20 Things to Consider Before You Buy a Pre-Existing Business

Benefits:

- Typically less risky
- You take over an operating that is already generating cash flow and profits
- Established customer base and reputation
- Established employees and procedures
- You may have access to patents/copyrights

Downside:

- Typically more costly
- It's easier to get financing generally
- Obsolete inventory
- Uncooperative employees
- Outdated distribution methods.

Is this the right decision for you?

a. Choose the right type of business for you.
b. Is your family supportive?
c. Do you understand the industry
d. Size of business you are looking for, in terms of employees, number of locations, sales.
e. Assess labor pool and costs of doing business in that area
f. Contact a business broker
    - Fortis Group in Bozeman
      Contact: Christopher Gregory, christopher@fortisgrp.com, 406.404.8810
    - Commission is typically 5 to 10 percent of the purchase price. **A Closer Look**
g. Put together your "acquisition team" including your banker, accountant and attorney.

20 Things to Consider

1. **Inventory.**
    - How old is it? What is its quality? What condition is it in? Keep in mind that you don't have to accept the value of this inventory: it is subject to negotiation.
2. **Furniture, fixtures, equipment and building.**
    - Get a list from the seller that includes the name and model number of each piece of equipment. Then determine its present condition, market value when purchased versus present market value, and whether the equipment was purchased or leased.

- Determine what modifications you'll have to make to the building or layout in order for it to suit your needs.
- Cost of Expenses spreadsheet

3. **Copies of all contracts and legal documents.**
    - Contracts would include all lease and purchase agreements, distribution agreements, subcontractor agreements, sales contracts, union contracts, employment agreements and any other instruments used to legally bind the business, Articles of incorporation, registered trademarks, copyrights, patents, etc.
    - Real estate lease, you need to find out if it is transferable, how long it runs, its terms, and if the landlord needs to give his or her permission for assignment of the lease.
4. **Incorporation.**
    - If the company is a corporation, check to see what state it's registered in and whether it's operating as a foreign corporation within its own state.
5. **Tax returns for the past five years.**
    - Many small business owners make use of the business for personal needs.
6. **Financial statements for the past five years.**
    - Evaluate these statements, including all books and financial records, and compare them to their tax returns. This is especially important for determining the earning power of the business. The sales and operating ratios should be examined with the help of an accountant familiar with the type of business you are considering. The operating ratios should also be compared against industry ratios.
7. **Sales cycles.**
8. **Complete list of liabilities.**
    - Capital equipment or accounts receivable as collateral to secure short-term loans, if there are liens by creditors against assets, lawsuits, or other claims. Your accountant should also check for unrecorded liabilities such as employee benefit claims, out-of-court settlements being paid off.
9. **All accounts receivable.**
    - Break them down by 30 days, 60 days, and 90 days and beyond. Checking the age of receivables is important because the longer the period they are outstanding, the lower the value of the account. You should also make a list of the top 10 accounts and check their creditworthiness. If the clientele is creditworthy and the majority of the accounts are outstanding beyond 60 days, a stricter credit collections policy may speed up the collection of receivables.
10. **All accounts payable.**
    - Like accounts receivable, accounts payable should be broken down by 30 days, 60 days, and 90 days. This is important in determining how well cash flows through the company. On payables more than 90 days old, you should check to see if any creditors have placed a lien on the company's assets.
11. **Debt disclosure.**
    - This includes all outstanding notes, loans and any other debt to which the business has agreed. See, too, if there are any business investments on the books that may have taken place outside of the normal area. Look at the level of loans to customers as well.
12. **Merchandise returns.**

- Does the business have a high rate of returns? Has it gone up in the past year? If so, can you isolate the reasons for returns and correct the problem(s).

13. **Marketing strategies and collateral.**
14. **Price checks.**
    - Evaluate current price lists and discount schedules for all products, the date of the last price increase, and the percentage of increase.
15. **Industry comparison.**
    - You should analyze the industry as well as the specific market segments of the business targets. You need to find out if sales in the industry, as well as in the market segment, have been growing, declining, or have remained stagnant. This is very important to determine future profit potential.
16. **Reputation of the business.**
    - Check for reviews
    - Ask the community
17. **Seller-customer ties.**
18. **Inflated salaries.**
19. **List of current employees and organizational chart.**
    - Management practices.
    - Examine any management-employee contracts that exist aside from a union agreement, as well as details of employee benefit plans; profit-sharing; health, life and accident insurance; vacation policies; and any employee-related lawsuits against the company.
20. **Insurance.**
    - Some businesses are underinsured and operating under potentially disastrous situations in case of fire or a major catastrophe. If you come into an underinsured operation, you could be wiped out if a major loss occurs.

Determining a Fair Price

- **Economy: Expanding or Recession?**
- **Motivation**
- **Equation/Multipliers**
- **Book Values**
- **Return on Investment**
- **Capitalized Earnings**
- **Intangible Value**

Alternatives to Cash

Short on cash? Try these alternatives for financing your purchase of an existing business:

1. **Use the seller's assets.**
    - As soon as you buy the business, you'll own the assets--so why not use them to get financing now? Make a list of all the assets you're buying (along with any attached liabilities), and use it to approach banks, finance companies and factors (companies that buy accounts receivable).

2. **Find a partner.**
    - If you can't afford the business yourself, try going co-op--buying with someone else that is. To find a likely co-op buyer, ask the seller for a list of people who were interested in the business but didn't have enough money to buy. (Be sure to have your lawyer write up a partnership agreement, including a buyout clause, before entering into any partnership arrangement.)
3. **Use an Employee Stock Ownership Plan (ESOP).**
    - ESOPs offer you a way to get capital immediately by selling stock in the business to employees. If you sell only non-voting shares of stock, you still retain control. By offering to set up an ESOP plan, you may be able to get a business for as little as 10 percent of the purchase price.
4. **Lease with an option to buy.**
    - Some sellers will let you lease a business with an option to buy. You make a down payment, become a minority stockholder and operate the business is if it were your own.
5. **Assume liabilities or decline receivables.**
    - Reduce the sales price by either assuming the business's liabilities or having the seller keep the receivables.

Common Mistakes to Avoid

- **Don't be too anxious when you're looking to buy a business.**
- **Buying on price.**
    - Buyers don't take into account ROI. If you're going to invest $20,000 in a business that returns a five-percent net, you're better off putting your money in stocks and commodities, the local S&L, or municipal bonds. Any type of intangible security is going to produce more than five percent.
- **Cash shortage.**
    - Some buyers use all their cash for the down payment on the business, though cash management in the startup phase of any business, new or existing, is fundamental to short-term success. They fail to predict future cash flow and possible contingencies that might require more capital. Further, there has to be some revenue set aside for building the business via marketing and PR efforts. So, if you have $20,000 to invest, make sure you don't invest the entire amount. Keep some of the capital. Though figures vary from industry to industry, a common contingency is 10 percent. Additionally, you may want to set aside a sum that you regard as your working capital, which in a number of businesses is enough to cover about three months' worth of expenses.
- **Buying all the receivables.**
    - It generally makes good sense to buy the receivables, except when they are 90 or 120 days old, or older. Too often buyers take on all the receivables, even those beyond 90 days. This can be very risky because the older the account, the more difficult it'll be to collect against. You can protect yourself by having the seller warrant the receivables; what's not collectible can be charged back against the purchase price of the business. For receivables beyond 90 days, give those to the owner, and see if he or she can collect.
- **Failure to verify all data.**

- Most business buyers accept all the information and data given to them by the seller at face value, without the verification of their own accountant (preferably a CPA, who can audit financial statements). Most sellers want to get their cash out of the business as soon as possible, and buyers frequently allow them to take all the quick assets such as receivables, cash, and equipment inventories, and sometimes bring in equipment. The seller talks the buyer into virtually anything, knowing that the buyer wants the business badly.

- **Heavy payment schedules.**
    - Novice business owners often overestimate their revenue during the first year and take on unduly large payments to finance the buyout. Generally, however, revenue rarely pans out. During the first year of any operation, the owner experiences numerous non-recurring costs such as equipment failures, employee turnover, etc. For this reason, it makes sense to have a payment schedule that begins fairly light, then gets progressively heavier. This is something that can be negotiated with a seller and should not be difficult to arrange.
- **Treating the seller unfairly.**
- **Discuss Transition Time**