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Buying a Business

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Buying a Business

Pros	Cons
Buildings, equipment, inventory and staff are operational.	Buildings and equipment may be unsuited or obsolete.
Location is good.	Location may be poor for this type of business.
Product or service is already being produced and sold.	Inventory may be loaded with dead stock.
Market and goodwill are established.	Accounts receivable may be too high or uncollectable.
Cash flow is being generated.	Hidden reasons such as lease expiring and not renewable; zoning changes; deteriorating local conditions; labour problems.
Relationships are established with supplier and banks.	Bad relationships with banks and suppliers.
Good growth potential.	No growth potential.

Questions to Answer Before You Buy

The key to successfully purchasing a business is to fully investigate before you commit yourself. It is important to find suitable answers to the following questions.

Sales

What's the future of your product or service? Is it expanding? Becoming oversold? Obsolete?

Is the location good, or is it the reason for the sale?

Have all sales been reliably recorded? Are the total sales broken down by product line if applicable?

Are bad debts deducted from records or are they still shown as receivables?

What are the monthly and annual sales patterns? Is it consistent? Seasonal? Related to other cycles?

Are some goods on consignment and able to be returned for full credit?

Are some goods on warranty? If so, will financial allowance be made for possible warranty commitments?

Are sales fluctuations due to particular promotional campaigns?

Is there a salesperson who contributes significantly to success? Can you keep him/her?

Is the seller's personal role critical to success?

Are sales figures solely from this business?

Is reported stock turnover in line with industry practice? Does existing stock include items from another business?

Will existing suppliers be available to you?

Can sales increase with current resources?

Costs

Are expenses all-inclusive? Will new ownership change them?

Is another business involved in the accumulation or payment of expenses?

Have some expenses been delayed (e.g., equipment maintenance)?

Will some annual expenses be due soon?

What new or increased expenses should you anticipate?

Are wages as well as an attractive profit margin provided for working owners?

Is interest paid for money lent to the business?

Does equipment value reflect reasonable annual depreciation?

Must staff salaries be adjusted soon?

Has your solicitor checked out your lease?

How will sales fluctuations affect cost?

What expenses do similar businesses have?

What costs are allocated to which product? How would a change in product 'mix' affect costs?

Did the seller prepay some expenses? Must you reimburse him for your share?

Is inventory accurately shown at true current value, for calculating actual cost of goods sold?

Have you considered the extra cost of the GST on the sale of assets?

Have you allowed for extra cash flow until you receive your GST input tax credit?

Profits

How will sales fluctuations affect profits?

Do you know minimum and maximum likely sales?

How will inflation affect sales and costs?

Are profits enough to take the risk?

Have records been well kept?

Have you analyzed them? Balance sheets? Profit and loss statements? Tax returns? Purchases and sale records? Bank statements?

Based on past results, have you projected future cash flow and profitability? What is break-even point?

Exactly what is and what is not included in the offer to purchase in writing?

What are the book value, market value, replacement value of the fixed assets?

If inventory and/or work in progress are included, has a value been agreed upon at time of offer? Have you agreed on how it will be adjusted at time of closing, and within what limits?

Is there inventory sold but not shipped?

Are intangibles like business name, mailing lists, exclusive right, leases, etc. included?

Can you obtain any necessary licenses?

Are you buying accounts receivable? Do you have a listing of these by age?

What would the accounts receivable sell for if sold to a factoring agency (bank or finance company)?

Is equipment in good repair? Efficient? Up-to-date? Easy to service? Saleable?

Is some equipment leased? At what cost?

Might you be offered the opportunity of ownership on maturity of a lease?

Must you build your own accounts receivable? How will this affect cash flow?

Is it a limited company? Are you buying assets or shares? Have you consulted your lawyer?

Has your accountant advised you on the best way to value assets for taxation purposes?

Liabilities

Are your assets free and clear of debts and liens? Are terms of debts you are assuming in writing?

Are there contingencies such as warranties or guaranteed debts or accounts?

Are you assuming any risk of liability for the seller's actions (as can happen with a limited company)? Will customers expect you to make refunds or honour warranties or risk losing goodwill even though you are not legally obliged to do so?

Are there advances or prepayments that should be turned over to you?

How's the business credit rating with suppliers?

If buying part of a company or entering a partnership, what limits are there and what authority will you have in the management of the firm?

Will cash flow cover the debts?

Why is the business for sale?

Is the seller co-operative in supplying information?

Will the seller agree not to set up in competition for an agreed time?

Will the seller train and assist you after the purchase?

Is this the business you really want? Is it compatible with your interest? Experience? Personality? Finances?

The Purchase Agreement

Does the contract of sale cover assets to be purchased, liabilities to be assumed, when the business is to be taken over?

Are you ready to negotiate, remembering a business is only worth what someone will pay and what a seller will accept?

Have you included escape clauses in the proposed contract covering: obtaining financing, inspecting records, receiving licenses, rights and other transfers?

Have you discussed this with someone who understands this type of business?

Determining Price or Value of A Business

How much is a business worth? Is the asking price reasonable?

Pricing a business is not an exact science and several methods are commonly used to arrive at a price. Each method has some value and one should use a number of the methods to arrive at a range of prices which you can use to set an asking price or use in negotiating if you are buying.

Asset Value Methods

Book Value: lists the business net balance sheet value of its assets minus the value of its liabilities. This method usually understates the value as listed assets are often depreciated more than their true market value.

Modified Book Value: simply book value adjusted to reflect current market value of assets.

Replacement Value: lists the replacement cost of the assets less liabilities. Since few assets in a business are usually new, this method will overstate the value.

Liquidation Value: net cash that would be received if all assets were sold and liabilities paid off. This would be the net cash result if the firm was going out of business and as such is probably the lowest value acceptable to the seller.

Market Value: evaluates a business by comparing it with similar properties that have recently sold. This method is very difficult to use as similar businesses differ widely in size, reputation, market and management.

Earning Value Methods

A buyer is interested in the performance of a business not only its asset value. Therefore, earning potential is a factor that should be taken into account.

Capitalizing Past Earning: in this method the profits for a selected period of past years is adjusted for unusual items and an appropriate rate of return is divided into the average profit level derived. The rate of return (capitalization rate) is what return an investor would require on his money given the risk he sees in the business relative to other more secure investments such as bonds, GIC's, etc.

Discounted Future Earnings: instead of using an average of past earnings, an average of the trend of predicted future earnings is used and divided by the capitalization rate.

Combined Methods

Since asset value and earning value are both important considerations there are a number of methods that combine both. One of the best known methods is the Bank of America formula that not only uses asset and earning value but addresses the difficulty of valuing goodwill. The steps of this formula involve:

1. Determine the tangible net worth of the business (market value of current and long-term assets less liabilities).
2. Estimate how much the buyer could earn annually with investments in a comparable risk business.
3. Calculate a reasonable salary for owner/operator in the business under consideration.
4. Determine the net earnings of the business over recent years (net profit before subtracting owner's salary).
5. Establish the extra earning power of the business (step 4 minus steps 2 and 3).
6. Try to value the intangibles, such as goodwill, of the business. This is done by multiplying the extra earnings (step 5) by what is termed the "years of profit" figure. To find out the "years of profit" multiplier consider: how unique are intangibles offered by the business? How long would it take to set up a similar business and bring it to this stage of development? What expenses and risks would be involved? What is the price of goodwill in similar businesses? A larger multiplier, for example a maximum of five, would reflect a

well-established business, which has a valuable name, patent, or location, whereas a younger firm might merely have a one-year profit figure multiplier.

7. Calculate the final price of the business, which equals the tangible net worth (step 1) plus the value of intangibles (step 6).

Example:

	Business A	**Business B**
Step 1	$100,000	$100,000
Step 2	10,000	10,000
Step 3	18,000	18,000
Step 4	30,000	24,000
Step 5	2,000	(4,000)
Step 6	6,000	None
Step 7	$106,000	$100,000

In Business A, the seller receives a value for goodwill because the business is moderately well established (years of profit multiplier of 3) and earning more than the buyer could earn elsewhere with similar risks. In Business B, the seller receives no value for goodwill because the business, even though it may have existed for a considerable time, is not earning as much as the buyer could through other investments.

Rules of Thumb

In certain industries rules of thumb can serve as guides to the valuation of a business. This is usually in terms of 'X' times sales or 'X' times net profit or some combination of asset value and percentage of sales. You should be very cautious when using rules of thumb as they are based on averages and often don't accurately reflect individual situations. They also may become obsolete if the industry is changing. Rules of thumb should only be used to support other methods of valuation.

GST Considerations

If you buy a business or part of a business, you and the seller can jointly elect to have **NO GST** apply to the sale of your business.

For more information contact Canada Revenue Agency at 1-800-959-5525 or visit their Web site.

Goodwill

Goodwill is the value of intangibles, such as location, reputation, customer lists, franchises, supplier arrangements, quality of personnel, etc. Goodwill can be thought of as the difference between an established, successful business and one that has yet to establish itself and achieve success. Thus a business that has run profitably for a number of years has a value over and above its asset value. Many sellers try to increase the value of goodwill by adding the potential they see for future business.

However, that is not something you should pay for, but really only a factor you can use to decide whether to buy or not to buy the business.

What to Buy — Assets or Shares?

If the business is a limited company you may have the choice of buying the seller's shares or you can purchase part or all of the assets. If shares are purchased you should be very aware of all possible liabilities (debts, liens, lawsuits, etc.) before you take over the shares. Also if shares are purchased, the assets on the books may have been fully depreciated to zero so there may be no further depreciation allowance available for tax purposes. There may be some advantage to purchasing shares if the company has previous tax losses that you can use against future profits. Due to the complexity of tax laws you should seek competent tax advice from an accountant or lawyer.

Financing the Purchase

Banks may be more receptive to financing a business that has a past track record of profitability as opposed to a new business start. However if goodwill is part of the purchase, the bank usually will not be interested in financing this portion of the purchase. Many businesses change hands with the seller providing some of the financing in the form of an agreement for sale. This is especially true if the seller is retiring and does not need all the cash up front. Banks will generally require a set of recently audited financial statements before they can proceed with financing.

The Purchase/Sale Agreement

This agreement should be made up by a lawyer and will include terms and conditions to protect both the buyer and seller. Conditions regarding help of the seller in training the new owner and conditions not to compete with the new owner for a period of time, are some of the points often included in a good agreement.

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