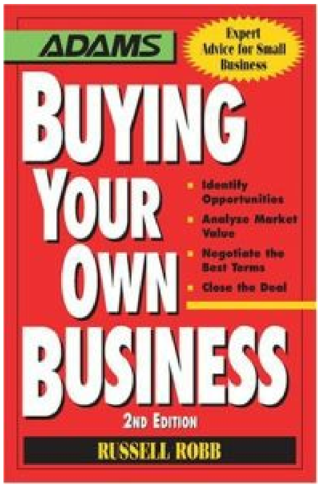

Book Buying Your Own Business

Identify Opportunities, Analyze True Value, Negotiate the Best Terms, Close the Deal

Russell Robb
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Recommendation

This book is an excellent primer for anyone who dreams of buying a company. Russell Robb is an experienced business broker and investment analyst who covers many of the pitfalls and opportunities a first-time business buyer will encounter. In short, punchy chapters, he presents the essential details of negotiating and closing deals, plus valuable sample letters and agreements. His case studies of business purchases offer important lessons for new buyers. Although the author devotes a chapter to acquiring small businesses, his true focus is buying middle-market companies with annual revenues up to $50 million. *BooksInShort* recommends this worthy introduction to the art of buying businesses to professionals with entrepreneurial ambitions.

Take-Aways

- People often sell their businesses due to "divorce, death or despair."
- Most of the companies for sale in the U.S. are service businesses.
- Owners of family businesses usually prefer to sell to their relatives. If a family business becomes available to nonfamily buyers, find out why before you make an offer.
- Only experienced buyers should try to acquire and turn around a troubled company.
- You will need the help of accountants, lawyers and other professionals to buy a business.
- Finding the right company is the most challenging part of the acquisition process.
- It requires good research, patience, decisiveness and the ability to prospect full-time.
- You are more likely to get financing if you have a good reputation and a focused business plan, and if you intend to invest your own money in the acquisition.
- Be prepared to pay legal, auditing, appraisal and other expenses associated with due diligence examinations of possible acquisitions.
- If your new business does well, you could recover your acquisition costs in three to five years.

Summary

Who's Buying, and Why?

As more companies urge employees aged 45 to 60 to leave their jobs, these older professionals are finding themselves in need of productive work. Many have the skills, confidence and financial backing to buy an existing middle-sized business and become self-employed. In fact, this group of buyers accounts for most purchases of middle-market firms, those with annual sales of $3 million to $50 million. Other types of buyers include laid-off executives, former business owners and the independently wealthy.

> "Buying a middle-market company is not a game for neophytes."

People buy businesses for a variety of reasons: to start second careers, to replace lost jobs or to adopt new lifestyles. But these motives alone are insufficient. Potential buyers should conduct a personal self-assessment to determine if they have what it takes to run a business, handle customers, manage staff and work long hours.

Are You Ready to Buy?

Buyers often seek guidance from a professional "intermediary" to navigate the pool of available businesses. Serious bidders will cover the cost of an outsourced business search for up to one year. They also are prepared to pay legal, auditing, appraisal and other expenses associated with so-called due diligence examinations of businesses for sale. Transaction closing costs are extra. For a $5 million business acquisition, these expenses could add up to more than $278,000.

> "Most individual buyers of middle-market companies take one to two years to complete an acquisition."

Many sellers of middle-market businesses prefer to negotiate with credible bidders who will maintain the operational integrity of their businesses. Professional intermediaries say the most credible buyers are willing to invest $500,000 to $750,000 of their own money, have senior management experience and retain a search firm to hunt for the right acquisition.

> "I am usually concerned when a small company owner wants to sell for financial reasons alone."

To begin the business acquisition process, develop a plan for buying a company. Then investigate your options until you find one that seems to best meet your needs. As you proceed, you will price the company, structure a deal, carry out due diligence, arrange financing and, finally, close the sale. The most important task is finding the right enterprise and that takes an intensive search.

Shopping for the Right Business

Finding a suitable acquisition requires commitment, good research, patience, decisiveness and the ability to prospect full-time. Typical acquisition opportunities include subsidiaries that parent companies wish to sell, struggling firms that have not yet filed for bankruptcy and businesses controlled by venture capital funds that want to cash in on their investments. The competition to buy a successful company can be intense. You may have to contend with experienced, powerful corporate buyers such as venture capital funds and private equity firms. Sellers generally engage with serious bidders and ignore the rest.

> "I would much rather see [the owner's] motivations to sell based on such reasons as death, divorce or despair."

Some buyers find acquisition opportunities by approaching business owners whose firms are not officially for sale. Or, they get leads by networking, attending industry meetings, or visiting bankers, accountants and brokers. Assigning a paid intermediary to screen prospects is the most efficient way to handle the business search. The types of businesses you are likely to encounter as you conduct your research include:

Service Businesses

Most companies for sale are service businesses. These organizations are attractive to buyers who want to invest relatively little capital, avoid foreign competition and generate repeat business. Buyers of service businesses primarily purchase human resources, not capital-intensive assets like plants, vehicles and equipment. Because workers are the main assets of service firms, these enterprises usually must expand their payrolls in order to grow.

> "As a potential buyer, you should realize that most sellers of privately held middle-market companies do not know how to value their business."

Bidders for service businesses commonly link their offers to certain conditions like retaining key employees and contracts, and achieving specific performance milestones. Instead of agreeing to pay one price at closing, a buyer may negotiate a payout schedule that hinges on, say, future increases in sales. The terms of a deal also could include a requirement that the buyer pay royalties to the seller in amounts linked to future performance.

Family Businesses

Family businesses are attractive to many buyers. When a family firm is for sale, the owner's relatives are the mostly likely buyers, because internal control of the business is often a priority in families. However, less than one-third of family businesses stay in the founding family beyond the second generation. Eventually, most owners decide to sell to nonfamily investors due to management succession problems, family disputes, taxes of up to 55% on the founder's estate or some combination of these causes.

> "Unfortunately, it costs a buyer as much in professional fees to acquire a company with $1 million in sales as it does one with $3 million in sales."

If you are interested in a family business, be patient and strategic. Families may be hesitant to sell their businesses, and they may even opt out of a deal at the last minute. If a company has suddenly become available to nonfamily buyers, find out why. Become well-acquainted with the people in the firm, and insist on speaking directly with the family member who has the largest stake in the business. Make the buyout offer in a face-to-face meeting with as many family members as possible to ensure their cooperation.

Troubled Businesses

Floundering businesses present buying opportunities. However, only experienced buyers should try to turn around a troubled company. Sure signs of problems include falling profits or rising losses, negative book value, cash depletion and loan defaults.

"Part of the difficulty in buying a business is that the buyer and the seller have different agendas when structuring the transaction."

Exercising due diligence is particularly critical when you assess distressed companies. Know who controls key customer accounts. Watch for loan covenants requiring that debts be repaid before any sales can occur. Verify the accuracy of financial and inventory records. Determine the quality of outside accounting and legal professionals retained by the owner. Investigate the owner's work ethic. Search for any outstanding lawsuits against the business.

"The process of buying a business is one where the more calls you make, the greater your results."

Asset purchases offer an alternative to buying a company's stock. They exclude the seller's liabilities from the transaction. Check to see if any creditors have filed claims on the assets for sale and if landlords have the authority to reassign any of the seller's leases.

Negotiating Terms with the Seller

Buyers and sellers have different priorities when the time comes to close a deal. Sellers generally want to collect as much money, and pay as little tax, as they can. Buyers want to make smaller up-front payments than sellers would prefer. To find common ground with the seller and reach agreement on deal terms, the successful bidder must:

1. **Focus on the process** – Create a strategy, refine the search, evaluate all your choices and perform due diligence.
2. **Rely on professional assistance** – Most business buyers are inexperienced, and many sellers are too invested in their companies to see them objectively. However, brokers, lawyers, accountants or appraisers can provide impartial, constructive advice.
3. **Invest considerable time and effort** – Many people devote up to two years on a full-time basis to the job of acquiring a company. Persistent bidders succeed.

A Patient Acquisition Strategy

Buying a business is indeed a lengthy process. You will need a strategy to formalize that process and generate the greatest number of quality opportunities. The strategy should identify the type and size of the business you seek.

"Most buyers underestimate the importance of raising sufficient cash early on."

The most common obstacles to closing a deal are price disputes, capital gains tax concerns, management succession issues, employee retention and payroll preservation. Price disputes are the biggest of these obstacles.

Screen the people who are selling the company according to their motivation. "Divorce, death and despair" are the leading catalysts of business sales. Prospective buyers who fail to determine a seller's motives, values and expectations can waste significant time pursuing a deal that will never happen. Retain advisers and professionals to refine your bid presentation. In a competitive bidding situation, promoting your qualifications to the seller may enhance your credibility.

What's It Worth?

Sellers of middle-market businesses rarely know how to price their firms. Families privately own an estimated 90% of all companies. Family businesses are not required to follow the rigorous accounting standards set for public companies. When valuing a middle-market company, potential buyers must determine if it has enough operating income to cover its debt payments and if the risk-adjusted return on investment meets their expectations. They should also consider the owner's salary. Valuation based on discounted cash-flow analysis is another popular metric.

"Many acquisitions fail principally because the due diligence was inept."

For manufacturing companies, a preferred valuation is a multiple of earnings before interest and taxes. Buyers commonly expect to recover the cost of acquiring a profitable manufacturing business in three to five years. A five-year payback period would translate to a 20% average annual return on investment.

"The seller sets the price and the buyer sets the terms."

Bidders also look at book value to set the price of a business. The owner of a company with operating losses might sell it for book value, or assets minus liabilities. If a company has negative net worth, the seller might accept a price of $1 if the buyer agrees to assume accounts payable and other debts. Bidders may need an appraiser to determine the purchase value of a troubled business. If creditors force a seller into bankruptcy, they can use the Uniform Fraudulent Transfer Act to challenge a bid as unfairly low in order to seize assets.

"Business owners are highly motivated to pay the least amount of corporate taxes possible."

Valuation techniques also differ based on what is being sold. In an asset sale, the seller of a Subchapter C corporation (an organization taxed under Subchapter C of the U.S. tax code) is taxed at the corporate level and then faces taxes a second time on the corporation's proceeds when they are distributed. In many sales, the selling price is likely to reflect the transaction's tax impact. In the disposal of a Subchapter S firm, the seller is taxed only once.

"The extent to which they stretch to minimize tax liability runs the gamut from legitimate to marginal to illegitimate."

Other important factors that determine a company's valuation are its real estate assets and any debt obligations the buyer would assume. If the buyer is purchasing inventory only, then the price should be discounted to cover for the possibility of product malfunctions.

Show Me the Money

Financing for business purchases can come from financial services providers that do asset-based lending, mortgage lending, inventory financing and insurance underwriting. Bankers feel most comfortable betting on niche companies with conservative balance sheets. Bidders are more likely to obtain funding if they have good reputations and focused business plans, and if they intend to invest their own money in the acquisition.

Negotiations of purchase terms vary by bidder. Individual investors with management experience, investor groups with no operational expertise, and a synergy-seeking competitor will take vastly different approaches to negotiation. In negotiations, bidders should present carefully prepared offers, communicate professionally and remain open to the seller's suggestions. Even if the discussions go poorly, working hard to maintain the relationship may pay off in the long run. If you reach an impasse, adjourn and agree to meet another time. The key is to remain committed to the negotiating process.

About the Author

Russell Robb is a 20-year veteran of the mergers and acquisitions business. He has sold three businesses of his own and has provided investment banking and corporate finance advice to a wide range of middle-market companies. He is the author of two books, *Buying Your Own Business* and, from the Streetwise series, *Selling Your Business.*