

How to Buy an Existing Business

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Introduction

- Small business is risky
- Buying a going business can be less risky than starting new
- Risks can be mitigated with homework, foresight, a good dose of skepticism and a strong contract

Introduction (continued)

- Today's objectives
 - Look at five major aspects of buying a business
 - Look at alternatives buyers should consider- may be helpful in negotiations
 - Assuming that target is identified, asking price is on the table, subject property is 100% ownership interest, buyer already received offering info
 - Mostly viewing from buyer's perspective

Why Buy an Existing Business Instead of Starting New?

- Fewer decisions to make
- Track record may mean easier financing
- Can hit the ground running
- Workforce and equipment in place

Key Issues

- Price
- Form of Purchase
- Due Diligence
- Terms
- Financing

Key Issues-Price

- Business value is driven by economic benefits
 - Risk dictates the return buyer should demand
 - Profits or cash flow = ROI \$
 - $\text{ROI \$} / \text{ROI target \%} = \text{Investment (price)}$

Key Issues-Price (continued)

- Identify the Benefit Stream
 - Benefits should be anticipated, not historical
 - Consider cash flows as measure (look at capital expenditures, working capital, etc.)
 - Beware of claims of “off-books” income
 - Deduct reasonable compensation for owner
 - Use after-tax profits
 - Be conservative/realistic

Key Issues-Price (continued)

- Compute Target Return %
 - Small business ROI% should be 20% to 25%, but higher may be appropriate
 - ROI is a function of risk
 - Specific risks include reliance on key employee(s), seller who is VERY “hands-on”, handful of significant customers
 - May be expressed as multiple (25%=4x, etc.)

Key Issues-Price (continued)

- Benefits / ROI % = Price Indication
- Result is fair price for control interest
- Price may be influenced by additional factors:
 - Form of purchase
 - Reliability of information reviewed
 - Terms
 - Seller financing needed?

Key Issues-Form of Purchase

- Applies to Corporate Targets (C or S)
- What property is for sale?
 - Is it stock?
 - Is it assets?
 - Is anything excluded?
 - Will liabilities be assumed or paid?

Key Issues-Form of Purchase (continued)

- A stock deal benefits seller, may hurt buyer
 - Seller gets capital gain treatment on all
 - Buyer takes over seller depreciation
 - Existing liabilities (known or unknown) go with corporation
 - Due diligence much more important

Key Issues-Form of Purchase (continued)

- Asset Purchase cleaner, safer (for buyer)
 - Easier to define what is being transferred (a list is included in contract)
 - Depreciation for buyer based on purchase price, not seller's original cost
 - Only specified liabilities (or no liabilities) are taken by purchaser
 - More flexibility for buyer to choose form of operating entity
 - May cost seller more tax

Key Issues-Form of Purchase (continued)

- Why would buyer agree to buy stock?
 - If seller insists, negotiate protections, offsets
 - Price reduction to split tax benefits
 - If purchaser is employee, familiarity with business cuts risks of unknown liabilities
 - Purchase holdback or escrow protects against unknown liabilities
 - Existing debt may be ready-made leverage
 - May be structured as purchaser buy-in followed by seller buy-out

Key Issues-Due Diligence

- This is the real work
- Information to request
 - 5 years financial statements plus most recent, preferably externally prepared
 - 5 years income tax returns
 - 1-2 years sales tax and payroll tax returns
 - Copies of bank account statements (1-2 years is reasonable)
 - Sales to top 10 customers (last 3 years)
 - Other, as appropriate

Key Issues-Due Diligence (continued)

- What to do with information
 - Affirm or revise your calculation of price
 - Look for consistency between income tax returns, sales tax returns and financial statements
 - Do bank statements correlate with financials and revenue/expense data?
 - Evaluate proforma information, if any (do modifications make sense?)

Key Issues-Due Diligence (continued)

- Due Diligence is your chance to look deep
 - Is the financial information you're relying on believable?
 - Evaluate the seller's reactions to your questions (are there a lot of "Yes, but..." answers?)
 - Dig into erratic results
 - Create your own pro-formas
 - Get comfortable---or not

Key Issues-Terms

- Several terms will affect long-term success
 - Is seller financing any part of deal?
 - Is price fixed or contingent?
 - How is price allocated?
 - Is seller available for consulting or training after closing? At what cost?
 - How will seller assist you to keep customers?
 - Will seller help retain employees?

Key Issues-Terms (continued)

- Fixed vs. Contingent Price
 - Sometimes called an “Earn-out”
 - A somewhat reduced base price plus one or more performance incentives
 - Useful when certain things (like sales) are speculative
 - May cost buyer more (if business performs) because he/she has spread some risk to seller
 - Keeps the seller interested

Key Issues-Terms (continued)

- Allocation of Purchase Price
 - Reported to IRS by both buyer and seller, makes sense to put in contract
 - All intangibles have fixed amortization period
 - Allocation to tangible assets will stand unless clearly unreasonable
 - Issue only applies to asset sales
 - Buyer's and seller's objectives may conflict

Key Issues-Terms (continued)

- If deal includes post-closing work by seller, get arrangement well defined
 - Put obligations in contract
 - Spell out compensation
 - Allocate part of price to consulting agreement; it may mean faster write-off
 - If seller to introduce buyer to customers, be clear about performance standards (i.e.-meetings, phone calls, letters?)

Key Issues-Financing

- Seller financing may be only option when intangible value is significant
- Outside (bank) financing is collateral based
- SBA financing can be useful if it fits their mold
- Buyer equity is great, but significant amounts are uncommon

Key Issues-Financing (continued)

- Seller financing is often present
 - Recognize that outside financing may not be readily available
 - Seller has more involvement in whether deal gets done, but retains higher risk
 - May be for short period (planned refinance)
 - Anything goes (except usury)-seller gets higher return on deferred price
 - May offer seller some tax advantages
 - Buyer's down payment is negotiable

Key Issues-Financing (continued)

- Outside Financing-bank/SBA
 - Straight bank financing is difficult unless tangibles are high and buyer has good downpayment or credit (or both)
 - SBA financing may include partial guarantees of bank loan and some direct lending
 - Different SBA programs have different requirements
 - May be combined with seller financing if seller takes subordinate position

Conclusion

- Many buyers focus solely on price, but if other aspects are poorly defined, a good price can become a bad deal
- Professional advisors are important part of process
- All elements are negotiable
- Consider tax consequences
- Remember---it's a business deal (keep a cool head)