

Stop! Read This Before You Buy or Sell a Business

Most of the “Rules of Thumb” As Basis For Valuing a Business Are Not Defensible

By Wayne J. Unze

According to *Fortune* magazine, more than 75 percent of the 400 wealthiest Americans have achieved their riches through business ownership. The rest found their pots of gold in the real estate market or stocks and bonds. These statistics suggest where to invest your money if you ever want genuine financial freedom. Invest in yourself!

Each year, thousands of men and women between the ages of 40 and 55 leave corporate America to pursue their entrepreneurial dreams. Some do it for financial independence, others like the tax advantages, while most are simply looking for job security and the freedom to control their own destiny. But freedom has never been achieved without some inherent risk. The trick is to minimize the risk by following a proven path.

Many buyers believe the only reason a business is for sale is a result of some financial trouble. Realistically, less than 15 percent of the businesses we review are drowning in red ink. The majority are being sold for reasons such as death, divorce, poor health, partnership disputes, a desire to acquire a larger business or simply to retire.

THREE WAYS TO GO INTO BUSINESS

There are three ways to go into business: 1) start one; 2) purchase an existing business; or 3) purchase a new franchise. A “start-up” can be the cheapest and most satisfying way to enter the entrepreneurial world, but U.S. Department of Commerce statistics reveal that more than two-thirds of all start-ups fail in the first three years. This is usually the result of the owners being under-capitalized or foregoing proper market research, e.g. the rise and fall of Albuquerque bagel shops during the 1990s. Demographic studies looked favorable but both franchisors and independents failed to take into account one important fact: Most New Mexicans prefer tortillas to bagels. If you want to manage risk, a start-up is rarely the answer.

Purchasing a new franchise offers a lower level of risk, because you are buying a proven name and product (or service). However, you still must find a suitable location (with the franchisor’s help) and survive the early stages of growth until the business finally makes a profit (usually one to three years). Franchisees must also finance all of the start-up costs through a bank note, which can sometimes be a difficult and expensive quest.

Purchasing an existing business offers the buyer a proven name and product (or service) and a proven location, three of the most important components of a successful business. The fourth component is management, and with the seller’s training and consulting, the buyer can assume that role with some measure of confidence.

The buying process begins with a frank assessment of your resources and acquisition criteria. The purchase of a business requires some investment, so it is necessary to determine the extent of your financial resources. You should also take a hard look at your

knowledge base and reservoir of experience in order to develop your acquisition criteria, i.e. business category, hours/days of operation, number of employees, required skill set, price range and location.

Armed with this data, the next step is to review business opportunities listed for sale in the newspaper's classified section, on the web and through personal contacts with business and professional associates. Also consider assembling a team of advisors—an attorney, accountant and business broker—to guide you through the crucial steps in the buying process. Discuss your ideas with successful business owners and ask their advice on how to grow a business. Another source of information is SCORE (Service Corps of Retired Executives), a volunteer division of the Small Business Administration (SBA).

After finding a few interesting business opportunities, ask the broker for a professional marketing package on each one and expect to sign a confidentiality agreement to assure the owner you will treat the enclosed information discretely. The marketing package is intended to provide you with enough data to whet your appetite for a meeting with the owner and a tour of the business, or to convince you the business is not a satisfactory fit.

If you choose a meeting, make a list of pertinent questions that weren't covered in the marketing package. Don't be surprised if the business owner refuses to answer some proprietary questions (that can be answered following an executed purchase agreement). While touring the business, ask yourself if it "fits". If it doesn't, don't buy it! But if the fit is there, and most of your criteria are satisfied, a purchase agreement with a suitable pricing strategy may be in order.

VALUATION

Most businesses are valued at a multiple of cash flow ranging from 1.5 (for businesses in decline) to 3.5 (for well-established businesses with strong earnings). In simple terms, cash flow is the amount of earnings available after all the expenses are paid but before the owner has received any compensation and before any payment has been made to service debt. Cash flow is often described as earnings before interest, taxes, depreciation and amortization as well as non-recurring expenses and owner's compensation and benefits.

Contrary to those who cite "rules of thumb" as a basis for valuing a business, we have found that most are not defensible. Because the net profit of a business can be adjusted up or down depending on the amount of compensation the owner receives, a multiple of net profit is seldom a valid approach to value. The same is true of multiples of gross sales, because businesses with identical sales can have vastly different cash flows due to expense variables (especially the owner's compensation). The acid test for any buyer should be whether or not you can service the debt on the business and pay yourself a suitable living wage.

A typical business sale is seller-financed, requiring a down payment of 25-40 percent of the purchase price and a note to the seller for 5-10 years at an interest rate of 6-8 percent. According to our records, approximately 15 percent of business sales are bank-financed,

usually with SBA-guaranteed notes, that require down payments from as low as 10 percent (for medical practitioners) to as high as 50 percent (for high-risk businesses such as restaurants). Unlike seller-financed deals that can be closed in about two weeks, SBA-guaranteed transactions can sometimes drag on for months as the paperwork filters through the layers of bureaucracy.

There is obviously more risk to the seller in a seller-financed installment sale because the buyer can default on the note payments. A buyer usually offsets this risk by signing personally on all of the purchase documents and leases to demonstrate a high level of commitment. As further inducement, the seller generally gets better tax treatment in an installment sale, enjoys a higher interest rate than being offered in bank certificates or the money market and exposes his business to a far greater number of potential buyers. A cash (bank-financed) sale can often command a 15 percent to 20 percent discount in the sale price.

Most buyers are encouraged by their attorneys to purchase only the assets of a small, closely-held company (asset sale) rather than its corporate stock (stock sale) for fear of contingent liabilities that may be lurking in the past and which could return to haunt a new owner. So what exactly do you get when you buy the assets of a small business?

BUYING THE ASSETS

For starters, the purchase agreement should include all of the furniture, fixtures and equipment (in working condition) that make the business run, a normal level of inventory and supplies, a leasehold interest that runs at least as long as the seller's (or bank's) promissory note, a list of all customers and vendors, as well as the company's trade name, trademarks, patents, telephone numbers and yellow pages ads.

In situations where the seller owns the real property (less than 10 percent of the time), either a lease or sale of the property may be considered. A lease is often in the best interests of both parties because it preserves the buyer's cash reserves, while providing the seller with another source of income and future appreciation in the property's value. By leasing, the seller also avoids a double tax hit at the time of the business sale. Buyers can protect their future interest in the property by asking the seller for a first right of refusal or an option to buy the property at a later date.

In addition to the description of assets being purchased, the purchase agreement should contain all of the terms and conditions that you feel are necessary for the transaction to be fair. That doesn't mean that all of your desires will be realized, but it's a good platform from which to launch your attempted acquisition. Bear in mind the sale price may not be the most important factor in negotiations, sometimes being preempted by such factors as down payment, size of monthly payments, training and consulting and a suitable lease or lease assignment.

Purchase agreements contain a list of contingencies, events that must occur before the closing such as: a) an inspection of books and records (due diligence); b) securing a bank

loan; and c) securing a new lease or lease assignment. All contingencies require a completion deadline so they don't drag on indefinitely.

There are also conditions, things that follow a closing, such as: a) free training (the time period depends on the complexity of the business and experience of the buyer); b) free consulting (usually limited to telephone calls); c) and a non-compete agreement (typically for five years and limited to the market area served by the business).

DUE DILIGENCE

During the due diligence contingency period, a purchaser is entitled to inspect every aspect of the business, from its books and records (a good time to involve your CPA) to its furniture and equipment. This is the moment of truth, when representations made by the seller are put to the test. The buyer generally requests income statements and balance sheets along with tax returns from the past three years, gross receipts tax statements, copies of leases and contracts in force, lists of vendors and customers and personnel data.

Beware the statement, "The books don't show all of the money I take out of the business." When we hear this disclosure, we tell sellers, "We can only sell what you can prove." A seller making this statement is in danger of having a prospective buyer use it as leverage in negotiations, so we heartily discourage this admission.

CLOSING

Once due diligence is completed, the sale can move along to a closing. This generally requires the services of an escrow attorney who takes the five-page purchase agreement, and creates a hundred-page set of closing documents that contain all of the legal verbiage required by our litigious society. As part of his closing duties, the escrow attorney should order a chattel and tax lien search to determine if there are any judgments, liens or other encumbrances that might prevent the transfer of "free and clear" assets to the purchaser. If buyer and seller and their respective attorneys approve the final closing documents, and the searches reveal no encumbrances, the deal can close and you're an entrepreneur.

Knowing the buying process can help a seller understand and anticipate the purchaser's motivation, concerns and standard contractual requests. The same is true for buyers who need to understand what the seller's concerns are in order to focus on ways to resolve any problems that occur in negotiations.

SELLERS MANTRA

In preparing to sell a business, timing is critical. Business owners should begin planning the sale at least two years in advance, at a time when the business is experiencing steady growth. There is also time to start recording all of the income being generated by the business in the event some cash is being "diverted" on the way to the cash register. As a seller, your mantra should be, "Best shape commands best price!"

Seller's also need a team of advisors: a) a broker, to appraise the business, develop a defensible sale price and terms and discreetly market the business to qualified prospects; b) an accountant, to suggest ways to minimize your tax burden, update your company's books and records and resolve any tax, contractual or financial problems; and c) an attorney, to settle any outstanding litigation in order to free the business assets from any encumbrances.

Prior to the broker marketing your business, you should remove all nonessential, personal effects from the premises, so there are no misconceptions as to what assets go with the business (I once saw a buyer and seller argue at length over a sailfish that was mounted above the seller's desk).

When the broker secures a qualified prospect, a meeting is arranged to introduce the two parties and allow the prospect to ask more intimate details regarding the business. After this meeting, if both parties wish to proceed, the seller will grant the broker permission to release more detailed financial information to help the buyer develop a business plan and structure an offer. However, if you leave the meeting convinced the prospective buyer is incapable of running your business, negotiations can be quickly terminated.

In the event the buyer requests seller financing, the purchase agreement should be accompanied by a copy of the buyer's financial statement and credit report so you can evaluate the buyer as a potential credit risk. An earnest money check, typically for 2 percent of the purchase price, should also accompany the offer.

Sellers should not announce the pending sale to employees prior to closing. I have found that the perceived "evil" (new owner) is often far worse than the actual, and employees will tend to start searching for a new job if alerted to the fact the business has been sold. After the closing, you can introduce a "real person" to the employees followed by a pep talk about the company's future and each employees' role in that future.

Most importantly, any sale should be a "win-win" transaction for both parties or it shouldn't happen.

In parting, here are a few tough lessons that I have learned over the past 30 years as a business broker:

1. Only about 25 percent of the businesses "handed down" to an owner's children survive the first two years. If this is your intention, insist that your offspring make some form of up-front investment so they have real stake in running the business.
2. More than a third of all business owners I have interviewed, regarding either an appraisal or sale, have been embezzled by a trusted employee.
3. Absentee ownership seldom works, especially if the business generates cash. If you want to own a successful business, you need to be a full-time manager.

4. Approximately two-thirds of all partnerships end in dispute. If you want a chance at a successful partnership, create a comprehensive agreement describing in detail all of the functions of the partners and how you all intend to deal with the dismal “Ds” (death, divorce, disability and dissolution).
5. 5. Don't rely on investors to help you purchase a business unless they are part of the buying process from the start. The disappointment, when they refuse to sign the check, is heartbreaking.
6. . If the deal looks too good to be true, it generally is!

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