts receivable.
- f. The location of the business may be bad.
- g. The financial condition of the business, and its relationship institutions, may be poor.

- h. As a buyer, you inherit any ill will that may exist for the established firm amongst customers or suppliers.
- i. As an entrepreneur you have more freedom of choice in defining the nature of the business if you start one of your own than if you purchase an existing firm.

As you can see there are both pluses and minuses in choosing to acquire an established business. You should view this option in terms of whether it will enable you to achieve your personal objectives. How do these advantages/disadvantages compare with those of starting a new business of your own? In buying an existing business do you see a reasonable opportunity to succeed? No one else can really advise you what to do. Instead, you must “do your own thing” and match the alternatives with your abilities and interests.