Guide to Buying A Business

Deciding to buy a business is an emotional decision. When looking for the right business for sale you must be both realistic and open. There is no "perfect business" as all businesses have their positives and negatives. There is also no business that is considered a steal at its price. If it appears to be a steal, then beware – as there may be something negative lurking beneath the facts and numbers.

Look at the entire business model. Not only should all financial figures be proven through financial statements, but the entire business should be open to you for review upon acceptance of confidentiality documents and rules. But there are certain business-related items that are not at your disposal. For instance, customer names, supplier names and employee names are not something you should ask for.

In addition, you should have no contact, visitation or any other communication with that business without the approval of the business broker or if no broker then the owner.

Some things you should ask for include the complete financial history up to the last 3 years – if owned less than 3 years then adjust these requests accordingly. You should also be given asset values including individual values of equipment and inventory. It is also valuable for you to ask where the increased potential rests in the business. Even though a value can't be placed on potential, you should investigate the business' potential for one main reason- DEBT SERVICE.

Debt service is defined as "*Cash required over a given period for the repayment of interest and principal on a debt*." So, while potential should not be part of the price of the business, you should look at potential when considering the increased debt service associated with the business loan that you will most likely need to complete the purchase. To keep the current annual cash flow – and hopefully increase it – the potential of a business should be a key focus. If the potential is unrealistic or does not match possible debt service, then either adjust your offer or simply walk away.

NO POTENTIAL = NO FUTURE

Look past the present and into the future but don't pay for this trip!

The business also must work for you. When looking at the business model you must consider the owner hours worked and possible increased expenses in hiring to replace some of these hours. Replacing these owner hours with a manager DOES NOT provide valid reasons to decrease the annual cash flow of the business – rather this represents expense potential that you should consider in any purchase.

So, if the current owner works it then so can you – and if not then the decreased cash flow should come from your willingness to take less revenue and not be reflective in the offer process. In other words – you shouldn't say "The cash flow is not $150,000 – it is $120,000 because I want to hire a manager at $30,000 per year thus the price should be reduced by $30,000". The business model has proven that hiring the new manager is now a discretionary expense.

But in the end – the offer IS what you are willing to pay for the business!

BUYER BEWARE – if it looks too good to be true – it is!!!

There is no such thing as a business where the annual cash flow (profit before taxes) exceeds the asking price. So, if you are looking to spend $100,000 and get an instant cash flow of say $150,000 then you will always be looking. This business for sale does not exist and if it does on the surface then beware as it may have other issues playing out.

The median asking price on a business nationwide is anywhere from 1 to 3 times annual cash flow + hard assets like equipment and inventory. This cash flow multiplier is eventually set by the industry type and provable annual cash flow.

You may also see higher cash flow multipliers as these higher multiples generally include the hard assets.

Then there are the gross sales multipliers for pricing a business and other similar formulas basing the price on gross sales. These median gross sales multipliers generally range between 33% to 100% of annual gross sales depending on the type of business. These multiples generally reflect a business that has substantial gross sales but little cash flow. As a reference, this type of business will generally have existing cash flow potential through better management of expenses, employees and time. In other words, the current and existing sales represent a substantial increase in cash flow through better management.

PRICING METHODS on a business are covered completely elsewhere herein.

Finding the Perfect Business for Sale

Unfortunately, finding that "perfect business" is a fairy tale. There is no "perfect business" - and don't let business brokers or sellers tell you that it is the perfect business for you. That's why 85% of all business buyers end up purchasing something other than that business for sale in which they were originally interested in.

All business buyers have a general idea on what they want or need but these general roadmaps are littered with potholes and detours. It's best for you to accept the fact that the "perfect business" and the business for sale that you buy will be different.

We are not saying that if you want a Laundromat you will never get a Laundromat. Rather we are saying is that the dream Laundromat in your mind will never materialize. A business for sale will never live up to your expectations because it's human nature to adjust expectations before they are met. If you are too finicky then we can guarantee that you will still be looking 10 years from now.

We recommend that you look at businesses for sale in areas where you have been qualified - good business brokers can help in the qualification - and one that interests you and one that you feel you can make money and grow. Instead of finding your dream business - develop it from an existing qualified business. This is where business brokers can help

General Rules of Thumb...

- Write your needs and wants
- Determine if you want employees
- Determine how many hours per week you want to work
- Determine how much you want to make from the business per year
- Determine areas where you have extensive experience
- Determine if you want to manage or have a manager in place
- Do you want a "cash" type business?
- Do you want a strictly invoice - check type of business?

Be Motivated – It Saves Time

Ask yourself the question "If I find what I want, am I prepared to place an offer?".

You are doing a disservice to yourself, the business brokers and seller if you are not prepared to follow through. All business brokers and sellers assume that interested buyers are prepared to make an offer should the business for sale fit the buyer's needs or wants. All business brokers and sellers put a ton of time and effort into preparing for and marketing the businesses for sale. A "tire kicker" (not motivated) buyer only wastes valuable time better spent elsewhere.

If you were in a service business - would you want a potential client misleading you? Truthfully, this is how business brokers feel if an unmotivated buyer goes through the process.

NOW, if you are a motivated and serious buyer, are you properly qualified - business brokers can help here - to make an offer then follow up on it? Anyone - including business brokers telling you that 100% financing is possible is LYING TO YOU!

As a rule, you will need at least 20% of the selling price on businesses for sale - liquid cash - to place as a down payment. Next you will need relevant experience in either the industry in question or in past ownership and/or high level sales & marketing.

Last, you will need good to great credit - generally a credit score of 640 or higher. If you are unsure about the qualification - contact business brokers for said qualification. All good business brokers qualify business buyers before disclosing businesses for sale.

QUALIFY yourself - do you meet the 3 criteria last above - consider getting get a credit report on yourself that you can show a broker/seller. NEVER LEAVE THE CREDIT REPORT WITH THE BROKER OR SELLER! Most business brokers will not require credit reports and/or financial statements, but they are good to have in place when looking at businesses for sale.

General Qualification Rules of Thumb...

- Some sellers will hold up to 80% on a note AND some will not hold a note at all.
- Each seller is different - it's their decision to hold a note - not yours
- Sellers and lenders will want you to have relevant experience and good to great credit if holding the note or providing a loan
- Some sellers or brokers will want a deposit before disclosing financials - DON'T DO IT! It's an old unethical trick by business brokers
- "Liquid Cash" is cash that you can get within 7-10 days.
- Take your liquid cash figure and multiply it by 5 - this is the high end of what you can afford

Understand How the Business Was Valued

GUESS WHAT: "It's what the owner wants" IS NOT a viable explanation from business brokers to how their businesses for sale are priced. Ask the business broker or seller for a detailed explanation of how it was priced. If business brokers or sellers decline your request on their businesses for sale, THEN GET AWAY!

Too many business brokers do not do ANY due diligence in pricing their businesses for sale and most sellers do not have any concept on pricing a business to sell. IN ADDITION, "my accountant told me" is also not a valid reason because an accountant places a hard value on a business NOT a market value as is needed when selling a business.

There are many models used by business brokers in placing a market value on businesses for sale. In some form of the analysis, a cash flow (true profit) and true gross sales figure needs to be determined. If real estate is involved, it should be added in as a separate figure

The following independent pricing models are widely used by business brokers and accepted throughout the industry - it is also easily verified (not including real estate) ...

- Cash Flow x Industry Multiplier usually 2 - 4 (cash flow is the bottom line + all unnecessary expenses added back into the bottom line) depending on industry and growth.
- Cash Flow x 1 - 3 + all equipment and inventory (depends on industry & growth)
- 70-100% of gross sales for retail or manufacturing related businesses (depends on cash flow)
- 60-80% of gross sales for food related businesses (depends on cash flow)
- 30-60% of gross sales for service related businesses (depends on cash flow)

Look past gross sales multipliers as they can be misleading

If you encounter a detailed and confusing market value formula from business brokers or sellers, then we suggest stepping back because an old ploy by some business brokers is to complicate a formula to where a buyer gives up and trusts the business broker or seller. If a business broker can't give you the cash flow and gross sales values, then move on.

Too many business buyers concentrate on gross sales without proper knowledge of the basic operating expenses to profit on businesses for sale (***cash flow***).

Cash flow is the true profit of the business and you should demand that the business broker show you the cash flow and how it was derived from the tax returns and/or other financial statements.

Cash Flow - not gross sales - determines the profitability of the business.

What is Cash Flow?

Cash flow is profit before taxes. It is what the owner is truly making. Cash Flow is determined by taking the Net Profit or Loss from the tax returns then "adding back" to the Net Profit or Loss any non-essential, non-business related or paper expenses (amortization, depreciation and interest).

There are additional "add backs" like one-time expenses or payroll expenses on an employee no longer with the business - just to name a couple.

For example - we have a fictitious business named *Widgets Inc*. In looking at their latest tax return we see that it has a Net Profit (bottom line) = $68,787.

In looking at the expenses on the tax returns we automatically add back to the Net Profit or Loss...

1. the $6,424 Depreciation expense
2. the $3,178 Amortization expense
3. the $1 674 Interest expense

In looking at the expenses on the tax returns we then question the seller and determine the following...

A. the $12,676 expense for "insurance" was all personal on the owner and wife
B. the $18,900 expense was a one-time expense for redesigning the interior
C. the $5,323 expense was for the owner's personal vehicle not made part of the sale not needed to operate the business.
D. the $4,568 expense was for his yearly dues at the country club - obviously not needed to operate the business.

So, in determining the cash flow...
* Take the Net Profit = $68,787
* then "add back" 1-3 above (cumulative $11,276)
* then "add back" A-D above (cumulative $41,467)
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TOTAL (Cash Flow) = $121,530

So, while the tax returns showed a NET profit of $68,787 – the actual profit (cash flow) is $121,530.

The business broker or seller should show you the exact cash flow analysis like above! And the business broker should show you the actual expenses from the tax returns. Don't assume anything - ASK them to show you ALL supporting data.

If you hear terms like EBIT or EBITA and don't understand it - Don't panic. Here is a simplified explanation...

- **EBIT** (Earnings Before Interest and Taxes) - Cash Flow Above less Interest
- **EBITA** (Earnings Before Interest, Taxes and Amortization) - Cash Flow Above less Interest & Amortization

The EBIT for Widgets Inc above would be **$119,856** (cash flow less the $1,674 Interest Expense)

The EBITA for same would be **$116,678** (cash flow less the $1,674 Interest Expense & $3,178 Amortization Expense)

What You Should Be Prepared For

Being Qualified - unless you have 100% cash to buy a business, you will need either seller financing or lender financing. If financing is needed at all then the general rule of thumb to follow is that you will need relevant experience in that type of business (or self-ownership), have at least 20% cash of the overall asking price to place down and you have good to great credit (credit score of 650 or up).

To determine the price of a business you can afford - take the amount of cash you have now to place as a deposit then multiply by 5 times that. This will be the maximum you can spend on a business.

To determine relevant experience - draw up a professional resume on yourself for the last 3- 10 years or more. A lender will want to see this - but now consider any field where you have at least 3 years' experience in the last 10 years may apply (3 of the last 5 years is optimum).

Relevant means just that - retail is retail whether it is a liquor store or convenience store. If you have extensive and successful self-ownership experience, then this may apply as relevant experience in most types of businesses.

To determine your credit score, use one of the credit reporting services like freecreditreport.com to determine your credit score. NEVER leave a credit report with a broker or seller unless you authorize a release to them - in writing.

Be prepared to work hard on buying a business while experiencing various pitfalls that may seriously stress you. There is no perfect business to buy so the work involved in buying a business is intensive and full of legal issues and agreements.

Business buyers who try to buy without representation and documentation eventually find that they get in too deep into areas where they have no knowledge or experience. At this point the buyer may be able to lose deposits as the deal falls apart.

So, make sure you have an attorney and accountant on call to assist you.

Next you should be prepared to place reasonable offers. The reality is that full offers would be nice, but owners understand that offers may come in for less. The owner will almost always consider all offers – if they are within reason.

Next be prepared to frequently meet with sellers. Most buyers are first time buyers and while they must be qualified, they do experience fears of the unknown. Buyers are encouraged to meet with sellers – frequently more than once – prior to placing an offer.

Last is that you must be prepared to manage in upwards of 20+ contingencies before and after the offer process. Failure to understand these contingencies will almost surely result in a damaged or failed transaction.

FAILURE TO BE PREPARED COULD RESULT IN A FAILED CLOSING

The Importance of Confidentiality

You should understand the importance of confidentiality.

The importance of confidentiality always during the sales process is the most important ingredient in the successful sale of an existing business. This IS NOT a real estate transaction where real estate is posted on public MLS services for everyone to find. This is a business with employees, customers, competition and possibly landlords and creditors. By making a business for sale public, all the above-mentioned entities associated with the business for sale will be thrown into a "cause and effect "flow that will permanently harm the business being sold.

The importance of a business buyer keeping all information confidential is paramount and if the buyer signs confidentiality agreements then it is required. Failure to adhere to the terms of confidentiality agreements will almost surely land you in court and likely a heft y monetary penalty.

COMMON CONFIDENTIALITY AGREEMENTS AND DOCUMENTS…

Non-Disclosure Agreement
This document is signed by ALL potential buyers before any specific information is shared with the BUYER. This includes all individuals associated with BUYER. This agreement prevents BUYER from disclosing the COMPANY to anyone not secured by a Non-Disclosure Agreement. The penalty may be a minimum of $10,000 and up.

The Importance of Financing

A buyer wanting 100% financing is dreaming as there is no such thing as 100% financing on a business – anyone who tells you that there is 100% financing is a liar!

So, it goes without argument that some sort of financing will be needed to close the deal. There are various options for financing that are covered below with the understanding that buyer qualification is the key ingredient to obtaining financing for the buyer. The ability to finance a buyer is the make or break point of getting to closing.

Before jumping into the three main financing categories, let us dispel one myth and that is the misconception that the owner HAS TO hold a note or mortgage on the business to get a deal closed. This is not true, and it totally rests with the individual owner's preference. We will advise that selling a business with some amount of owner held financing does make it slightly easier to sell.

Three Types of financing…

1. Owner held financing is one option but see the last above paragraph to dispel the

myth that an owner must hold financing. We always advise owners to speak with an accountant about the pros and cons to holding the loan on their business. There may be some tax benefits to doing it this way.

2. Local bank SBA financing is very difficult for a buyer to secure in the small business for sale environment. It is also the primary reason why there is the misconception that lender financing is difficult. But there is a third and viable option – Acquisition financing.

3. SBA Acquisition financing from third party lending sources is the primary lending source used to fund buyers of small businesses. These sources are specifically in business for small business lending. Most business owners – and business buyers - do not know of these types of lenders nor do they have the contacts to use them successfully.

FAILURE TO OBTAIN BUYER FINANCING WILL KILL THE DEAL

We have the sources to finance buyers and it DOES NOT have to be on a business that we list.

Who are Business Brokers

Good business brokers are a trained intermediary experienced in the confidential sale of businesses for sale to qualified buyers. They usually work for and are compensated by the seller though some brokers do represent the buyer. Some states even allow for dual agency (representation). ASK the business broker who he or she represents.

The benefits to a business buyer in dealing with a business broker representing a business owner …

1. Protect Confidentiality always
2. Qualified Buyer Processes
3. Financing Buyers through SBA acquisition lenders
4. Proving market value on the business
5. Obtaining information from the sellers
6. Management of offers
7. Management of closing contingencies

So even though a business broker may represent the seller – it is still beneficial for business buyers to work through a business broker when considering a business for sale.

A good business broker is like a sports referee who does a great job – nobody knows he or she is there. The same can be said for a good business broker – they work in the shadows and nobody knows that the business is for sale or sold.

-Scott Radin

Don't trust all business brokers – there are three types of brokers – the greedy – the clearinghouse and the one who looks out for their client's best interest.

Here are some other important questions to ask the broker or seller...

- Why is he or she selling - have them explain - it is your business?
- Is the seller willing to hold a note - and for how much?
- If applicable, can the broker help in finding outside financing?
- Is the seller willing to train, and for how long?
- Is the seller willing to sign a non-compete agreement for at least 2 years and 20 miles?
- If there a lease in place that will be assigned, is it assignable - ask for a copy?
- Are there 3 years of tax returns or financial statements available?
- Is the seller willing to allow a third-party inventory/equipment audit as part of any offer?

- Is the seller willing to allow a window of opportunity to verify tax returns with the government?

Here are some ethical and accepted practices in selling a business...

- Buyers can review tax returns and financial statements with the broker or seller, BUT copies do not need to be provided until after an offer is accepted. Just be sure you have a window to cancel the agreement if the financials are not as represented. However, we do provide these before offer.
- Brokers or sellers might require you to visit the business and meet the owner before any tax returns or financial statements are reviewed with the buyer.
- A minimum deposit of 10% may and is almost always required after the seller accepts an offer
- Deposits should always be held in a broker's escrow account or - if no broker - in the seller attorneys escrow account. Never should a buyer's attorney or the seller hold the deposit.
- Closing should be scheduled to a date and time (generally 6-8 weeks out) when an offer is accepted
- Final inventory/equipment audit should be done 1-4 days before closing
- The closing should take place at the seller's attorney's office or at the business

Here are some unethical and deceptive practices to stay away from...

- No representation of financial figures until after the offer is accepted
- No review of how the business was priced
- Representation of profit that can't be verified
- Representation of equipment/inventory that can't be verified
- Asking for a deposit before business is disclosed to you
- Asking for a deposit to review the financials
- Asking for any deposit other than that directly associated with an accepted offer
- Any broker or seller that pressures you with "I have other offers coming" etc.