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Buying Your Own Business

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Don't Start It, Buy It! - When buying beats starting from scratch

There are seven reasons to buy a going business.

You get:

1. Established customer base,
2. Experienced employees,
3. A recognized market position and
4. Business operating systems that are in place.
5. You often get the best combination of seller, bank or vendor financing possible.

If all these elements are in place, you, as a buyer of a going business, will also get:

6. Immediate cash flow and
7. A reduced risk of business failure.

Even When the Owner Leaves . . .

Customers and/or clients come in many varieties. They establish loyalties to locations and businesses even when the owner leaves. If handled correctly, the customer/client base can be carefully preserved by the seller for the buyer. Most sellers will agree to a transition period.

Recruiting customers and clients is very expensive when starting a business from scratch. Even the outdated customer/client list is a valuable asset for an aggressive new buyer. Often customers will buy certain items on a cyclical basis. Even a ten-year-old customer list might be valuable if it is the list of a business where customers purchase on the average of every ten years. I once worked with a major appliance dealer in a stable community where such a list was very carefully preserved so the new owner could use the data to create a new database of prospective re-sale opportunities.

Experienced, skilled and predictable employees are a valued asset of a going concern. They're not on the balance sheet and a buyer really doesn't pay for them directly. They often know the business operations quite well, however, and they can be re-energized by new ownership if they are made part of the process at the right time.

The timing of employee interviews varies widely. Usually, the buyer is allowed to talk with key employees only after a purchase and sale agreement has been signed and it is certain that the buyer will buy the business. This demonstrates how important key employees really are! Sellers don't want to risk losing them. It is extremely important for both buyer and seller not to mishandle this process.

A going business has an accepted product or service. This defines its market position. New start-up operations face many stumbling blocks. They can misdesign their products and misposition their services. They can get the prices wrong. They can stock the wrong inventory. If you purchase an established business, the chances for these errors are minimized.

Also minimizing the chances for failure are the established systems of a going business. Sales and marketing, accounting, inventory tracking, employee payroll and production systems are all in place. Employees know what to do. Customers even have established patterns of relating to the business. There may be changes needed, but not all at once!

In a start-up, all systems have to be created from scratch. Most people who have started a business from scratch can tell you how difficult this is. Just think, for example, how long it took you to learn and fully utilize your last new software program. Now, multiply that by 100! There are at least 100 different 'systems' of how things are done in a small business.

Financing Partners

Because of these advantages - customers, employees, market position and established systems - more favorable financing terms are available to the buyer of an established business. Seller financing, bank financing and even the financing by vendors (suppliers) is often available.

Along with the buyer, the seller, banker and vendor become partners in the business, sharing some of the risk. Every creditor feels more secure with an established entity and most banks don't finance new start-ups at all. For going businesses, seller financing at below-market rates is common and available without the same security requirements as other arms-length lenders.

A buyer of a going concern often has immediate cash flow. In fact, in most cases, that's what has been carefully protected by the financing partners: the seller, the bank and vendors. These lenders will only agree to participate in transactions that make sense to them. They know they won't get paid unless the cash flow works for the new business owner.

In a new start-up, the vendors will usually still help, but the buyer must fund the start-up for months and sometimes even years until the business gets going. Most start-ups fail, in fact, because they run out of money before they succeed.

Overall, there is less risk in purchasing a business than in starting one, even if there are major areas which need improvement.

Start-Up Fallacies

Why, then, do some us start new businesses? Some people can genuinely see a new need in the marketplace and fill it. Sometimes, there are no businesses for sale in a certain category. But, except for these unique start-ups, or start-ups in fields where none are for sale, the reasons for starting our own businesses from scratch can usually be found in our own egos. The logical reasons we think we have may only be rationalizations.

One common rationalization I hear is that the prospective entrepreneur wants a "clean business" without the inherent liabilities of a going concern. But, asset sales are always possible - instead of stock sales - so that no legal liabilities are assumed. Or, the seller can indemnify the buyer. There are several ways to do this.

The idea that there are operational systems that can't easily be changed is usually just wrong. Small businesses are usually quite flexible and changeable. Employees usually welcome enlightened change.

The most commonly given reason for starting from scratch, however, is to avoid paying for "goodwill" or "blue sky". My experience is that we pay for it one way or the other. Either we pay the seller for goodwill or we have to put lots of extra money into working capital to develop goodwill ourselves. There's no free lunch - something I discovered myself almost twenty years ago!

In 1981, I had a chance to buy the only established business brokerage firm in Maine for about $125,000, with plenty of seller financing, an experienced and friendly seller, a great name and location and an established track record of financial success. Instead, my ego drove me to start my own business, Maine Business Brokers. In the 1980's, my new firm struggled and barely survived, while the firm I didn't buy made profits many times in excess of its 1981 asking price.

At the time, I wanted a 'clean business.' My style was different from the seller, and I feared that I could not change the business into what I wanted. I also feared paying for 'blue sky.' For $125,000, all I thought I was getting was a bunch of old filing cabinets and historic files. I also would have had to move my family to the coast to buy and run this business. What I didn't realize is that paying for established cash flow would have made more sense. It took me years and a great deal of working capital to make my phone ring as much as theirs. It also took me a decade to realize I needed to move to Maine's coast anyway! I figure that not paying $125,000 in 1981 cost me well in excess of $1,000,000 in lost income. Ouch!

Franchises & Network MLMs

Two other common mistakes I see made by naive buyers are the purchase of a worthless franchise or the latest network multi-level marketing (MLM) 'opportunity.' Caution is needed here, however, because there are legitimate franchises and network marketing companies. My warnings should not be taken as universal condemnation of all businesses in these categories. There are, however, many more bad ones than good ones!

A good franchise -- and there are many -- should give you an instant market position and/or a protected territory, proven operational systems with excellent long-term support and perhaps even some financing. But, a franchise that only sells you a plan, a pile of equipment, a one-week seminar and a life-long obligation to pay royalties and buy supplies from them is a rip-off!

The rule of thumb I would advise following on the purchase of franchises is simple. Consider only those you have heard about before. If you have never before heard of the franchise you are thinking about buying, forget it. If you don't know about it, who does? There is no value to a franchise that isn't readily recognized by its potential customers. Name recognition in the market is supposed to be the biggest benefit franchises offer. The value of the manual and training will quickly fade.

The long-term value of a good franchise is the market position and information you get from a strong franchisor. There should be other franchisees you can talk to, and meet with, on a regular basis. A good way to evaluate a franchise and check its legitimacy is to call other franchisees and look at buying an existing franchise. You can then look at real income and expense numbers, not just someone's projection.

Business 'network marketing' or 'multi-level marketing' opportunities that require you to resell the opportunity to your friends and neighbors to build a 'multi-level marketing' organization are even more ill-advised than a bad franchise. Except for Tupperware®, Amway®, Avon® and Mary Kay Cosmetics®, four unusually successful multi-level marketing organizations, the failure rate on these businesses approaches 100% on all the other cases I know about.

Most network marketing businesses sell 'unique' products. Some are okay; most aren't legitimate enough to make it in the normal retail distribution channels. As for the extra sales you could get from getting your friends to sign up, forget it. 99% will fail anyway. They may also tell you it's a part-time effort. Don't you believe that any start-up is ever part-time!

My advice here would parallel that given for franchises: consider only those you recognize. Wide market acceptance of the product or service is essential for success. Otherwise, the only way an MLM works is if you get in early, recruit others and sell hard during the early growth curve, then bail out before the inevitable crash. This is not a very good way to build a business career.

Don't confuse these schemes with legitimate 'networking' in which all businesses engage. If you want to sell products, buy a retail store. The margins are better and you won't alienate your friends and relatives. To get other people to sell for you so that you can make money from their efforts, hire salespeople for your store. That's the way it's done in the legitimate world of business.

Due Diligence: Do Your Homework

Whatever you choose to do, there is no substitute for doing your homework when you buy or start a business. We call this homework 'due diligence.'
You need to exercise due diligence in examining what you're buying or starting. A business plan is always in order. If you are not the 'planning type' because you are a successful sales person, that's okay. Just be sure there is someone involved who is good at planning!

Common areas for business planning are the same categories as the advantages for buying a business: customers, employees, market position, systems, financing, cash flow and risk.

Your lenders will insist on knowing - and you should know - where you are going to get your customer base, who you will employ, how you will serve your market, what operating systems you will create, where the money is coming from and going to, and how risky it is.

With an existing owner by your side, your job is made much easier. There are more known factors to build upon as you plan your future. You can grow the business you acquire to an exciting new level and by-pass many of the start-up frustrations.
Buying an existing business gives you a head-start on creating your own dreams!

Article written by Glen Cooper. Published with permission from Glen Cooper, Maine Business Brokers' Network.

Business Valuation Rules of Thumb

Business brokers and other professional intermediaries use business valuation rules of thumb to help sellers price their businesses for sale. These "rules" are very useful for appraising nearly every small business, however they are gross simplifications and should only provide a general idea of a suitable price range for a particular business.

If a rule of thumb is used to value a business, some type of earnings multiplier makes the most sense to prospective buyers. It directly addresses the buyer's motive to make money to achieve a return on investment. Sales multiples mean nothing unless they can be translated into earnings.

Two areas of confusion are inappropriate comparisons to investment real estate or to stock market earnings multiples. Real estate is often priced at 8 to 10 times its net operating income. Stock market prices are often as much as, or even more than, 20 times earnings. These two comparisons do not work for small businesses primarily because the risk of owning a small, closely-held, privately owned business is thought to be much higher than owning either real estate or publicly held stock. A business has lower liquidity than real estate and stock, and running a small business is also a lot tougher than managing an office building or a stock portfolio.

To determine an appropriate earnings multiplier, the following questions must be taken into consideration:

* How is the business doing in terms of earnings? What are the average earnings per year in the last three to five years? What are the future projected earnings?
* How is earnings calculated? Should it include or exclude the owner's pay and perks, interest expenses, depreciation, and taxes? What about those one-time expenses that may be on the books?
* How do you choose the right earnings multiplier to value the business? What is the multiplier based on? Most people can agree that the multiplier varies based on the risk of the business, but how can risk be measured?
* What about the various tangible and intangible asset values? Do we include the real estate, equipment, vehicles, and inventory? Is there a separate value for a seller's agreement to consult with the new owner after the sale? What about non-compete agreements? What about patents, franchises and other extraordinary intangible assets? Is "value" defined as fair market value or a specific value for a specific circumstance?

As you can see, determining an appropriate earnings multiplier is fairly subjective. The reality is that it is very difficult to estimate the market value of a business because a marketplace of buyers and sellers cannot be easily observed. In fact, there are not many buyer prospects for a given small business and the result is that buyers pay prices that are unique to their circumstances, sometimes considerably above or below any so-called "fair market value".

A buyer must use common sense and remember that potential buyers create the market. Determining an earnings multiplier can be difficult, and the following six guidelines could be used to help calculate earnings:

1. Examine the most recent year's earnings on the seller's latest tax return. It would make sense to look at the last three years, but remember as a buyer you are buying the future and not the past. Use these figures to determine projected annual future earnings with you as the new owner. Do you have experience in this type of business? Can you perform the duties and responsibilities of the seller? Will you be able to maintain sales at their current levels?
2. Look at the tangible and intangible assets. They often seem to have a value separate from the business. Is there real estate and inventory for re-sale included in the sale? Real estate and inventory for re-sale is theoretically less risky than owning the other assets of a business because it is believed that real estate could be easily sold on the open market and inventory for re-sale could be easy to liquidate if the business failed. Generally, inventory is valued at cost. These assets may be valued separately from the business, and then added back to the multiple-derived value of the business. Aside from real estate and inventory for re-sale, other assets should already be included in the multiple-derived business value as they are needed to generate the projected future earnings.
3. If there is real estate involved but it is not for sale, a real estate rent expense must be subtracted from the earnings figure. The seller did not have to pay rent if he or she owned the property where the business is located, but this would not be the case for you as the buyer. You must take future rent expense into consideration.
4. Owner's salary, perks, and certain one-time expenses should be included in the earnings calculation. If these expenses were subtracted from profit on the tax returns, they should be added back in your earnings calculation. Businesses tend to maximize deductible expenses to minimize taxes.
5. Depreciation / amortization is a non-cash expense, meaning the owner does not have to pay out of pocket each year. If these expenses were subtracted from profit on the tax returns, they should be added back to your earnings calculation.
   Earnings = Net Profit before taxes + Owner's Salary + Fringe Benefits + Depreciation / Amortization.
6. Generally, intangible assets such as an owner's agreement to not compete, or to consult during a transition period, are included in the value of the business derived by using a multiple of earnings, even though such assets may well be treated separately at a business closing for tax purposes.

Once you have calculated projected annual future earnings, also known as EBIT (Earnings Before Interest and Taxes) by accountants and is an understood norm, consider the risks involved in owning the business. How much are you willing to pay for the business given the risks involved? The right earnings multiple really depends. For most businesses, it's somewhere between 3 to 5 times EBIT. But, the multiple is less when there are few tangible assets and more when the business is uniquely attractive.

In summary, the rule of thumb to use to value a business is based on an earnings multiple. The right multiple is, in the eyes of buyers, a matter of assumed risk. Buyers feel better about buying tangible assets that they can appreciate with their five senses - things like real estate and equipment. On the other hand, buyers are also enticed when there is a clearly attractive opportunity to make money, regardless of the tangible assets included.

Article written by Jim Brown with excerpts by Glen Cooper. Published with permission from Glen Cooper, Maine Business Brokers' Network.

Financial Statements - How to verify Financial Information when Buying a Business

Yes, in the perfect world, business sellers will support their financial claims about their businesses by providing tax returns. They will also provide three years financial statements signed by accountants. Well, if you have been searching for a business for a while, specifically for a business with asking price of less than $250,000, you have probably discovered that we do not live in the perfect world.

There are many reasons why financial reports are not available. First, small business owners are often too busy with running their business, and they simply don't care or don't have the time to establish good financial documentation. Second, hiring outside help to keep records for the business is usually an unnecessary and expensive cost. Finally, don't tell Uncle Sam, but some small business owners enjoy the lack of documentation. So far, I haven't told you anything that you didn't already know, right?

Have you considered, however, that the lack of financial documentation is often in the buyer's favor? Yes, I said in the buyer's favor. A business owner, who kept great financial documentation, would ask top dollars for his / her business and he can. It's like selling a car in excellent shape vs. a car with no maintenance. However, a good business broker would educate his seller that with the lack of financial documentation, the seller should lower his / her expected asking price. Therefore, lack of financial documentation means more bargaining power to the buyer. Often, buyers ask me: "what is a great business?" And my answer is: "a business with no financial documents."

So, am I asking you to buy a business blindly? Based on the good word of the seller? No, I am asking you to do a little bit of due diligence. You are going to buy a business, for crying out loud. Understand whether the business is valuable or not. You are going to spend a big chunk of your savings and most of your time on this business; start doing the work before you purchase it.

There are many ways to verify the business profitability without looking at tax returns or audited financial statements. First, I would estimate the gross sales figures. For example, you can do it by looking at daily register records or adding up checking account statements and credit card statements (credit card paid by clients). However, the best way to verify gross sales figures is actually to spend a few days and observe the business. Count clients and see how much they spend. Then, estimate how much business is being conducted.

Second, I would estimate all expenses. Simply list all the different expense items, such as rent, utilities, payroll, cost of goods, advertising, etc. and add them up. Now, you can estimate the potential profitability of the business. Maybe this sounds like common sense to you, but you would be surprised by how many business buyers don't consider this simple method as the most important tool to evaluate a business. Remember, even if financial statements are available they might be misleading by overstating the true profitability of the business, so you need to do this analysis anyways.

It is important to note that financial documents are a necessity if you are applying for a loan, but that should be discussed in another article.

All told, do not be discouraged by the lack of financial statements and tax returns when looking for a business. Lack of financial statement is often a buyer's advantage. It increases the buyer's bargaining power, and encourages the buyer to do a thorough investigation of the business.

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