Purchasing a small business 1676

Business, Marketing

Purchasing a Small Business

Outline

I. Deciding to buy

A. Why buy a small business?

B. Starting out-the nine steps

C. Initial details to consider

1. Are partners needed?

2. Economic factors

3. Is the location acceptable?

4. Tax strategy

II. Where to start

A. How much income is needed?

B. The " Thirteen Steps" to acquiring a business

III. Locating a potential purchase

A. The Acquisition Plan

B. Beginning the search-who can help?

III. Negotiating a purchase price

A. Valuation of a small business

1. Why do a valuation?

2. Choosing the method that is best for your situation

3. Some different methods of valuing a business

a. Ability-To-Pay Method

b. Discounted Cash Flow Method

c. Excess Earnings Method

B. Calculating goodwill

C. Setting the purchase price

D. The letter of intent

IV. Finding the initial capital

A. Sources of financing

1. Traditional sources

2. Nontraditional sources

B. Guaranteed loan programs

V. Closing the deal

1. Get a lawyer

2. Audit review

3. The closing

VI. The rewards of working for yourself

The decision to purchase a business of your own is not an easy task. There are many things to consider before the final decision is made. First of all, exactly what do you want to accomplish? To make millions of dollars, right? Or is it to have the freedom of being your own boss? Whatever the reason, you must be sure that it is something that you are ready to devote an exorbitant amount of time and energy into and that it is something that you really want. Otherwise, you might be stuck doing something that you hate. If you are ready to commit then you must ask yourself just how far will that commitment extend. How much of your own time, energy, and money are you willing to sacrifice?

After the decision is made, the acquisition of a small business can be summed-up into nine steps, in which most will be elaborated upon later. " These are the nine steps to any business acquisition, regardless of its size or industry:

1. The search, locating a business available for sale.

2. Identifying alternative candidates.

3. Valuing the business.

4. Negotiating a price and terms.

5. Investigating the company.

6. Preparing the business plan.

7. Sourcing the financing.

8. Preparing the closing documents.

9. Managing the transition period." (Tuller, 10)

Some considerations that cannot be avoided when purchasing a small business

include: the question of needing a partner, the current economic factors, considering alternate locations, and developing a tax strategy. When debating whether or not a partner is needed or wanted, you need to know if you're going to need additional equity as well as sharing the risk of failure. For these reasons, a partnership seems to be a great idea, but there are also many cons that should be recognized. Having too many partners can alter the ease of decision-making, shared liability can cause obvious problems, and sharing profits means less for you. Added to this, getting out of a partnership can be very difficult.

Evaluating the current economic factors simply means to know what you are getting into. Be sure to have some knowledge about the business itself and it's market. Know how to make and sell the product efficiently and in a service industry, be sure to know the current and correct way things are done-sometimes they are not one in the same.

Location is key. " Location of the target can be a major determinate in both the financing of the deal and probable success in managing the business after closing. There's no sense spending time, effort, and money on a target located in the wrong place." (Tuller, 12) Along with this, the personal strife of having to travel a great distance to get to work can be very frustrating. So, be sure that the location of your potential business is profitable in every way.

One the greatest minds of the 20th century, Albert Einstein, once said, " tax is the most difficult thing in the world to understand". Unfortunately, with the ever-changing laws, that problem gets worse every year. This means that you should have knowledge of the current tax laws. "'You will have a unique opportunity to make decisions on exactly how much money will change hands, and how I will allocated on the payment schedule."(Smorgenburg, 112) Maximizing profit for both you and the seller can only be done through proper knowledge of tax law, if you are not comfortable handling this alone, a consultant might not bad a bad idea.

After all of the above is settled, the next thing to figure is the amount of initial income is required. Not only the income required to purchase the entity (which will be elaborated upon later), but also the amount of money that you need to survive for the years to come. " If you need $100, 000, then don't look at smaller companies which can only yield $30, 000." (Tuller, 23)

" The following 13 steps will help to locate a target and close the deal in the shortest possible time-and when buying a company, time is money.

1. Define realistic parameters.

2. Prepare a reasonable Acquisition Plan.

3. Review current tax laws for structuring the deal.

4. Develop a detailed plan for sourcing potential targets.

5. Perform a preliminary due diligence investigation.

6. Negotiate a price and terms based on a realistic valuation.

7. Perform a thorough due diligence investigation.

8. Prepare a complete business plan.

9. Develop sources for at least three alternative financing structures.

10. Arrange for the final updated due diligence investigation.

11. Write the Buy/Sell Agreement and negotiate the final contract language.

12. Plan how you will operate the company after closing.

13. Attend the closing.

Yet another crucial instrument in the purchase of any business is the Acquisition

Plan. This document lists every step and detail leading to the closing of the deal. Starting with the industry survey, it lists the start date, the finish date, and the cost of each of these processes. Following the survey is the target search, then on to the due diligence investigations. The importance of this plan revolves around the organization of a solid purchase. With this, you are able to enact the purchase at the right moment for you, this time being a buyer's market. If you need to wait out the bear market, you can do it much easier with everything laid out in front of you. Hence, the Acquisition Plan does the job.

All of the above steps and considerations are a waste if you are unable to find a business for sale. The difficulty of finding the type of business that you will purchase is put to ease through an M & A consultant, accountant, or simply browsing the Wall Street Journal. A smaller gas station or party store-type business can usually be found in the local paper. On the other hand, if you are looking for a larger company, an M & A consultant may be pricey (2-15, 000 dollars for a retainer), but this is probably the best way to go. Be sure to ask the consultant many questions regarding his or her creditability. For instance, get a list of references and ask about the number of deals he closed in the past 12 months.

Negotiating a purchase price involves a thorough valuation of the projected purchase. Evaluation of a business is essential because you need to know what you are paying for and how much you should pay. " If you are a buyer, your valuation will also be helpful to you when you meet with lenders, so that you can help justify the mount you are asking to borrow. For this purpose alone, however, a valuation is not generally worth the effort." (Horn, 20) There are many different methods that you can use to properly determine the value of the entity. The most common methods are as follows: the Ability-To-Pay Method, this method is used in almost all buy/sell cases. It makes clear whether the acquisition can pay for itself out of its own cash flow. The Discounted Cash Flow Method is most often used when the company is going to be purchased as an investment and held for a limited number of years. It is also used in high-risk situations, such as highly leveraged deals that have more of a proportion of debt than usual. The third method is the Excess Earnings Method, used to value any profitable company. The Excess Earnings method " assumes that a business is worth the market value of its tangible assets, plus a premium for 'goodwill' if the earnings are high enough."(Horn, 51)

Another area that must be calculated is goodwill. " Goodwill is not an operating cost and cannot be depreciated. It does not provide you with tax relief."(Smorenburg, 114) Since there is no record of the worth of goodwill, it can be fairly difficult to determine an accurate buying price. Usually the seller will set the price based on their knowledge of the company. The set price, however, should be reasonable. Negotiations can be made to produce an agreeable price.

The next step is to set a purchase price. " There is no right or wrong way to value a business. Each company has different characteristics. Obviously, the seller will argue that the net asset value method is right because that's what he invested in the business."(Tuller, 103) You should consider all factors in the P/E/ ratios, liquidation value, net asset value, and historic and projected cash flow. After analyzing these aspects of the business, you should be able to determine a fair price for the entity.

" The letter of intent is a document that aims to formalize the terms around which a later negotiation will revolve. As such, the letter is primarily a tentative offer that remains subject to further negotiations and confirmation of material facts through a process of due diligence. By offering a letter of intent, you tangibly solidify your resolve and thereby make the seller understand that you are a serious buyer."(Smorenburg, 126)

The letter of intent covers the precise terms of the deal, the payment details, and management and other issues involving the transfer. You need to give your accountant and lawyer a draft of the letter for review. This way, you are protected from any loopholes that can harm you. It proves that you are a serious buyer and entices the seller to more openly discuss sensitive aspects of the business. The letter is a written contract that can be legally cancelled at any time without the consent of the other party, so be sure that you and the seller are in agreement.

Once everything is settled and you and the seller are in agreement to the term of the letter of intent, the next task you face is finding the initial capital. Using other people's money to finance a purchase is a key ingredient if business success. Financing falls into two separate categories: debt and equity.

Debt financing is the most elementary of the two. It is basically taking a loan from a lender and paying it back with interest. It is reliant on the business or individual's ability to pay the loan off. Usually, collateral will be made available to the source of the loan in the case that you cannot continue to make payments. A good credit history and reputation is another aspect that financing is reliant upon. With these, a loan is much easier to get.

" Equity financing means obtaining funds in exchange for selling or giving up a part of interest in the business. Equity financing is not a loan; rather, it is the sale of a part of you business."(Fallek, 82) The popularity of equity financing has increased in the high tech industries in the past few years. However, selling a part of your newly purchased business may not be your cup of tea, so choose your type of financing wisely.

Some traditional sources of capital include yourself, family and friends, commercial banks, loan companies, insurance companies, credit unions and private investors. The old saying, " don't mix business with pleasure" is applicable when dealing with family and friends. Taking a loan from these sources can cause turmoil if the loan cannot be paid back. Banks are the standard for business lending. " The amount they charge is based on two factors: the size and history of the customer and the risk the bank will take in providing the loan."(Fallek, 85) If you are able to decrease the bank's risk and have a standing credit line, you will get the most out of your loan. The other types of traditional lenders are less frequently used, but are also good sources of capital.

" Nontraditional money sources are unlimited in number and type, but you need to be creative to acquire the necessary funds from them."(Fallek, 89) These sources include customers, suppliers, leasing companies, local development companies, and advertising for money. Customers or potential customers are often great sources of funding, as well as suppliers. Suppliers will furnish you with the necessary equipment and product. Leasing companies and local development companies are also good nontraditional sources of capital. " You can actively seek funding by running a display advertisement in the business section under the appropriate heading in the classified ads of your local newspaper. Specify the amount of money needed and the type of business for which it will be used."(Fallek, 91)

Yet another source for funding might be through the Small Business Administration. They offer different types of loan programs to small businesses. The SBA Guaranteed Loan Program grants a loan on the basis that the individual needs more time than allotted by other lenders to pay back the loan, has insufficient credit, or lack business experience. " There are no restrictions as to the number of SBA loans a company or individual may have, as long as the SBA's exposure does not exceed $750, 000."(Fallek, 96)

The final step in acquisition of a business is the closing. You will need a lawyer if you don't currently have one. The search for the right lawyer requires certain questions to be answered. For instance, you want to find out the lawyer's hourly rates, experience, availability, if there is any conflict of interest between the lawyer and the seller, and any other applicable questions. The best way to find a lawyer is word of mouth, ask friends and family for references. When a lawyer is located, you must then begin the audit review.

" Even thought most buyers work with their local CPA in preparing the business plan and counsel with him on tax matters relative to the acquisition, the audit review should be preformed by an independent CPA firm in the same city as the target company; preferably on of the 'Big-5' firms. The audit review consists of a comprehensive look at business since the last audit with particular emphasis on determining the adequacy of internal controls and internal reports."(Tuller, 192) Be sure to take this step, it examines all aspects of the business and insures that it is a safe investment. After this is complete, it's time to close the deal.

The documents generally needed for proper closure are: a buy/sell agreement, an earn out agreement, a promissory note terms and conditions agreement, title search and title insurance, lease agreements, employment contracts, personal guarantees, and an equity agreement with the lender. These documents are dealt with and an announcement should be made to the employees, customers, and vendors of the change in ownership. " There is a mood of anticipation, of excitement, and even-if the truth be know-of fear. Of all the events which take place in the business world, nothing can match an acquisition closing for pure excitement and thrill."'(Tuller, 203) the actual signing of the transfer documents will not usually take more than an hour. The key is not to worry about what you are signing, that's what your lawyer is for. After all the money spent, the time devoted and the effort put forth, the business is finally yours.

Running your own business can be very rewarding. You don't have anyone to answer to besides the government. You are in complete control. Along with this the ability to write off certain expenses is enough of a reward in itself. The effort you put forth is completely up to you. The life and death of the business is in your hands.

Bibliography

1. Fallek, Max (1994). Finding Money for Your Small Business

Enterprise-Dearborn: USA

2. Fluery, Robert (1995). The Small Business Survival Guide

Sourcebooks, Inc.: Naperville, IL

3. Horn, Thomas (1990). Business Valuation Manual

Charter Oak Press: Lancaster PA

4. Peterson, C. D. (1990). How To Leave Your Job and But A Business of Your Own

SVS, Inc. (Video)

5. Smorenburg, Michael (1998) Business Buyer's Kit

Career Press: Franklin Lakes, NJ

6. Tuller, Lawrence (1990) Buying In: A Complete Guide to Acquiring a Business or

Professional Practice

Liberty Hall Press: Blue Ridge Sumit, PA