7 Buying an Existing Business

Goodwill, like a good name, is gotten by many actions, and lost by one. —Lord Jeffrey

There is nothing so easy to learn as experience and nothing so hard to apply. —Josh Billings

On completion of this chapter, you will be able to:

1 Understand (A) the advantages and (B) the disadvantages of buying an existing business.
2 Define the steps involved in the right way to buy a business.
3 Explain the process of evaluating an existing business.
4 Describe the various techniques for determining the value of a business.
5 Understand the seller’s side of the buyout decision and how to structure the deal.
6 Understand how the negotiation process works and identify the factors that affect it.
Rather than launch their own businesses or purchase a franchise, some entrepreneurs opt for a more direct route to business ownership: They buy an existing business. In fact, in a typical year, more than 500,000 businesses are bought and sold. Each circumstance is unique, but the process of evaluating a potential business acquisition is not. The “due diligence” process that involves analyzing and evaluating an existing business for possible purchase is no less time consuming than developing a comprehensive business plan for a start-up. Done correctly, this due diligence process will reveal both the negative and the positive aspects of an existing business. Skipping or glossing over the due diligence process is a huge mistake because a business that looks good on the surface may have serious flaws at its core. Investigating a business to discover its real condition and value requires time, dedication, and, as the name implies, diligence, but the process is worthwhile because it can prevent an entrepreneur from purchasing a business destined for failure. When considering purchasing a business, the first rule is, “Do not rush into a deal.” Taking shortcuts when investigating a potential business acquisition almost always leads to nasty—and expensive—surprises. Prospective buyers must be sure that they discover the answers to the following fundamental questions:

- Is the right type of business for sale in a market in which you want to operate?
- What experience do you have in this particular business and the industry in which it operates? How critical to your ultimate success is experience in the business?
- What is the company’s potential for success?
- What changes will you have to make—and how extensive will they be—to realize the business’s full potential?
- What price and payment method are reasonable for you and acceptable to the seller?
- Will the company generate sufficient cash to pay for itself and leave you with a suitable rate of return on your investment?
- Should you be starting a business and building it from the ground up rather than buying an existing one?

**Buying an Existing Business**

**The Advantages of Buying an Existing Business**

Over the next decade, entrepreneurs looking to buy existing businesses will have ample opportunities to consider. A recent study by PricewaterhouseCoopers reports that 50 percent of existing company owners plan to sell their businesses within the next decade. Those who purchase an existing business may reap the following benefits.

**A Successful Existing Business May Continue to Be Successful**

Purchasing a thriving business at an acceptable price increases the likelihood of success. The previous management team already has established a customer base, built supplier relationships, and set up a business system. The customer base inherited in a business purchase can carry an entrepreneur while he or she studies how the business has become successful and how to build on that success. Time spent learning about the business and its customers before introducing changes will increase the probability that any changes made will be successful. The new owner’s objective should be to make those modifications that will attract new customers while retaining the company’s existing customers. Maintaining the proper balance of old and new is not an easy task, however.

**An Existing Business May Already Have the Best Location**

When the location of the business is critical to its success (as is often the case in retailing), it may be wise to purchase a business that is already in the right place. Opening in a second-choice location and hoping to draw customers may prove fruitless. In fact, an existing business’s biggest asset may be its prime location. If this advantage cannot be matched by other locations, an entrepreneur may have little choice but to buy a business instead of launching one. As part of its expansion plans, one fast food chain recently purchased a smaller chain, not so much for its customer base or other assets as for its prime store locations.
Employees and Suppliers Are Established An existing business already has experienced employees who can help the new owner through the transition phase. Experienced employees enable a company to continue to earn money while a new owner learns the business. Many new owners find it valuable to solicit ideas from employees about methods for increasing sales or reducing costs. In many cases, the previous owner may not have involved employees in this fashion and never gained the advantages found in the wisdom of employees. Few people know a job better than the people who are performing it.

In addition, an existing business has an established set of suppliers with a history of business dealings. Those vendors can continue to supply the business while the new owner investigates the products and services of other suppliers. However, suppliers may want to ensure that the new owners are capable of running the business successfully.

When Reid Chase and Scott Semel purchased Cole-Kramer Imports, a high-end candy company that imported and distributed Swiss mint candies, they invested $100,000 of their own money and borrowed the remaining $500,000. The new owners soon discovered that the previous owners had no written contracts with its key suppliers. When Chase and Semel attempted to negotiate a formal supply contract, their suppliers refused, insisting that the new owners first prove their ability to operate the candy company successfully. Chase and Semel expanded their product line beyond mints and landed several major retail accounts in the process. Convinced that the new owners could manage the business, the Swiss suppliers forged long-term contracts with Cole-Kramer Imports, whose sales climbed from $600,000 to more than $40 million in just seven years.²

Equipment Is Installed and Productive Capacity Is Known Acquiring and installing new equipment exerts a tremendous strain on a fledgling company’s financial resources. In an existing business, a potential buyer can determine the condition of the plant and equipment and its capacity before buying. The previous owner may have established an efficient production operation through trial and error, although the new owner may need to make modifications to improve it. In many cases, entrepreneurs can purchase physical facilities and equipment at prices significantly below their replacement costs.

Inventory Is in Place and Trade Credit Is Established The proper amount of inventory is essential to both controlling costs and generating adequate sales volume. If a business has too little inventory, it will not have the quantity and variety of products it needs to satisfy customer demand. However, if a business has too much inventory, it is tying up excessive capital unnecessarily, thereby increasing costs and reducing profitability. Owners of successful established businesses have learned the proper balance between these extremes. In addition, previous owners have established trade credit relationships with vendors that can benefit the new owner. No supplier wants to lose a good customer.

The New Business Owner Hits the Ground Running Entrepreneurs who purchase existing businesses avoid the time, costs, and energy required to launch a new business. The day they take over an ongoing business is the day their revenues begin. Entrepreneurs who buy existing successful businesses do not have to invest a lifetime building a company to enjoy its success.

Lania D’Agostino, a sculptor who moved from Michigan to Baltimore, Maryland, to attend the Maryland Institute College of Art, began working at Mannequin Service Company, a business that specializes in designing and creating custom mannequins for museums, special events, and entertainment companies. D’Agostino spent three years learning the business before buying it from the founder, who had built the business by making display mannequins for retail stores such as Sears. After buying the business,
D’Agostino shifted the strategy to focus on highly specialized, artistic projects. A big break came for the company when D’Agostino landed a contract with Lucasfilm Inc., the company that produced the Star Wars trilogies, to provide mannequins depicting the characters from the films, from Obi-Wan Kenobi and Princess Leia to Padme and Chewbacca, the Wookiee. Requiring as many as 80 hours to create, the company’s character mannequins sell for $7,500 and up.³

**The New Owner Can Use the Experience of the Previous Owner** Even if the previous owner is not around after the sale, the new owner will have access to all of the business’s records to guide him or her until he or she becomes acclimated to the business and the local market. The new owner can trace the impact on costs and revenues of the major decisions that the previous owner made and can learn from his or her mistakes and profit from his or her achievements. In many cases, the previous owner spends time with the new owner during the transition period, giving the new manager the opportunity to learn about the policies and procedures in place and the reasons for them. Previous owners also can be extremely helpful in unmasking the unwritten rules of business in the area, including critically important intangibles such as how to keep customers happy and whom one can trust and cannot trust. After all, most owners who sell out want to see the buyer succeed in carrying on their businesses.

**Easier Financing** Attracting financing to purchase an existing business often is easier than finding the money to launch a company from scratch. Many existing businesses already have established relationships with lenders, which may open the door to financing through traditional sources such as banks. As we will see later in this chapter, many business buyers also have access to another important source of financing: the seller.

**It’s a Bargain** Some existing businesses may be real bargains. The current owners may need to sell on short notice, which may lead them to sell the business at a low price. Many small companies operate in profitable but tiny niches, making it easy for potential buyers to overlook them. The more specialized a business is, the greater the likelihood is that a buyer can find a bargain. If special skill or training is required to operate a business, the number of potential buyers will be significantly smaller. If the seller wants a substantial down payment or the entire selling price in cash, few buyers may qualify; however, those who do may be able to negotiate a good deal.

**Disadvantages of Buying an Existing Business**

**It’s a “Loser”** A business may be for sale because it is struggling and the owner wants out. In these situations, a prospective buyer must be wary. Business owners sometimes attempt to disguise the facts and employ creative accounting techniques to make the company’s financial picture appear much brighter than it really is. Few business sellers honestly state “It’s losing money” as the reason for putting their companies up for sale. If there is one area of business where the maxim “let the buyer beware” still prevails, it is in the purchase of an existing business. Any buyer unprepared to do a complete and thorough analysis of a business may be stuck with a real loser.

Although buying a money-losing business is risky, it is not necessarily taboo. If an analysis of a company shows that it is poorly managed or suffering from neglect, a new owner may be able to turn it around. However, a prospective buyer who does not have well-defined plan for improving a struggling business should not consider buying it.

Andrew Taitz spent three years searching for the right business to buy. After screening many options, Taitz and a group of investors purchased Union City Body Company in Union City, Indiana, a bankrupt division of General Motors that made bodies for delivery trucks. Renamed Workhorse Custom Chassis, the company has expanded its product line to make the frames that support the wheels, engine, fuel systems, brakes, and suspension for motor homes and delivery trucks. “I saw an excellent opportunity to
turn a low-tech, nuts-and-bolts product into a growth market,” says Taitz. Taitz and his
investors spent $100 million, including the initial purchase price, revamping the entire
plant to make it more flexible, efficient, and ergonomically sound. Today, Workhorse
builds customized frames from more than 3,500 parts one right after another on the
same assembly line. Taitz also implemented a host of changes in the company’s man-
agement style, cutting the workweek to four 10-hour days (from five 8-hour days) and
allowing employees to work in small teams and to practice job rotation. Taitz also set
up a Web site that allows customers to design their own chassis online, and the com-
pany’s FasTrack program delivers a chassis to a customer in just four weeks. The result
is that Workhorse’s revenues exceed $300 million per year, and the company is now
profitable.4

The Previous Owner May Have Created Ill Will Just as ethical, socially responsible
business dealings create goodwill for a company, improper business behavior creates ill
will. The due diligence process may reveal that customers, suppliers, creditors, or
employees may have extremely negative feelings about a company’s reputation because of
the unethical actions of its current owner. Business relationships may have begun to
deteriorate, but their long-term effects may not yet appear in the business’s financial
statements. Ill will can permeate a business for years.

Employees Inherited with the Business May Not Be Suitable Previous managers
may have kept marginal employees because they were close friends or because they
started with the company. A new owner, therefore, may have to make some very
unpopular termination decisions. For this reason, employees often do not welcome a
new owner because they feel threatened by change. Some employees may not be able to
adapt to the new owner’s management style, and a culture clash may result. If the due
diligence efforts reveals that existing employees are a significant cause of the problems
a business faces, the new owner will have no choice but to terminate them and make
new hires.

The Business Location May Have Become Unsatisfactory What was once an ideal
location may have become obsolete as market and demographic trends change. Large
shopping malls, new competitors, or highway re-routings can spell disaster for small retail
shops. Prospective buyers should always evaluate the existing market in the area
surrounding an existing business as well as its potential for expansion. Buyers must
remember that they are buying the future of a business, not merely its past. A location in
decline may never recover. If business success is closely linked to a good location,
acquiring a business in a declining area or where demographic trends are moving
downward is not a good idea. The value of the business will erode faster than the
neighborhood surrounding it.

Equipment and Facilities May Be Obsolete or Inefficient Potential buyers
sometimes neglect to have an expert evaluate a company’s facilities and equipment
before they purchase it. Only later do they discover that the equipment is obsolete and
inefficient and that the business may suffer losses from excessively high operating
costs. The equipment may have been well suited to the business they purchased, but not
to the business they want to build. Modernizing equipment and facilities is seldom
inexpensive.

Change and Innovation Are Difficult to Implement It is easier to plan for change
than it is to implement it. Methods, policies, and procedures the previous owner used in a
business may have established precedents that a new owner finds difficult to modify.
Customers may resist changes the new owner wants to make to the business.
When Charles Usry purchased the landmark Esso Club in Clemson, South Carolina, he quickly discovered that the bar’s regulars were skeptical of the changes he had planned to implement. Originally begun as a gas station/grocery store in 1935, the Esso Club eventually was converted into a bar and became a legendary destination for sports fans when *ESPN the Magazine* named it one of the top must-visit locations for sports fans. When Usry announced his plans to upgrade the décor of the no-frills, cinder-block building and to transform the club into a sports bar, long-time customers and loyal visitors howled in protest. “It’s the ambiance of the place that really does it for us,” says David Ford, an Esso Club regular, only half-joking. “The closest thing [to the Esso Club] is Cheers,” says another long-time customer.5

Reversing a downward slide in an existing company’s sales can be just as difficult as implementing change. Making changes that bring in new business and convince former clients to return can be an expensive, time-consuming, and laborious process. A business buyer must be aware of the effort, time, and expense it takes to change the negative momentum of a business in trouble. Before a business can go forward, it must stop going backward.

**Inventory May Be Outdated or Obsolete** Inventory is valuable only if it is salable. Smart buyers know better than to trust the inventory valuation on a firm’s balance sheet. Some of it may actually appreciate in value in periods of rapid inflation, but inventory is more likely to depreciate. A prospective buyer must judge inventory by its market value, not by its book value.

**Accounts Receivable May Be Worth Less Than Face Value** Like inventory, accounts receivable rarely are worth their face value. The prospective buyer should age the company’s accounts receivable (a breakdown of accounts 30, 60, 90, and 120 days old and beyond) to determine their collectibility. The older the receivables are, the less likely they are to be collected, and, consequently, the lower their value is. Table 7.1 shows a simple but effective method of evaluating accounts receivable once they have been aged, using the estimated probabilities of collecting the accounts.

### TABLE 7.1 Valuing Accounts Receivable

A prospective buyer asked the current owner of a business about the value of her accounts receivable. The owner’s business records showed $101,000 in receivables. But when the prospective buyer aged the accounts and multiplied them by his estimated collection probabilities, he discovered their real value:

<table>
<thead>
<tr>
<th>Age of Accounts (days)</th>
<th>Amount ($)</th>
<th>Collection Probability (%)</th>
<th>Value ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0–30</td>
<td>40,000</td>
<td>95</td>
<td>38,000</td>
</tr>
<tr>
<td>31–60</td>
<td>25,000</td>
<td>88</td>
<td>22,000</td>
</tr>
<tr>
<td>61–90</td>
<td>14,000</td>
<td>70</td>
<td>9,800</td>
</tr>
<tr>
<td>91–120</td>
<td>10,000</td>
<td>40</td>
<td>4,000</td>
</tr>
<tr>
<td>121–150</td>
<td>7,000</td>
<td>25</td>
<td>1,750</td>
</tr>
<tr>
<td>151–plus</td>
<td>5,000</td>
<td>10</td>
<td>500</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>101,000</strong></td>
<td></td>
<td><strong>78,050</strong></td>
</tr>
</tbody>
</table>

Had he blindly accepted the seller’s book value of these accounts receivable, this prospective buyer would have overpaid nearly $25,000 for them!
When one buyer was considering purchasing an existing business, his research showed that a substantial volume of accounts receivable were well past due. Further investigation revealed that the company and its largest customer were locked in a nasty dispute over outstanding account balances. The buyer decided to withdraw his preliminary offer.

**The Business May Be Overpriced** Each year, many people purchase businesses at prices far in excess of their value, which can impair the companies’ ability to earn a profit and generate a positive cash flow. If a buyer accurately values a business’s accounts receivable, inventories, and other assets, he or she will be in a better position to negotiate a price that will allow the business to be profitable. Making payments on a business that was overpriced is a millstone around the new owner’s neck, making it difficult to keep the business afloat.

Although most buyers do not realize it, the price they pay for a company typically is not as crucial to its continued success as the terms on which they make the purchase. Of course, wise business buyers will try to negotiate a fair and reasonable price, but they are often equally interested in the more specific terms of the deal. For instance, how much cash they must pay out and when, how much of the price the seller is willing to finance and for how long, the interest rate at which the deal is financed, and other such terms can make or break a deal from the buyer’s perspective. A buyer’s primary concern is making sure that the terms of the deal do not endanger the company’s future financial health and that they preserves the company’s cash flow.

**The Steps in Acquiring a Business**

Buying an existing business can be risky if approached haphazardly. Studies show that more than 50 percent of all business acquisitions fail to meet the buyer’s expectations. To avoid costly mistakes, an entrepreneur-to-be should follow a logical, methodical approach:

- Analyze your skills, abilities, and interests to determine what kind(s) of businesses you should consider.
- Prepare a list of potential candidates.
- Investigate those candidates and evaluate the best one(s).
- Explore financing options.
- Ensure a smooth transition.

**Analyze Your Skills, Abilities, and Interests**

The first step in buying a business is not searching out potential acquisition candidates. Every entrepreneur considering buying a business should begin by conducting a self-audit to determine the ideal business for him or her. The primary focus is to identify the type of business you will be happiest and most successful owning. Consider, for example, the following questions:

- What business activities do you enjoy most? Least? Why?
- Which industries or markets offer the greatest potential for growth?
- Which industries interest you most? Least? Why?
- What kind of business do you want to buy?
- What kinds of businesses do you want to avoid?
- What do you expect to get out of the business?
- How much time, energy, and money can you put into the business?
- What business skills and experience do you have? What skills and experience do you lack?
- How easily can you transfer your skills and experience to other types of businesses? In what kinds of businesses would that transfer be easiest?
- How much risk are you willing to take?
Are you willing and able to turn around a struggling business?
What size company do you want to buy?
Is there a particular geographic location you desire?

Answering these and other questions beforehand will allow you to develop a list of criteria a company must meet to become a purchase candidate. Addressing these issues early in the process will also save a great deal of time, trouble, and confusion as you wade through a multitude of business opportunities. The better you know yourself and your skills, competencies, and interests, the more likely you will be to find and manage a successful business.

Prepare a List of Potential Candidates

Once you know what your goals are for acquiring a business, you can begin your search. Do not limit yourself to only those businesses that are advertised as being “for sale.” In fact, the hidden market of companies that might be for sale but are not advertised as such is one of the richest sources of top-quality businesses. Many businesses that can be purchased are not publicly advertised but are available either through the owners or through business brokers and other professionals. Although they maintain a low profile, these hidden businesses represent some of the most attractive purchase targets a prospective buyer may find.

When brothers Art and Allan McCraw, two enterprising college graduates, returned to their hometown, they approached the owners of B.W. Burdette and Sons, a local hardware store that had been founded by the current owners’ father 80 years earlier, about buying the business. The company was not listed for sale, but because they were familiar with the business, the McCravws knew that the current owners might be interested in selling. After several months of due diligence and negotiations, the young entrepreneurs closed the deal. They have since expanded the business to include two more locations, expanded its market reach, and increased its profitability many times over.

How can you tap into this hidden market of potential acquisitions? Typical sources include the following:

- Business brokers
- Bankers
- Accountants
- Investment bankers
- Industry contacts—suppliers, distributors, customers, insurance brokers, and others
- “Networking”—social and business contact with friends and relatives
- Knocking on the doors of businesses you would like to buy (even if they’re not advertised as being “for sale”)
- Trade associations
- Newspapers and trade journals listing businesses for sale

In recent years, the World Wide Web also has become an important tool for entrepreneurs looking to buy businesses. In the past, the market for businesses was highly fragmented and unstructured, making it difficult for entrepreneurs to conduct an organized, thorough search for companies that might meet their purchase criteria. Today, hundreds of business brokers have established Web sites that list thousands of companies for sale in practically every industry imaginable, enabling entrepreneurs to search the entire country for that perfect business from the comfort of their own homes. Using the Web, potential buyers can eliminate the companies that do not suit them and can conduct preliminary research on those that look most promising. The more opportunities an entrepreneur has to find and evaluate potential acquisitions, the greater the likelihood of finding a match that meets his or her criteria.
Investigate and Evaluate Candidate Businesses and Evaluate the Best One

Finding the right company requires patience. Although some buyers find a company after only a few months of looking, the typical search takes much longer, sometimes as much as two or three years. Once you have a list of prospective candidates, it is time to do your homework. The next step is to investigate the candidates in more detail:

- What are the company’s strengths? Weaknesses?
- Is the company profitable? What is its overall financial condition?
- What is its cash flow cycle? How much cash will the company generate?
- Who are its major competitors?
- How large is the customer base? Is it growing or shrinking?
- Are the current employees suitable? Will they stay?
- What is the physical condition of the business, its equipment, and its inventory?
- What new skills must you learn to be able to manage this business successfully?

Determining the answers to these and other questions addressed in this chapter will allow a prospective buyer to develop a list of the most attractive prospects and to prioritize them in descending order of attractiveness. This process also will make the task of valuing the business much easier.

When Mark Forst and his father decided to leave the corporate life and go into business for themselves, they knew that they wanted to buy an existing business rather than start their own. “We wanted a company that could use better marketing and service, one that we could take from the local to the national level,” says Forst. Forst spent weeks poring over the business listings in Fort Lauderdale newspapers and hired a business broker to help uncover potential purchase candidates. One day he noticed a listing in the newspaper for a business called Rip’s Uniforms that specialized in providing uniforms for postal workers. Forst and his father thought the asking price of $100,000 was reasonable, and they began researching the industry. Their research was encouraging. They discovered that the uniform supply industry had solid growth rates and that although a number of local uniform distributors were scattered across the United States, only five operated on a national level. Forst and his father began the due diligence process, talking with the small company’s owners, studying the industry, and interviewing the company’s vendors and its sole employee. They even conducted market research, talking with postal workers to glean ideas about how they could win them as customers and integrating what they learned into their business plan for the company. Their research of the company revealed that Rip’s Uniforms had much more debt and far less inventory than the current owners believed, but the Forsts still believed in the company’s potential. Using the information they had gathered, the Forsts purchased Rip’s Uniforms after they were able to whittle the purchase price down to just $10,000. They renamed the company A.M.E.’s Uniforms, and sales, which now top $3 million annually, are growing so fast that the company has made Inc. magazine’s list of the 500 fastest-growing small companies twice.6

Explore Financing Options

Placing a value on an existing business (a topic you will learn more about later in this chapter) represents a major hurdle for many would-be entrepreneurs. The next challenging task in closing a successful deal is financing the purchase. Although financing the purchase of an existing business usually is easier than financing a new one, some traditional lenders shy away from deals involving the purchase of an existing business. Those that are willing to finance business purchases normally lend only a portion of the value of the assets, and buyers often find themselves searching for alternative sources of funds. Fortunately, most business buyers have access to a ready source of financing: the seller.
Seller financing often is more flexible, faster, and easier to obtain than loans from traditional lenders.

Once a seller finds a suitable buyer, he or she typically will agree to finance anywhere from 25 to 80 percent of the purchase price. Usually, a deal is structured so that the buyer makes a sizeable down payment to the seller, who then finances a note for the balance. The buyer makes regular principal and interest payments over 5 to 10 years—perhaps with a larger balloon payment at the end—until the note is paid off. The terms and conditions of such a loan are a vital concern to both buyer and seller. They cannot be so burdensome that they threaten the company’s continued existence; that is, the buyer must be able to make the payments to the seller out of the company’s cash flow. At the same time, the deal must give the seller the financial security he or she is seeking from the sale. Defining reasonable terms is the result of the negotiation process between the buyer and the seller.

Tim Johnstone’s experience in conducting due diligence for his former employer gave him an advantage when he was considering buying Anywhere Shoe Company, a Seattle-based maker and distributor of professional footwear. Johnstone’s thorough analysis of the company revealed several factors that caused him concern, including a wrongful termination lawsuit filed by a former employee. Consequently, these discoveries caused him to assign a lower value to the business than the seller’s asking price. Johnstone’s offer included a “holdback” clause that allowed him to deduct from the purchase price the value of any undisclosed claims against Anywhere. To avoid paying off the seller at the expense of the security of the company’s financial future, he also stipulated that the payout the seller was to receive would be based on the company’s financial performance. Finally, Johnstone’s terms required the seller to finance 55 percent of the purchase price. Initially, the owner balked at the terms but agreed to them rather than risk losing a viable buyer. “If we had not used seller financing, the deal probably wouldn’t have come together,” says Johnstone. His foresight paid off when, 14 months after the purchase, he discovered that a customer had filed a lawsuit against the company before he had signed the contract to buy the business. “Having seller financing gives you some protection that you otherwise might not have,” says Johnstone. “It turned out to be the smartest thing I ever did.”

Ensure a Smooth Transition

Once the parties strike a deal, the challenge of making a smooth transition immediately arises. No matter how well planned the sale is, there are always surprises. For instance, the new owner may have ideas for changing the business—sometimes radically—that cause a great deal of stress and anxiety among employees and the previous owner. Charged with such emotion and uncertainty, the transition phase is always difficult and frustrating—and sometimes painful. To avoid a bumpy transition, a business buyer should do the following:

- Concentrate on communicating with employees. Business sales are fraught with uncertainty and anxiety, and employees need reassurance.
- Be honest with employees. Avoid telling them only what they want to hear. Share with the employees your vision for the business in the hope of generating a heightened level of motivation and support.
- Listen to employees. They have first-hand knowledge of the business and its strengths and weaknesses and usually can offer valuable suggestions for improving it.
- Consider asking the seller to serve as a consultant until the transition is complete. The previous owner can be a valuable resource, especially to an inexperienced buyer.

Table 7.2 describes 15 steps potential buyers should take to increase the probability that the businesses they buy are the right ones for them.
TABLE 7.2 Fifteen Steps to Buying the Company That’s Right for You

1. Make sure you shouldn’t be starting a company instead. You should have solid reasons for buying a company rather than starting one—and you should know what they are.
2. Determine the kind of business you want—and whether you’re capable of running it. This requires an unflinching assessment of your strengths, weaknesses, personality, and goals.
3. Consider the lifestyle you want. What are you expecting from the business? Money? Freedom? Flexibility?
4. Consider the location you want. What part of the country (or world) do you want to live in?
5. Reconsider lifestyle again. You may own this business for a long, long time; it had better be one you enjoy.
6. Cozy up to lenders in advance. Visit potential lenders long before you need to borrow any money. Develop a rapport with them.
7. Prepare to sell yourself to the seller. You’re buying their “baby,” and they’ll want to make sure you’re the right person.
8. Once you’ve defined the kind of business you’re after, find the right company. Three major sources of potential candidates are (1) the network of business people and advisers in the area, (2) business brokers specializing in companies of the size or type you want to buy, and (3) businesses that technically are not for sale but are very attractive.
9. Choose the right seller. Is he or she honest? What’s the real reason he or she is selling the business?
10. Do your research before agreeing to a price. Ask lots of questions and get the facts to help you estimate the company’s value.
11. Make sure your letter of intent is specific. It should establish deadlines, escape clauses, payment terms, confidentiality, and many other key issues.
12. Don’t skimp on due diligence. Don’t believe everything you see and hear; a relentless investigation will show whether the seller is telling the truth. Not all of them are.
13. Be skeptical. Don’t fall in love with the deal; look for reasons not to buy the company.
14. Don’t forget to assess the employees. You’re not just buying a company; you’re also buying the people who go with it.
15. Make sure the final price reflects the company’s real value. Don’t lower your chances of success by paying too much for the business.


Buying Dad’s Business

Brian Schraff’s father started an advertising agency for technology companies in 1976, and Brian joined the company after graduating from college in 1982. In 1996, Brian and a co-worker, Rick Roelofs, approached the elder Schraff with an offer to buy the company. “We have a completely different management philosophy in terms of the way we want to fund and capitalize the business and grow it,” they told him. Their idea for increasing the company’s revenue was to create a variety of services—from public relations to Internet services—around each client, which would require an investment in technology and in staff. The approach was a far cry from the business philosophy Schraff’s father employed: keep costs low.

Because Schraff’s father really had not wanted to sell the business, the young men knew they had to work hard if they were going to close the deal. Their proposal included seller financing; they would make an initial down payment and then pay Schraff’s father the balance of the purchase price over several years out of the company’s cash flow. The elder Schraff wanted to be sure that the company would remain financially sound enough to make all of the future payments. In addition, says Brian, “my Dad was like any other entrepreneur.
He's got a lot of pride, and he had built something really great. So it was difficult for him to let go of that.”

As the parties began negotiating the sale of the business, it became apparent that one of the biggest stumbling blocks was the value of the business. “For us, it wasn’t an emotional issue,” recalls Brian. “It was ‘What would it cost us to start this thing up ourselves?’ As founder, my father had a lot of blood, sweat, and tears in the agency. He [believed] that the market price should me much more—at least 100 percent more—than we thought it should be.”

Brian, his father, and Roelofs went on a retreat to try to come to an agreement over the sale of the company. Brian had received some shares of ownership in the company, and that was the key to making a deal that was acceptable to everyone. “It came down to my saying, ‘I want out of the company. I want to sell my shares back to you for the price you want me to buy your shares for.’ Once my father said, ‘There’s no way I would pay you that for your shares,’ we were able to come back with, ‘What would you pay me, and why wouldn’t that be a good price for me to pay you?’”

With buyers and seller having come to an agreement on price, the deal moved forward. Brian and Roelofs made Brian’s father chief financial officer of the new company and began to make the changes they had envisioned for the agency. “It really became a team effort to make sure that the transition was working,” says Brian. Today, Brian’s father serves as a high-level account manager for the company’s technology clients, but he no longer is involved in the management of the company on a daily basis. Brian and Roelofs have increased the agency’s annual billings to more than $5 million since buying it.

In hindsight, Brian realizes that he should have conducted the deal to buy the agency from his father differently, in particular, taking steps to remove some of the emotion from the process. Buying a business is difficult enough, but the difficulty is compounded when a father–son relationship is involved.

1. Evaluate the way in which Brian Schraff went about buying his father’s business. What did he do right? What did he do wrong?
2. Work with a team of your classmates to develop a list of recommendations that would have made the process go faster and more smoothly. Write a brief report (no more than one page) summarizing your recommendations and the logic behind them.


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**Evaluating an Existing Business—The Due Diligence Process**

When evaluating an existing business, a buyer can quickly feel overwhelmed by the tremendous number and complexity of the issues involved. Therefore, a smart buyer will assemble a team of specialists to help investigate a potential business opportunity. This team is usually composed of a banker, an accountant familiar with the particular industry, an attorney, and perhaps a small business consultant or a business broker. The cost of assembling a team can range from $3,000 to $20,000, but most buyers agree that using a team significantly lowers the likelihood of making a bad purchase. Because making a bad purchase will cost many times the cost of a team of experts, most buyers see it as a wise investment. It is important for a buyer to trust the members of the business evaluation team. With this team assembled, the potential buyer is ready to explore the business opportunity by examining five critical areas:

1. Why does the owner want to sell?
2. What is the physical condition of the business?
3. What is the potential for the company’s products or services?
4. What legal aspects should be considered?
5. Is the business financially sound?

Evaluating these five areas of a business is known as performing due diligence. A prospective buyer should never consider purchasing a business without conducting the necessary due diligence to learn about the strengths, weaknesses, opportunities, and threats facing the company. “There are so many ugly stories,” explains Robert Strang, president of Strang Hayes Consulting, a firm that specializes in helping prospective buyers through the due diligence process. Strang Hayes discovered that the CEO of a company that one of its

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**LEARNING OBJECTIVES**

3. Explain the process of evaluating an existing business.

**due diligence**

the process of investigating the details of a company that is for sale to determine the strengths, weaknesses, opportunities, and threats facing it.
clients was considering purchasing had hidden five sexual harassment lawsuits that had been filed against him. Another search revealed that the business another buyer was considering purchasing had been banned from doing business in Florida, which was a major market for the prospective buyer. The message is clear: Those buyers who neglect thorough due diligence do so at their own peril.

**Why Is The Business for Sale?**

Every prospective business buyer should investigate the real reason the business owner wants to sell. A study by DAK Group and Rutgers University found that the most common reason that owners of small businesses cite for selling their companies is to reduce the risk of having most of their personal assets tied up in their businesses (see Figure 7.1). Their goal is to cash out their business investments and diversify into other types of assets. Many owners tell buyers that they have become bored or burned out and want to move on to other business ventures, but is that really the case? Note that market competition and external pressures are the next-most-common reasons owners give for selling their companies.

Smart business buyers know that the biggest and most unpleasant surprises can crop up outside the company’s financial records and may never appear on the spreadsheets designed to analyze a company’s financial position. For instance, a business owner might be looking to sell his or her business because a powerful new competitor is about to move into the market, a major highway rerouting will cause customer traffic to evaporate, the lease agreement on the ideal location is about to expire, or the primary customer base is declining. Every prospective buyer should investigate thoroughly any reason a seller gives for wanting to sell a business.

Businesses do not last forever, and smart entrepreneurs know when the time has come to sell. Some owners consider their behavior ethical only if they do not make false or misleading statements. Buyers should not expect to get a full disclose of the whole story behind the reasons for a business being offered for sale. In most business sales, the buyer bears the responsibility of determining whether the business is a good value. The best way to do that is to get out into the local community, talk to people, and ask a lot of questions. Visiting local business owners may reveal general patterns about the area and its overall vitality. The local Chamber of Commerce also may have useful information. Suppliers, customers, and even competitors may be able to shed light on why a business is up for sale. By combining this information with an analysis of the company’s financial records, a potential buyer should be able to develop a clear picture of the business and its real value.

**FIGURE 7.1**

Reasons Business Owners Plan to Sell Their Companies

*Source: DAK Group and Whitcomb Center for Research and Financial Services at Rutgers University.*

![Figure 7.1: Reasons Business Owners Plan to Sell Their Companies](image-url)
The Condition of the Business

What Is the Physical Condition of the Business? A prospective buyer should evaluate the business’s assets to determine their value. Are they reasonably priced? Are they obsolete? Will they need to be replaced soon? Do they operate efficiently? The potential buyer should check the condition of both the equipment and the building. It may be necessary to hire a professional to evaluate the major components of the building—its structure and its plumbing, its electrical, and heating, and cooling systems, and other elements. Unexpected renovations are rarely inexpensive or simple and can punch a gaping hole in a buyer’s financial plans.

How fresh is the company’s inventory? Is it consistent with the image the new owner wants to project? How much of it would the buyer have to sell at a loss? A potential buyer may need to get an independent appraisal to determine the value of the company’s inventory and other assets because the current owner may have priced them far above their actual value. These items typically comprise the largest portion of a business’s value, and a potential buyer should not accept the seller’s asking price blindly. Remember: Book value is not the same as market value. Usually, a buyer can purchase equipment and fixtures at substantially lower prices than book value. Value is determined in the marketplace, not on a balance sheet.

Other important factors that the potential buyer should investigate include the following:

Accounts receivable. If the sale includes accounts receivable, the buyer should check their quality before purchasing them. How creditworthy are the accounts? What portion of them is past due? How likely is it they can be collected? By aging the accounts receivable, a buyer can judge their quality and determine their value. (Refer to Table 7.1).

Lease arrangements. Is the lease included in the sale? When does it expire? What restrictions does it have on renovation or expansion? The buyer should determine beforehand what restrictions the landlord has placed on the lease and negotiate any change prior to purchasing the business.

Business records. Well-kept business records can be a valuable source of information and can tell a prospective buyer a lot about the company’s pattern of success (or lack of it). Typically, buyers should expect to see financial statements documenting revenues and net income, operating budgets, and cash flow statements for at least five years. Sales and earnings forecasts from the seller for at least three years also can be helpful when trying to determine the value of a business.

Unfortunately, many business owners are sloppy record keepers. Consequently, the potential buyer and his or her team may have to reconstruct some critical records. It is important to verify as much information about the business as possible. For instance, does the owner have customer mailing lists? These lists can be a valuable marketing tool for a new business owner. Has the owner created an operations manual outlining the company’s policies and procedures?

Intangible assets. Does the sale include any intangible assets such as trademarks, patents, copyrights, or goodwill? How long do patents have left to run? Is the trademark threatened by lawsuits for infringement? Does the company have logos or slogans that are unique or widely recognized? Determining the value of such intangibles is much more difficult than computing the value of the tangible assets.

Location and appearance. The location and the overall appearance of a business are important factors for a prospective buyer to consider. What had been an outstanding location in the past may be totally unacceptable today. Even if the building and equipment are in good condition and are fairly priced, the business may be located in a declining area. What other businesses operate in the surrounding area? Every buyer should consider the location’s suitability not only for the present but also for several years into the future.

Table 7.3 offers a checklist of items every business buyer should investigate before closing a deal.
TABLE 7.3 A Business Buyer’s Checklist

Buildings, Furnishings, and Fixtures
Every buyer should get a list of all of the fixed assets included in the purchase and then determine their condition, their age, their usefulness, and their value.

Inventory
Inventory may be the biggest part of a business sale, and it can be one of the trickiest parts of the deal. What inventory is on hand? What is its condition? How salable is it? What is its value? (Remember not to confuse book value with market value.) What is the company’s merchandise return policy? How high is its return rate?

Financial Statements
Although small business owners are notoriously poor record keepers, a business buyer must have access to a company’s financial statements for the last five years. This is the only way a buyer can judge the earning power of a company. The most reliable financial statements are those that have been audited by a certified public accountant. Comparing financial ratios against industry standards found in reports from RMA and Dun & Bradstreet can reveal important patterns.

Tax Returns
A good accountant should be able to reconcile the owner’s or company’s tax returns with its financial statements.

Sales Records
A prospective buyer should determine sales patterns by getting a monthly breakdown by product categories, sales representatives, cash versus credit, and any other significant factor for the company for three years. It is also a good idea to identify the company’s top 10 customers and review their purchases over the last three years. What percentage of total sales did these 10 customers account for?

Accounts Receivable
Age the company’s accounts receivable to see how many are current and how many are past due. Identify the top 10 accounts and check their credit ratings.

Accounts Payable
Conduct an analysis similar to the one for accounts receivable for the company’s accounts payable. Past-due accounts are an indication that a business is experiencing cash flow difficulties.

Legal Documents
A prospective buyer should investigate all significant contracts (especially long-term ones) a company has with vendors, suppliers, distributors, lenders, employees, unions, customers, landlords, and others. Can the current owner assign the rights and obligations of these existing contracts to the buyer? If the company is incorporated, it is wise to check the articles of incorporation (or its articles of organization and operating agreement if it is a limited liability company.)

Patents, Trademarks, and Copyrights
Reviewing the documentation for any patents, trademarks, and copyrights the company holds is vital.

Lawsuits
Is the company facing any lawsuits, either current or pending?

Liabilities
It is essential that the seller provide the buyer with a complete list of liabilities that are outstanding against the company, including accounts and notes payable, loans, liens by creditors against business assets, lawsuits, and others.

Advertising and Sales Literature
A business buyer should study the company’s advertising and sales literature to get an idea of the image it is projecting to its customers and the community. Talking to customers, suppliers, bankers, attorneys, and other local business owners will provide clues about the company’s reputation.
TABLE 7.3  Continued

Organization Chart
Current employees can be a vital asset to a business buyer if they are willing to stay after the sale. Ask the seller to develop an organization chart showing the company’s chain of command, and get copies of employees’ job descriptions so you can understand who is responsible for which duties.

Insurance Coverage
Evaluate the types and amounts of insurance coverage the company currently has, including Workers’ Compensation. Is it sufficient? If not, will you be able to obtain the necessary coverage at a reasonable price?


Products and Services

What Is the Potential for the Company’s Products or Services? No one wants to buy a business with a shrinking customer base. A thorough market analysis helps a buyer to develop his or her own sales forecast for an existing business (in addition to the one he or she should ask the seller to prepare). This research will tell a prospective buyer whether or not to consider buying a particular business and may reveal important trends in the business’s sales and customer base.

Customer Characteristics and Composition
Before purchasing an existing business, a buyer should analyze both existing and potential customers. Discovering why customers buy from the business and developing a profile of the company’s existing customer base can help the buyer to identify a company’s strengths and weaknesses and discover how to market more effectively to them. A potential buyer should determine the answers to the following questions:

- Who are the company’s customers? What are their race, age, gender, and income levels? What is their demographic profile?
- Why do they buy?
- What do customers want the business to do for them? What needs are they satisfying when they make a purchase?
- How often do customers buy? Do they buy in seasonal patterns?
- How loyal are present customers?
- Is it practical to attract new customers at a reasonable cost?
- Does the business have a well-defined customer base? Is it growing? Do these customers come from a large geographic area or do they all live near the business?

Analyzing the answers to these questions can help a potential buyer to create and implement a more powerful marketing plan. Most likely he or she will try to keep the business attractive to existing customers while changing some features of its marketing plan to attract new ones.

Competitor Analysis
A potential buyer must identify the company’s direct competition—those businesses in the immediate area that sell the same or similar products or services. The potential profitability and survival of the business may well depend on the behavior of these competitors. Important factors to consider are the number of competitors and the intensity of the competition. How many competitors have opened in recent years? How many have closed in the last five years? What caused them to fail? Has the market already reached the saturation point? Being a latecomer in an already saturated market is not the pathway to long-term success.
When evaluating the competitive environment, a prospective buyer should address other questions:

- Which competitors have survived and what characteristics have led to their success?
- How do competitors’ sales volumes compare with those of the business under consideration?
- What unique services do competitors offer?
- How well organized and coordinated are competitors’ marketing efforts?
- What are the competitors’ reputations?
- What are the strengths and weaknesses of the company’s primary competitors?
  - Which competitor is strongest?
- What competitive edge does each rival have?
- How can you gain market share in this competitive environment?

**Legal Aspects**

**What Legal Aspects Should You Consider?** Business buyers must be careful to avoid several legal pitfalls as they negotiate the final deal. The biggest potential legal traps include liens, bulk transfers, contract assignments, covenants not to compete, and ongoing legal liabilities.

**Liens.** The key legal issue in the sale of any asset is typically the proper transfer of good title from seller to buyer. However, because most business sales involve a collection of assorted assets, the transfer of a good title is more complex. Some business assets may have a lien (creditors’ claim) against them, and unless the lien is satisfied before the sale, the buyer must assume it and is financially responsible for it. One way to reduce this potential problem is to include a clause in the sales contract stating that any liability not shown on the balance sheet at the time of sale remains the responsibility of the seller. A prospective buyer should have an attorney thoroughly investigate all of the assets for sale and their lien status before buying any business.

**Bulk transfers.** To protect against surprise claims from the seller’s creditors after purchasing a business, the buyer should meet the requirements of a bulk transfer under Article 6 of the Uniform Commercial Code. Suppose that an owner owing many creditors sells his business to a buyer. The seller, however, does not use the proceeds of the sale to pay his debts to business creditors. Instead, he pockets them to use for his own benefit. Without the protection of a bulk transfer, those creditors could make claim to the assets that the buyer purchased in order to satisfy the previous owner’s debts (within six months). To be effective, a bulk transfer must meet the following criteria:

- The seller must give the buyer a signed, sworn list of existing creditors.
- The buyer and the seller must prepare a list of the property included in the sale.
- The buyer must keep the list of creditors and the list of property for six months.
- The buyer must give written notice of the sale to each creditor at least 10 days before he or she takes possession of the goods or pays for them (whichever is first).

By meeting these criteria, a buyer acquires free and clear title to the assets purchased, which are not subject to prior claims from the seller’s creditors. Because Article 6 can create quite a burden on a business buyer, 16 states have repealed it, and more may follow. About a half-dozen states have revised Article 6 to make it easier for buyers to notify creditors. Under the revised rule, if a business has more than 200 creditors, the buyer may notify them by public notice rather than by contacting them individually.

**Contract assignments.** Buyers must investigate the rights and the obligations they would assume under existing contracts with suppliers, customers, employees, lessors, and others. To continue the smooth operation of the business, the buyer must assume the rights of the seller under many existing contracts. Assuming these rights and obligations requires the seller to assign existing contracts to the new owner. For example,
the current owner may have 4 years left on a 10-year lease and will need to assign this contract to the buyer. To protect her or his interest, the buyer (who is the assignee) should notify the other party involved in the contract of the assignment. In the previous example, the business buyer should notify the landlord promptly of the lease assignment from the previous owner.

Generally, the seller can assign any contractual right to the buyer, unless the contract specifically prohibits the assignment or the contract is personal in nature. For instance, loan contracts sometimes prohibit assignments with a due-on-sale clause. These clauses require the buyer to pay the full amount of the remaining loan balance or to finance the balance at prevailing interest rates. Thus, the buyer cannot assume the seller’s loan (which may be at a lower interest rate than the prevailing rate on a loan). In addition, a seller usually cannot assign her or his credit arrangements with suppliers to the buyer because they are based on the seller’s business reputation and are personal in nature. If such contracts are crucial to the business operation and cannot be assigned, the buyer must renegotiate new contracts. A prospective buyer also should evaluate the terms of any other unique contracts the seller has, including exclusive agent or distributor contracts, real estate leases, financing and loan arrangements, and union contracts.

Covenants not to compete. One of the most important and most often overlooked legal considerations for a prospective buyer is negotiating a covenant not to compete (or a restrictive covenant or a noncompete agreement) with the seller. Under a restrictive covenant, the seller agrees not to open a new, competing store within a specific time period and geographic area of the existing one. (The covenant should be negotiated with the owner, not with the corporation, because if the corporation signs the agreement, the owner may not be bound.) However, the covenant must be a part of a business sale and must be reasonable in scope in order to be enforceable. Although some states place limitations on the enforceability of restrictive covenants, business buyers should insist on the seller signing one. Without this protection, a buyer may find his or her new business eroding beneath his or her feet. For instance, suppose that Bob purchases a tire business from Alexandra, whose reputation in town for selling tires is unequaled. If Bob fails to negotiate a restrictive covenant, nothing can stop Alexandra from opening a new shop next to his old one and keeping all of his customers, thereby driving Bob out of business. A reasonable covenant in this case might restrict Alexandra from opening a tire store within a three-mile radius for three years. Every business buyer should negotiate a covenant not to compete with the seller.

To be enforceable, a restrictive covenant must be reasonable in geographic scope and in duration, must protect a legitimate business interest (such as a company’s goodwill), and must be tied to a contract for the sale of an existing business (i.e., no “free-standing” restrictive covenants that restrain trade).

After launching Wild Oats Markets as a single store in Boulder, Colorado, Mike Gilliland turned the company into a national chain with $1 billion in annual sales. After selling out, Gilliland launched Sunflower Natural Markets, a seven-store discount natural food chain located in the Southwest. Gilliland’s former company filed a lawsuit against him, claiming that launching the business was a violation of the restrictive covenant he had signed. A court enforced the noncompete agreement, forcing Gilliland to sell his shares in Sunflower Natural Markets to his former partners. Once the time limit on the restrictive covenant expired, Gilliland rejoined Sunflower Natural Markets and opened other stores.10

Ongoing legal liabilities. Finally, a potential buyer must look for any potential legal liabilities the purchase might expose. These typically arise from three sources: (1) physical premises, (2) product liability claims, and (3) labor relations. First, the buyer must examine the physical premises for safety. Are employees at risk because of asbestos or some other hazardous material? If the business is a manufacturing
product liability lawsuits

lawsuits that claim a company is liable for damages and injuries caused by the products it makes or sells.

operation, does it meet Occupational Safety and Health Administration (OSHA) and other regulatory agency requirements? One entrepreneur who purchased a retail business located in a building that once housed a gasoline service station was quite surprised when the Environmental Protection Agency informed him that he would have to pay for cleaning up the results of an old, leaking gas tank that still sat beneath the property. Even though he had no part in running the old gas station and did not know the leaking tank was there, he was responsible for the cost of the cleanup. Removing the tank and cleaning up the site cost him several thousand dollars that he had not budgeted.

Second, the buyer must consider whether existing products contain defects that could result in product liability lawsuits, which claim that a company is liable for damages and injuries caused by the products or services they make or sell. Existing lawsuits might be an omen of more to follow. In addition, the buyer must explore products that the company has discontinued because he or she might be liable for them if they prove to be defective. The final bargain between the parties should require the seller to guarantee that the company is not involved in any product liability lawsuits.

Third, what is the relationship between management to employees? Does a union contract exist? The time to discover sour management–labor relations is before the purchase, not after.

If the buyer’s investigation reveals potential legal liabilities, it does not necessarily eliminate the business from consideration. Insurance coverage can shift such risks from the potential buyer, but the buyer should check to see whether the insurance will cover lawsuits resulting from actions predating the purchase.

Financial Soundness of the Business

A prospective buyer must analyze the financial records of a target business to determine its condition. He or she shouldn’t be afraid to ask an accountant for help. Accounting systems and methods can vary tremendously from one type of business to another and can be quite confusing to a novice. Current profits can be inflated by changes in the accounting procedure or in the method for recording sales. For the buyer, the most dependable financial records are audited statements, those prepared by a CPA firm in accordance with generally accepted accounting principles (GAAP). Unfortunately, audited records do not exist in many small companies that are for sale. In some cases, a potential buyer has to hire an accountant to construct reliable financial statements because the owner’s accounting and record keeping is so sloppy.

When evaluating the financial status of any business prospect, buyers must remember that any investment in a company should produce a reasonable salary for themselves, an attractive return on the money they invest, and enough to cover the amount they must borrow make the purchase. Otherwise, it makes no sense to purchase the business. Because most investors know that they can earn at least eight percent per year by investing wisely in the stock market, they expect any business they buy to earn at least that amount plus an extra return that reflects the additional risk of buying a business. Many owners expect to earn a return of at least 15 percent to 30 percent on the amount invested in their businesses.

Buyers also must remember that they are purchasing the future profit potential of an existing business. To evaluate the firm’s profit potential, they should review past sales, operating expenses, and profits as well as the assets used to generate those profits. They must compare current balance sheets, income statements, and statements of cash flow with previous ones and then develop a set of projected statements for the next two to five years. Sales tax records, income tax returns, and financial statements are valuable sources of information.

Are profits consistent over the years, or are they erratic? Is this pattern typical in the industry, or is it a result of unique circumstances or poor management? Can the business survive with serious fluctuations in revenues, costs, and profits? If these fluctuations are the result of poor management, can a new owner turn the business around?
Some of the financial records that a potential buyer should examine include the following:

**Income statements and balance sheets for the past three to five years.** It is important to review data from several years because creative accounting techniques can distort financial data in any single year. Even though buyers are purchasing the future profits of a business, they must remember that many businesses intentionally keep net income low to minimize the owners’ tax bills. Low earnings should prompt a buyer to investigate their causes.

**Income tax returns for the past three to five years.** Comparing basic financial statements with tax returns can reveal discrepancies of which the buyer should be aware. Some small business owners engage in skimming from their businesses—taking money from sales without reporting it as income. Owners who skim will claim their businesses are more profitable than their tax returns show. Although such underreporting is illegal and unethical, it is surprisingly common. Buyers should not pay for undocumented, “phantom” earnings a seller claims exist. In fact, buyers should consider whether they want to buy a business from someone who admits to doing business unethically.

**Owner’s compensation (and that of relatives).** The owner’s compensation is especially important in small companies; and the smaller the company is, the more important it will be. Although many companies do not pay their owners what they are worth, others compensate their owners lavishly. The buyer must consider the impact of fringe benefits—company cars, insurance contracts, country club memberships, and the like. It is important to adjust the company’s income statements for the salary and fringe benefits that the seller has paid himself or herself and others.

**Cash flow.** Most buyers understand the importance of evaluating a company’s profitability, but fewer recognize the necessity of analyzing its cash flow. They assume that if earnings are adequate, there will be sufficient cash to pay all of the bills and to fund an attractive salary for them. That is not necessarily the case! Before agreeing to a deal, prospective buyers should sit down with an accountant and convert the target company’s financial statements into a cash flow forecast. This forecast must take into account not only existing debts and obligations, but also any modifications the buyer would make in the business, including necessary capital expenditures. It must also reflect the repayment of any financing the buyer arranges to purchase the company, whether it is through the seller or a traditional lender. Will the company generate enough cash to be self-supporting? How much cash will it generate for you?

A potential buyer must look for suspicious deviations from normal (in either direction) for sales, expenses, profits, cash flow, assets, and liabilities. Have sales been increasing or decreasing? Is the equipment really as valuable as it is listed on the balance sheet? Are advertising expenses unusually high or low? How is depreciation reflected in the financial statements?

This financial information gives a buyer the opportunity to verify the seller’s claims about a company’s performance. Sometimes, however, an owner will take short-term actions that produce a healthy financial statement but weaken the company’s long-term health and profit potential. For example, a seller might lower expenses and increase earnings by gradually eliminating equipment maintenance or boost sales by selling to marginal businesses that will never pay their bills. Techniques such as these artificially inflate earnings, but a well-prepared buyer should be able to see through them.

Finally, a potential buyer should walk away from a deal—no matter how good it may appear on the surface—if the present owner refuses to disclose the company’s financial records or any other operating information the buyer needs to make an informed decision. If that is the case, says Marc Kramer, author of Small Business Turnaround, “don’t walk—run—away.”

Buying an existing business is a process filled with potential missteps along the way. The expression “Let the buyer beware” should be the prospective buyer’s mantra.
FIGURE 7.2

The Acquisition Process

1. Identify candidate
2. Sign nondisclosure statement
3. Sign letter of intent
4. Buyer’s due diligence investigation
5. Draft the purchase agreement
6. Close the final deal
7. Begin the transition

Negotiations

1. **Approach the candidate.** If a business is advertised for sale, the proper approach is through the channel defined in the ad. Sometimes buyers will contact business brokers to help them locate potential target companies. If you have targeted a company in the “hidden market,” an introduction from a banker, accountant, or lawyer often is the best approach. During this phase, the seller checks out the buyer’s qualifications, and the buyer begins to judge the quality of the company.

2. **Sign a nondisclosure document.** If the buyer and the seller are satisfied with the results of their preliminary research, they are ready to begin serious negotiations. Throughout the negotiation process, the seller expects the buyer to maintain strict confidentiality of all of the records, documents, and information he or she receives during the investigation and negotiation process. The nondisclosure document is a legally binding contract that ensures the secrecy of the parties’ negotiations.

3. **Sign a letter of intent.** Before a buyer makes a legal offer to buy the company, he or she typically will ask the seller to sign a letter of intent. The letter of intent is a nonbinding document that says that the buyer and the seller have reached a sufficient “meeting of the minds” to justify the time and expense of negotiating a final agreement. The letter should state clearly that it is nonbinding, giving either party the right to walk away from the deal. It should also contain a clause calling for “good faith negotiations” between the parties. A typical letter of intent addresses terms such as price, payment terms, categories of assets to be sold, and a deadline for closing the final deal.

4. **Buyer’s due diligence.** While negotiations are continuing, the buyer is busy studying the business and evaluating its strengths and weaknesses. In short, the buyer must “do his or her homework” to make sure that the business is a good value.

5. **Draft the purchase agreement.** The purchase agreement spells out the parties’ final deal! It sets forth all of the details of the agreement and is the final product of the negotiation process.

6. **Close the final deal.** Once the parties have drafted the purchase agreement, all that remains to making the deal “official” is the closing. Both buyer and seller sign the necessary documents to make the sale final. The buyer delivers the required money, and the seller turns the company over to the buyer.

7. **Begin the transition.** For the buyer, the real challenge now begins: making the transition to a successful business owner.


LEARNING OBJECTIVES
4. Describe the various techniques for determining the value of a business.

goodwill
the difference in the value of an established business and one that has not yet built a solid reputation for itself.

Methods for Determining the Value of a Business

Business valuation is partly an art and partly a science. Part of what makes establishing a reasonable price for a privately held business so difficult is the wide variety of factors that influence its value: the nature of the business, its position in the market or industry, the outlook for the market or industry, the company’s financial status, its earning capacity, any intangible assets it may own (e.g., patents, trademarks, or copyrights), the value of other similar publicly held companies, and many other factors.

Computing the value of the company’s tangible assets normally poses no major problem, but assigning a price to the intangibles, such as goodwill, almost always creates controversy. Goodwill represents the difference in the value of an established business and one that has not yet built a solid reputation for itself. The buyer is willing to pay extra only for those intangible assets that produce additional income. The seller, however, believes that goodwill is a measure of the hard work, sacrifice, and long hours invested in building the business, something for which he or she expects to be paid—often quite handsomely.
Potential buyers also must recognize the role that the seller’s ego can play in the business valuation process. Norm Brodsky, who owns a successful document storage business, explains:

As a group, we [entrepreneurs] tend to have fairly large egos, which isn’t entirely bad. You need one to make a business grow . . . But our egos can get us into trouble when it comes to putting a dollar value on something we’ve created. We generally take the highest valuation we’ve heard for a company somewhat like ours—and multiply it.12

So, how can the buyer and the seller arrive at a fair price? There are few hard and fast rules in establishing the value of a business, but the following guidelines are helpful:

- The wisest approach is to compute a company’s value using several techniques and then choose the one that makes the most sense.
- The deal must be financially feasible for both parties. The seller must be satisfied with the price received for the business, but the buyer cannot pay an excessively high price that would require heavy borrowing and would strain his or her cash flows from the outset.
- The potential buyer must have access to the business records.
- Valuations should be based on facts, not fiction.
- No surprise is the best surprise. Both parties should commit to dealing with one another honestly and in good faith.

The main reason that buyers purchase existing businesses is to get their future earning potential. The second -most- common reason is to obtain an established asset base; it is much easier to buy assets than to build them. Although evaluation methods should take these characteristics into consideration, too many business sellers and buyers depend on rules of thumb that ignore the unique features of small companies. Often, these rules of thumb are based on multiples of a company’s net earnings or sales and vary by industry.

The next section describes three basic techniques and several variations on them for determining the value of a hypothetical business, Lewis Electronics.

**Balance Sheet Techniques: Net Worth = Assets — Liabilities**

**Balance Sheet Technique** The balance sheet technique is one of the most commonly used methods of evaluating a business, although it is not highly recommended because it oversimplifies the valuation process. This method computes the company’s net worth or owner’s equity (Net worth = Total assets — Total liabilities) and uses this figure as the value. The problem with this technique is that it fails to recognize reality: Most small businesses have market values that exceed their reported book values.

The first step is to determine which assets are included in the sale. In most cases, the owner has some personal assets that he or she does not want to sell. Professional business brokers can help the buyer and the seller arrive at a reasonable value for the collection of assets included in the deal. Remember that net worth on a financial statement will likely differ significantly from actual net worth determined in the marketplace. Figure 7.3 shows the balance sheet for Lewis Electronics. Based on this balance sheet, the company’s net worth is $266,091 — $114,325 = $151,766.

**Variation: Adjusted Balance Sheet Technique** A more realistic method for determining a company’s value is to adjust the book value of net worth to reflect actual market value—the so-called adjusted balance sheet technique. The values reported on a company’s books may either overstate or understate the true value of assets and liabilities. Typical assets in a business sale include notes and accounts receivable, inventories, supplies, and fixtures. If a buyer purchases accounts receivable, he or she should estimate the likelihood of their collection and adjust their value accordingly (refer to Table 7.1).
FIGURE 7.3

Balance Sheet for Lewis Electronics

Lewis Electronics
Balance Sheet
June 30, 200X

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets:</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$11,655</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>15,876</td>
</tr>
<tr>
<td>Inventory</td>
<td>56,523</td>
</tr>
<tr>
<td>Supplies</td>
<td>8,574</td>
</tr>
<tr>
<td>Prepaid Insurance</td>
<td>5,587</td>
</tr>
<tr>
<td><strong>Total Current Assets</strong></td>
<td><strong>$98,215</strong></td>
</tr>
<tr>
<td>Fixed Assets:</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>$24,000</td>
</tr>
<tr>
<td>Buildings</td>
<td>$141,000</td>
</tr>
<tr>
<td>Less Accumulated Depreciation</td>
<td>89,500</td>
</tr>
<tr>
<td>Office Equipment</td>
<td>$12,760</td>
</tr>
<tr>
<td>Less Accumulated Depreciation</td>
<td>5,601</td>
</tr>
<tr>
<td>Factory Equipment</td>
<td>$59,085</td>
</tr>
<tr>
<td>Less Accumulated Depreciation</td>
<td>31,235</td>
</tr>
<tr>
<td>Trucks and Autos</td>
<td>$28,730</td>
</tr>
<tr>
<td>Less Accumulated Depreciation</td>
<td>17,540</td>
</tr>
<tr>
<td><strong>Total Fixed Assets</strong></td>
<td><strong>$167,876</strong></td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>$266,091</strong></td>
</tr>
</tbody>
</table>

| Liabilities                                 |       |
| Current Liabilities:                        |       |
| Accounts Payable                           | $19,497 |
| Mortgage Payable (current portion)          | 5,215  |
| Salaries Payable                           | 3,671  |
| Note Payable                               | 10,000 |
| **Total Current Liabilities**               | **$38,383** |
| Long-Term Liabilities:                      |       |
| Mortgage Payable                           | $54,542 |
| Note Payable                               | 21,400 |
| **Total Long-Term Liabilities**             | **$75,942** |
| **Total Liabilities**                      | **$114,325** |

| Owners’ Equity                              |       |
| Owners’ Equity                              | $151,766 |
| Total Liabilities and Owners’ Equity        | **$266,091** |

In manufacturing, wholesale, and retail businesses, inventory is usually the largest asset in the sale. Taking a physical inventory count is the best way to determine accurately the quantity of goods to be transferred. The sale may include three types of inventory, each having its own method of valuation: raw materials, work-in-process, and finished goods. The buyer and the seller must arrive at a method for evaluating the inventory.
First-in-first-out (FIFO), last-in-first-out (LIFO), and average costing are three frequently used techniques, but the most common methods use the cost of last purchase and the replacement value of the inventory. Before accepting any inventory value, the buyer should evaluate the condition of the goods. One young couple purchased a lumberyard without sufficiently examining the inventory. After completing the sale, they discovered that most of the lumber in a warehouse they had neglected to inspect was warped and was of little value as building material. The bargain price they paid for the business turned out not to be the good deal they had expected.

To avoid problems, some buyers insist on having a knowledgeable representative on an inventory team count the inventory and check its condition. Nearly every sale involves merchandise that cannot be sold, but by taking this precaution, a buyer minimizes the chance of being stuck with worthless inventory. Fixed assets transferred in a sale might include land, buildings, equipment, and fixtures. Business owners frequently carry real estate and buildings at values well below their actual market value. Equipment and fixtures, depending on their condition and usefulness, may increase or decrease the true value of the business. Appraisals of these assets on insurance policies are helpful guidelines for establishing market value. In addition, business brokers can be useful in determining the current market value of fixed assets. Some brokers use an estimate of what it would cost to replace a company’s physical assets (less a reasonable allowance for depreciation) to determine value. For Lewis Electronics, the adjusted net worth is $274,638 – $114,325 = $160,313 (see the adjusted balance sheet in Figure 7.4), indicating that some of the entries in its books did not accurately reflect true market value.

Business evaluations based on balance sheet methods suffer one major drawback: they do not consider the future earning potential of the business. These techniques value assets at current prices and do not consider them as tools for creating future profits. The next method for computing the value of a business is based on its expected future earnings.

**Earnings Approach**

The buyer of an existing business is essentially purchasing its future income. The **earnings approach** focuses on the future income potential of a business and assumes that a company’s value depends on its ability to generate consistent earnings over time. In other words, the earnings approach recognizes that assets derive their real value from the income they produce in the future. There are three variations of the earnings approach.

**Variation 1: Excess Earnings Method** This method combines the value of a business’s existing assets (minus its liabilities) and an estimate of its future earnings potential to determine its selling price. One advantage of this technique is that it offers an estimate of goodwill. Goodwill is an intangible asset that often creates problems in a business sale. In fact, the most common method of valuing a business is to compute its tangible net worth and then to add an often arbitrary adjustment for goodwill. In essence, goodwill is the difference between an established, successful business and one that has yet to prove itself. It is based on the company’s reputation and its ability to attract customers. A buyer should not accept blindly the seller’s arbitrary adjustment for goodwill because it is likely to be inflated. The real value of a company’s goodwill lies in its financial value to the buyer, not in its emotional value to the seller.

The excess earnings method provides a consistent and realistic approach for determining the value of goodwill. It measures goodwill by the amount of profit the business earns above that of the average firm in the same industry (its “extra earning power”). It also assumes that the owner is entitled to a reasonable return on the company’s adjusted tangible net worth.

**Step 1 Compute adjusted tangible net worth.** Using the adjusted balance sheet method of valuation, the buyer should compute the firm’s adjusted tangible net worth. Total tangible assets (adjusted for market value) minus total liabilities yields adjusted tangible net worth. In the Lewis Electronics example, adjusted tangible net worth is $274,638 – $114,325 = $160,313 (refer to Figure 7.4).
### FIGURE 7.4

**Balance Sheet for Lewis Electronics, Adjusted to Reflect Market Value**

**Lewis Electronics**  
**Adjusted Balance Sheet**  
**June 30, 200X**

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Assets:</strong></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$11,655</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>10,051</td>
</tr>
<tr>
<td>Inventory</td>
<td>39,261</td>
</tr>
<tr>
<td>Supplies</td>
<td>7,492</td>
</tr>
<tr>
<td>Prepaid Insurance</td>
<td>5,587</td>
</tr>
<tr>
<td><strong>Total Current Assets</strong></td>
<td><strong>$74,046</strong></td>
</tr>
<tr>
<td><strong>Fixed Assets:</strong></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>$36,900</td>
</tr>
<tr>
<td>Buildings</td>
<td>$177,000</td>
</tr>
<tr>
<td>Less Accumulated Depreciation</td>
<td>51,500</td>
</tr>
<tr>
<td>Office Equipment</td>
<td>$11,645</td>
</tr>
<tr>
<td>Less Accumulated Depreciation</td>
<td>7,159</td>
</tr>
<tr>
<td>Factory Equipment</td>
<td>$50,196</td>
</tr>
<tr>
<td>Less Accumulated Depreciation</td>
<td>27,850</td>
</tr>
<tr>
<td>Trucks and Autos</td>
<td>$22,550</td>
</tr>
<tr>
<td>Less Accumulated Depreciation</td>
<td>11,190</td>
</tr>
<tr>
<td><strong>Total Fixed Assets</strong></td>
<td><strong>$200,592</strong></td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>$274,638</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Liabilities:</strong></td>
<td></td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>$19,497</td>
</tr>
<tr>
<td>Mortgage Payable (current portion)</td>
<td>5,215</td>
</tr>
<tr>
<td>Salaries Payable</td>
<td>3,671</td>
</tr>
<tr>
<td>Note Payable</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Total Current Liabilities</strong></td>
<td><strong>$38,383</strong></td>
</tr>
<tr>
<td><strong>Long-Term Liabilities:</strong></td>
<td></td>
</tr>
<tr>
<td>Mortgage Payable</td>
<td>$54,542</td>
</tr>
<tr>
<td>Note Payable</td>
<td>21,400</td>
</tr>
<tr>
<td><strong>Total Long-Term Liabilities</strong></td>
<td><strong>$75,942</strong></td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td><strong>$114,325</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Owners’ Equity</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Owners’ Equity</td>
<td>$160,313</td>
</tr>
<tr>
<td><strong>Total Liabilities and Owners’ Equity</strong></td>
<td><strong>$274,638</strong></td>
</tr>
</tbody>
</table>

---

**opportunity cost**  
the cost of the next best alternative choice; the cost of giving up one alternative to get another.

**Step 2** Calculate the opportunity costs of investing in the business.  
**Opportunity cost** represents the cost of forgoing a choice. If a buyer chooses to purchase the assets of a business, he or she cannot invest that money elsewhere. Therefore, the opportunity cost of the purchase would be the amount that the buyer could earn by investing the same amount in a similar-risk investment.
There are three components in the rate of return used to value a business: (1) the basic, risk-free return, (2) an inflation premium, and (3) the risk allowance for investing in the particular business. The basic, risk-free return and the inflation premium are reflected in investments such as U.S. Treasury bonds. To determine the appropriate rate of return for investing in a business, a buyer must add to this base rate a factor reflecting the risk of purchasing the company. The greater the risk, the higher will be the rate of return. A normal-risk business typically translates into a rate of return in the 20 to 25 percent range. In the Lewis Electronics example, the opportunity cost of the investment is $160,313 \times 25\% = $40,078.

The second part of the buyer’s opportunity cost is the salary that he or she could earn working for someone else. For the Lewis Electronics example, if the buyer purchases the business, he or she must forgo the $25,000 salary that could be earned working elsewhere. Adding these amounts together yields a total opportunity cost of $65,078.

**Step 3 Project net earnings.** The buyer must estimate the company’s net earnings for the upcoming year before subtracting the owner’s salary. Averages can be misleading, so the buyer must be sure to investigate the trend of net earnings. Have they risen steadily over the last five years, dropped significantly, remained relatively constant, or fluctuated wildly? As you learned earlier in this chapter, past income statements provide useful guidelines for estimating earnings. In the Lewis Electronics example, the prospective buyer and the buyer’s accountant project net earnings for the upcoming year to be $74,000.

**Step 4 Compute extra earning power.** A company’s extra earning power is the difference between forecasted earnings (Step 3) and total opportunity costs (Step 2). Many small businesses that are for sale do not have extra earning power (i.e., excess earnings), and they show marginal or no profits. The extra earning power of Lewis Electronics is $74,000 − $65,000 = $8,922.

**Step 5 Estimate the value of intangibles.** The owner can use the business’s extra earning power of the business to estimate the value of its intangible assets—that is, its goodwill. Multiplying the extra earning power by a years-of-profit figure yields an estimate of the intangible assets’ value. The years-of-profit figure for a normal-risk business ranges from three to four. A very high risk business may have a years-of-profit figure of just one, whereas a well-established firm might warrant a years-of-profit figure of seven. For Lewis Electronics, the value of intangibles (assuming normal risk) would be $8,922 \times 3 = $26,766.

**Step 6 Determine the value of the business.** To determine the value of the business, the buyer simply adds together the adjusted tangible net worth (Step 1) and the value of the intangibles (Step 5). Using this method, we find that the value of Lewis Electronics is $160,313 + $26,766 = $187,079.

The buyer and the seller should consider the tax implications of including in the purchase the value of goodwill and the value of a covenant not to compete. Because the buyer can amortize both the cost of goodwill and a restrictive covenant over 15 years, the tax treatment of either would be the same for him or her. However, the seller would prefer to have the amount of the purchase price in excess of the value of the assets allocated to goodwill, which is a capital asset. The gain on the capital asset would be taxed at the lower capital gains rates. If that same amount were allocated to a restrictive covenant (which is negotiated with the seller personally, not the business), the seller must treat it as ordinary income, which would be taxed at regular rates that are higher than the capital gains rates.

**Variation 2: Capitalized Earnings Approach** A variation of the earnings approach capitalizes expected net earnings to determine the value of a business. As you learned earlier in this chapter, buyers should prepare their own pro forma income statements and should ask the seller to prepare one also. Many appraisers use a five-year weighted average of past sales (with the greatest weights assigned to the most recent years) to estimate sales for the upcoming year.

Once again, a buyer must evaluate the risk of purchasing the business to determine the appropriate rate of return on the investment. The greater the perceived risk, the higher is
the return that the buyer requires. Risk determination is always somewhat subjective, but it is necessary for proper evaluation.

The capitalized earnings approach divides estimated net earnings (after subtracting the owner’s reasonable salary) by the rate of return that reflects the risk level. For Lewis Electronics, the capitalized value (assuming a reasonable salary of $25,000) is

\[
\frac{\text{Net earnings (after deducting owner’s salary)}}{\text{Rate of return}} = \frac{\$74,000 - \$25,000}{25\%} = \$196,000
\]

Clearly, firms with lower risk factors are more valuable (a 10 percent rate of return would yield a value of $499,000 for Lewis Electronics) than those with higher risk factors (a 50 percent rate of return would yield a value of $99,800). Most normal-risk businesses use a rate-of-return factor ranging from 20 to 25 percent. The lowest risk factor that most buyers would accept for any business is around 15 percent.

**Variation 3: Discounted Future Earnings Approach** This variation of the earnings approach assumes that a dollar earned in the future is worth less than that same dollar today. Therefore, using this approach, the buyer estimates the company’s net income for several years into the future and then discounts these future earnings back to their present value. The resulting present value is an estimate of the company’s worth because it reflects the company’s future earning potential stated in today’s dollars.

The reduced value of future dollars represents the cost of the buyers’ giving up the opportunity to earn a reasonable rate of return by receiving income in the future instead of today, a concept known as the time value of money. To illustrate the importance of the time value of money, consider two $1 million sweepstake winners. Rob wins $1 million in a sweepstakes, but he receives it in $50,000 installments over 20 years. If Rob invested every installment at 15 percent interest, he would have accumulated $5,890,505.98 at the end of 20 years. Lisa wins $1 million in another sweepstakes, but she collects her winnings in one lump sum. If Lisa invested her $1 million today at 15 percent, she would have accumulated $16,366,537.39 at the end of 20 years. The difference in their wealth is the result of the time value of money.

The discounted future earnings approach includes five steps:

**STEP 1. PROJECT FUTURE EARNINGS FOR FIVE YEARS INTO THE FUTURE** One way is to assume that earnings will grow by a constant amount over the next five years. Perhaps a better method is to develop three forecasts—an optimistic, a pessimistic, and a most likely—for each year and then find a weighted average using the following formula, which weights the most likely forecast four times as heavily as either the optimistic or pessimistic forecasts:

\[
\text{Forecasted earnings for year } i = \frac{\text{Optimistic earnings for year } i + 4(\text{Most likely forecast for year } i) + (\text{Pessimistic forecast for year } i)}{6}
\]

For Lewis Electronics, the buyer’s forecasts (in dollars) are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Pessimistic</th>
<th>Most Likely</th>
<th>Optimistic</th>
<th>Weighted Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>XXX1</td>
<td>65,000</td>
<td>74,000</td>
<td>92,000</td>
<td>315,000</td>
</tr>
<tr>
<td>XXX2</td>
<td>74,000</td>
<td>90,000</td>
<td>101,000</td>
<td>476,000</td>
</tr>
<tr>
<td>XXX3</td>
<td>82,000</td>
<td>100,000</td>
<td>112,000</td>
<td>496,000</td>
</tr>
<tr>
<td>XXX4</td>
<td>88,000</td>
<td>109,000</td>
<td>120,000</td>
<td>513,000</td>
</tr>
<tr>
<td>XXX5</td>
<td>88,000</td>
<td>115,000</td>
<td>122,000</td>
<td>518,000</td>
</tr>
</tbody>
</table>

Buyers must remember that the farther into the future they forecast, the less reliable their estimates will be.
STEP 2. DISCOUNT THESE FUTURE EARNINGS AT THE APPROPRIATE PRESENT VALUE RATE
The rate that the buyer selects should reflect the rate he or she could earn on a similar-risk investment. Because Lewis Electronics is a normal-risk business, the buyer chooses a present value rate of 25 percent.

<table>
<thead>
<tr>
<th>Year</th>
<th>Income Forecast (Weighted Average) ($)</th>
<th>Present Value Factor (at 25%)*</th>
<th>Net Present Value ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>XXX1</td>
<td>75,500</td>
<td>0.8000</td>
<td>60,400</td>
</tr>
<tr>
<td>XXX2</td>
<td>89,167</td>
<td>0.6400</td>
<td>57,067</td>
</tr>
<tr>
<td>XXX3</td>
<td>99,000</td>
<td>0.5120</td>
<td>50,688</td>
</tr>
<tr>
<td>XXX4</td>
<td>107,333</td>
<td>0.4096</td>
<td>43,964</td>
</tr>
<tr>
<td>XXX5</td>
<td>111,667</td>
<td>0.3277</td>
<td>36,593</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>248,712</td>
</tr>
</tbody>
</table>

*The appropriate present value factor can be found by looking in published present value tables, by using a calculator or computer, or by solving the formula

Present value factor = \( \frac{1}{(1 + k)^t} \)

where \( k \) is the rate of return and \( t \) is the year \( (t = 1, 2, 3, \ldots, n) \).

STEP 3. ESTIMATE THE INCOME STREAM BEYOND FIVE YEARS
One technique suggests multiplying the fifth year income by \( 1 \div \text{rate of return} \). For Lewis Electronics, the estimate is

\[ \text{Income beyond year 5} = 111,667 \times \frac{1}{25\%} = 446,668 \]

STEP 4. DISCOUNT THE INCOME ESTIMATE BEYOND FIVE YEARS USING THE PRESENT VALUE FACTOR FOR THE SIXTH YEAR
For Lewis Electronics

Present value of income beyond year 5 = 446,668 \( \times \) 0.2622 = 117,116

STEP 5. COMPUTE THE TOTAL VALUE OF THE BUSINESS
Add the present value of the company’s estimated earnings for years 1 through 5 (Step 2) and the present value of its earnings from year 6 on (Step 4):

Total value = 248,712 + 117,116 = 365,828

The primary advantage of this technique is that it evaluates a business solely on the basis of its future earning potential, but its reliability depends on making forecasts of future earnings and on choosing a realistic present value rate. In other words, a company’s present value is tied to its future performance, which is not always easy to project. The discounted cash flow technique is especially well suited for valuing service businesses (whose asset bases are often very thin) and for companies experiencing high growth rates.

Market Approach
The market approach (or price/earnings approach) uses the price/earnings (P/E) ratios of similar businesses listed on a stock exchange to establish the value of a company. A buyer must use businesses in the same industry whose stocks are publicly traded to get a meaningful comparison. A company’s price/earnings ratio is the price of one share of its common stock in the market divided by its earnings per share (after deducting preferred stock dividends). To get a representative P/E ratio, a buyer should average the P/Es of as many similar businesses as possible.

To compute the company’s value, the buyer multiplies the average price/earnings ratio by the private company’s estimated earnings. For example, suppose that the buyer found market approach a method of valuing a business that uses the price/earnings (P/E) ratio of similar, publicly held companies to determine value.
four companies comparable to Lewis Electronics but whose stock is publicly traded. Their price/earnings ratios are

<table>
<thead>
<tr>
<th>Company</th>
<th>P/E ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company 1</td>
<td>3.3</td>
</tr>
<tr>
<td>Company 2</td>
<td>3.8</td>
</tr>
<tr>
<td>Company 3</td>
<td>4.7</td>
</tr>
<tr>
<td>Company 4</td>
<td>4.1</td>
</tr>
<tr>
<td>Average P/E ratio</td>
<td>3.975</td>
</tr>
</tbody>
</table>

Using this average P/E ratio produces a value of $294,150:

\[ \text{Value} = \text{Average PE ratio} \times \text{Estimated net earnings} = 3.975 \times 74,000 = 294,150 \]

The biggest advantage of the market approach is its simplicity. However, this method does have several disadvantages, including the following:

**Necessary comparisons between publicly traded and privately owned companies.** Because the stock of privately owned companies is not as liquid as that of publicly held companies, the P/E ratio used is often subjective and lower than that of publicly held companies.

**Unrepresentative earnings estimates.** A private company’s net earnings may not realistically reflect its true earning potential. To minimize taxes, owners usually attempt to keep earnings low and rely on fringe benefits and bonuses to make up the difference.

**Finding similar companies for comparison.** Often, it is extremely difficult for a buyer to find comparable publicly held companies when estimating the appropriate P/E ratio.

**Applying the after-tax earnings of a private company to determine its value.** If a prospective buyer is using an after-tax P/E ratio from a public company, he or she also must use the after-tax earnings from the private company.

Despite its drawbacks, the market approach is useful as a general guide to establishing a company’s value.

Which of these methods is best for determining the value of a small business? Simply stated, there is no single best method. Valuing a business is partly an art and partly a science. Use of these techniques will yield a range of values. Buyers should look for values that might cluster together and then use their best judgment to determine a reasonable offering price. Table 7.4 summarizes the valuation techniques covered in this chapter.

TABLE 7.4 What’s It Worth? A Summary of Business Valuation Techniques

<table>
<thead>
<tr>
<th>Balance Sheet Technique</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book value of net worth = Total assets − Total liabilities</td>
</tr>
<tr>
<td>= $266,091 − $114,325 = $151,766</td>
</tr>
</tbody>
</table>

**Variation: Adjusted Balance Sheet Technique**

Net worth adjusted to reflect market value = $274,638 − $114,325 = $160,313

<table>
<thead>
<tr>
<th>Earnings Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Variation 1: Excess Earnings Method</strong></td>
</tr>
<tr>
<td>Step 1: Adjusted tangible net worth = $274,638 − $114,325 = $160,313</td>
</tr>
<tr>
<td>Step 2: Opportunity costs = Opportunity cost of investing + salary forgone</td>
</tr>
<tr>
<td>= $160,313 × 25% + 25,000 = $65,078</td>
</tr>
<tr>
<td>Step 3: Estimated net earnings = $74,000</td>
</tr>
</tbody>
</table>
TABLE 7.4 Continued

Step 4: Extra earning power = Estimated net earnings – Total opportunity costs
= $74,000 – $65,078 = $8,922

Step 5: Value of intangibles (goodwill) = Extra earning power × Years of profit figure
= $8,922 × 3 = $26,766

Step 6: Value of business = Tangible net worth + Value of intangibles
= $160,313 + 26,766 = $187,079

Variation 2: Capitalized Earnings Approach

Value = $74,000 – $25,000
× Rate of return on a similar-risk investment
= \frac{25\%}{25\%} = $196,000

Variation 3: Discounted Future Earnings Approach

Step 1: Project future earnings:

<table>
<thead>
<tr>
<th>Year</th>
<th>Pessimistic</th>
<th>Most Likely</th>
<th>Optimistic</th>
<th>Weighted Average*</th>
</tr>
</thead>
<tbody>
<tr>
<td>XXX1</td>
<td>$65,000</td>
<td>$74,000</td>
<td>$94,000</td>
<td>$75,500</td>
</tr>
<tr>
<td>XXX2</td>
<td>$74,000</td>
<td>$90,000</td>
<td>$101,000</td>
<td>$89,167</td>
</tr>
<tr>
<td>XXX3</td>
<td>$82,000</td>
<td>$100,000</td>
<td>$112,000</td>
<td>$99,000</td>
</tr>
<tr>
<td>XXX4</td>
<td>$88,000</td>
<td>$109,000</td>
<td>$120,000</td>
<td>$107,333</td>
</tr>
<tr>
<td>XXX5</td>
<td>$88,000</td>
<td>$115,000</td>
<td>$122,000</td>
<td>$111,667</td>
</tr>
</tbody>
</table>

*Weighted average = \frac{\text{Pessimistic} + 4(\text{Most likely}) + \text{Optimistic}}{6}

Step 2: Discount future earnings using the appropriate present value factor:

<table>
<thead>
<tr>
<th>Year</th>
<th>Forecasted Earnings</th>
<th>Present Value Factor</th>
<th>Net Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>XXX1</td>
<td>$75,500</td>
<td>0.8000</td>
<td>$60,400</td>
</tr>
<tr>
<td>XXX2</td>
<td>$89,167</td>
<td>0.6400</td>
<td>$57,067</td>
</tr>
<tr>
<td>XXX3</td>
<td>$99,000</td>
<td>0.5120</td>
<td>$50,688</td>
</tr>
<tr>
<td>XXX4</td>
<td>$107,333</td>
<td>0.4096</td>
<td>$43,964</td>
</tr>
<tr>
<td>XXX5</td>
<td>$111,667</td>
<td>0.3277</td>
<td>$36,593</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>$248,712</td>
</tr>
</tbody>
</table>

Step 3: Estimate income stream beyond 5 Years:

Income stream = Fifth-year forecasted income × \frac{1}{\text{Rate of return}}
= $111,667 × \frac{1}{25\%}
= $446,668

Step 4: Discount income stream beyond 5 years using sixth-year present value factor:

Present value of income stream = $446,668 × 0.2622 = $117,116

Step 5: Compute total value:

Total value = $248,712 + $117,116 = $365,828

Market Approach

Value = Estimated earnings × Average price/earnings ratio of representative companies
= $74,000 × 3.975 = $294,150

Which value is correct? Remember: There is no best method of valuing a business. These techniques provide only estimates of a company’s worth. The particular method used depends on the unique qualities of the business and the special circumstances surrounding the sale.
Understanding the Seller’s Side

A recent study by DAK Group and Columbia University’s Lang Center for Entrepreneurship reports that 64 percent of the owners of closely held companies expect to sell their businesses within three years. For entrepreneurs, few events are more anticipated—and more emotional—than selling their businesses. Selling their companies often produces vast personal wealth and a completely new lifestyle, and this newly gained wealth offers freedom and the opportunity to catch up on all the things the owners missed out on while building their businesses. Yet, many entrepreneurs who sell out experience a tremendous void in their lives, a “separation anxiety” that is the result of their lives having revolved around the businesses they created and nurtured for so many years. For these business owners, their companies were the focal point of their lives in their communities and were an essential part of their identities. When they sell their companies, a primary concern for many entrepreneurs is preserving the reputation, culture, and principles on which they built and operated the company. Will the new owner display the same values in managing the business? Can the company founder cope with the inevitable changes the new owner will make to the business?

Seven years after founding the California Pizza Kitchen, Rick Rosenfield and Larry Flax were surprised when PepsiCo offered to buy a majority stake in their company for $100 million. The soft drink giant kept Rosenfield and Flax on as co-chairmen but relieved them of any daily operating and decision-making duties and replaced them with a more experienced CEO, Fred Hipp. Hipp’s strategy for the company was quite different from that of the founders, who had built the company on the basics: quality ingredients, upscale locations, and steady growth. When Hipp’s decisions pushed the company toward financial ruin, PepsiCo brought Rosenfield and Flax back in to save it. They closed underperforming outlets, upgraded the remaining ones, and introduced interesting new menu items designed to appeal to California Pizza Kitchen’s core customers.

Some business brokers differentiate between “financial buyers” and “strategic buyers.” Financial buyers, usually individuals, see buying a business as a way to generate income for themselves and their families. Their primary concern is the company’s ability to generate profits and positive cash flow in the future. Strategic buyers, often other businesses or even competitors, view buying a company as part of a larger picture, a piece in a strategic puzzle that gives them an advantage such as access to a new, fast-growing market, a unique product, or a new technological innovation. “Financial buyers typically will pay a lower price because they have a ‘fire sale’ mentality,” says Andy Agrawal, a partner in an investment banking firm. “You need to find strategic buyers and paint a picture for them,” he advises. “Show the strategic buyer how one plus one equals three.”

Nancy Silverton, who in 1989 co-founded a restaurant, Campanile, and a bakery, La Brea Bakery, with her husband in Los Angeles, managed to find a strategic buyer for La Brea bakery in the Irish food giant IAWS Group, which recently purchased 80 percent of the company for $68.5 million. When Silverton decided to sell, La Brea was generating annual profits of $9.4 million on sales of more than $50 million, primarily because the company had developed a unique flash-freezing process that allowed it to ship its breads almost anywhere without damaging its flavor and texture. (Celebrity chef Wolfgang Puck, who serves Silverton’s bread at his star-studded Spago restaurant in Los Angeles, says, “Nobody’s bread is as good as hers.”) IAWS Group already had a par-baked operation in Europe and wanted to gain access to the premium bread market in the United States.
La Brea Bakery's established network of customers and its unique flash-freezing process were a perfect match for this strategic buyer's needs. As part of the deal, Silverton even managed to maintain “artistic integrity” over the breads the company sells.16

Selling a business involves developing a plan that maximizes the value of the business. Before selling her business, an entrepreneur must ask himself or herself some important questions: Do you want to walk away from the business completely, or do you plan to stay on after the sale? If you decide to stay on, how involved do you want to be in running the company? How much can you realistically expect to get for the business? Is this amount of money sufficient to maintain your desired lifestyle? Rather than sell the business to an outsider, should you be transferring ownership to your kids or to your employees? Who are the professionals—business brokers, accountants, attorneys, tax advisers—you will need to help you to close the sale successfully? How do you expect the buyer to pay for the company? Are you willing to finance at least some of the purchase price?

Sellers who have answered these fundamental questions are prepared to move forward with the sale of their companies.

**Seller’s Remorse**

In 1961, Larry Freeman went into his family’s business, Freeman Sales Agency, like his father and his grandfather before him. The company served as a manufacturer’s representative for makers of shampoo, lotions, and creams. Larry’s father died in 1967, leaving Larry and his younger brother, Richard, both in their 20s, in charge of the family business. By the early 1970s, the ambitious, hard-working brothers had moved the company from just selling other manufacturers’ cosmetics to producing and marketing their own line of products, some of which proved to be cutting edge at the time. For instance, the brothers launched one of the first shampoos made with all organic ingredients.

By 1984, Freeman Cosmetics, as the company was now known, was generating sales of $5 million but was losing money. Richard decided to leave the company, and Larry brought in his son, Mark, to help him run the business. The father–son team began to rebuild the company, introducing a string of new products made with oatmeal, avocados, and apples packaged in colorful bottles that appealed to young buyers. In 1991, Larry’s sister, Jill, joined the business and found her niche in marketing. Mark had a knack for developing international markets and was busy building the Freeman’s international division. Larry focused on building long-term relationships with the company’s customers and guiding its social responsibility efforts. “A business is more than a business,” he says. “It’s a platform to do other things.” For instance, in 1994, Freeman Cosmetics opened a 165,000-square-foot factory that created jobs for 300 people in South Central Los Angeles.

Since its beginning, Freeman’s growth has been steady and methodical, funded solely by the company’s cash flow. Larry never had brought in a dime of outside financing. By 1998, however, Freeman’s sales, which had climbed to $70 million, were growing so fast that the company could no longer generate sufficient cash to fuel the growth. Larry contacted an investment banker to explore external financing options for the company and included a very explicit edict: “Do not bring me a buyer. I do not want to sell this [company].”

Ignoring Larry’s decree, the investment banker brought a handful of enticing offers to Larry and the other family members involved in the business. Several family members had serious doubts about selling the company, but they all changed their minds when they began to see the offers. Dial, Inc., the consumer products giant, was offering the family $80 million for Freeman Cosmetics—far more than any of them had ever imagined they could get for their family business.
Everyone except Larry was ready to sell. He didn’t need the money, and he wanted his grandchildren to have a chance to run the family business one day. Not wanting to stand in the way of his children, however, Larry reluctantly agreed to sell Freeman Cosmetics to Dial. After the closing, the family members escaped to a bathroom, where they hugged one another and cried.

The deal called for Larry to be president of Dial’s personal care division, which included the newly acquired Freeman’s Cosmetics. Just six weeks after closing the deal, however, Dial’s chairman called Larry and told him, “Stay home; collect your checks.” Larry and the rest of the Freeman clan could only stand by and watch Dial run their business. Unfortunately, the decisions Dial executives were making were running the once successful company straight into the ground. For instance, Dial managers cut Freeman’s product line by one-third, closed the factory in South Central Los Angeles, and cut R&D expenditures. Sales began to slide, and the Freemans walked away in disgust from employment contracts with Dial valued at $2.5 million. “I was watching Dial destroy what it took me 25 years to build,” Larry recalls.

After three years, Dial sold its personal care division, including Freeman Cosmetics, for $12 million to the Hathi Group, which was no better at running the business than Dial was. When Hathi declared bankruptcy in September 2003, the Freemans bought back their business for $10 million. Larry, Mark, and Jill are back at their same desks handling much the same areas they managed before the sale. Yet the new Freeman Cosmetics is quite different from the company they sold years ago. Instead of the vertically integrated business with 400 employees, the company is a lean, 25-person sales and marketing company that outsources all of its manufacturing to other factories. That does not concern Mark, however, who says that manufacturing never was one of the family’s strengths.

The Freemans are focusing on their company’s growth, knowing that if they did it once before, they can do it again. What happens down the road once they reach their goals? “It may be that ten years from now someone makes us an offer so big that we have to take it again,” says Larry with a big smile, sounding as if he already is trying to convince himself that it would be the right thing to do.

1. Why do many entrepreneurs who sell their businesses suffer from seller’s remorse? Use the Web to research entrepreneurs who have sold their businesses. What emotional issues do they face after the sale?
2. Referring to entrepreneurs who sell their companies, Eugene Muscat, director of the Gellert Foundation Family Business Center at the University of San Francisco, says, “If you were a business owner and then all of a sudden all you are is just a rich person, that’s a big fall from grace.” What does he mean? Do you agree? How does this tendency affect entrepreneurs?
3. Could the Freemans have done anything differently to avoid the problems they encountered when they sold their family business? Write a brief report (no more than one page) summarizing your recommendations and the logic behind them.


**Structuring the Deal**

Next to picking the right buyer, planning the structure of the deal is one of the most important decisions a seller can make. Entrepreneurs who sell their companies without considering the tax implications of the deal may wind up paying the IRS as much as 70% of the proceeds in the form of capital gains and other taxes. A skilled tax adviser or financial planner can help business sellers to legally minimize the bite various taxes take out of the proceeds of the sale. When it comes to exit strategies, entrepreneurs have the following options available to them.

**Exit Strategies**

**Straight Business Sale** A straight business sale often is best for those entrepreneurs who want to step down and turn over the reins of the company to someone else.
After graduating from a community college, Paul Hanlon, then 22, took a job earning minimum wage plus commissions for a company selling portable pop-up displays for use in trade shows. Five years later, Hanlon borrowed $47,000 to buy the company for just the cost of its inventory. Over the next decade, Hanlon, who renamed the company Folio Inc., expanded its product line and landed big-name clients such as Reebok, Oracle, and GE. When he was 39, Hanlon decided to sell Folio and retire and become an author and a motivational speaker when he received an offer for $20 million.  

In straight business sales, owners must decide whether to sell the assets of the business or transfer ownership to the buyer through a sale of company stock. Which choice is best for the seller and the buyer depends on the form of ownership. In an S corporation, the seller does not care if it the transaction is through stock or assets because the tax considerations are the same. Owners of C corporations are far better off selling stock rather than selling assets. Buyers will generally prefer to acquire the “hard” assets of the business, thus, avoiding any potential hidden liabilities. Despite these concerns, more than 90 percent of business sales involve a sale of shares of stock. 

**Business Sale with an Agreement from the Founder to Stay on** Sometimes business owners want to sell their companies but stay on to operate them. Doing so enables an entrepreneur to avoid concentrating his or her personal wealth in a single asset—the business—and to stay involved in managing the company he or she founded. 

Kevin McDonald co-founder of Compendit Inc., a consulting business specializing in enterprise resource planning, recently sold his firm to a larger company in the consulting business, Inforte Corporation, for $6 million and stayed on as executive vice-president and general manager. Inforte simply integrated Compendit into its corporate structure as a division, allowing McDonald’s company to stay intact. Most of the company’s 54 employees also stayed on. Although now subject to a corporate hierarchy, McDonald takes a philosophical view. “As an entrepreneur, I have always worked for my team, my customers, my wife, the bank . . . What’s one more boss?”  

Although this scenario sounds like the ideal solution for entrepreneurs who are seeking more free time without stepping away entirely from the companies they built, it does not always prove to be. Accustomed to being in control, making the key decisions, and calling all of the shots, entrepreneurs who sell out with an agreement to stay on often have great difficulty relinquishing control of the company to the new owner. The situation is particularly difficult when the new owner makes decisions that jeopardize the company’s future, forcing the founder to stand by and watch the business spiral slowly downward toward failure. 

That’s exactly what happened to John Diebel, who, in 1972 founded Meade Instruments as a small telescope maker and distributor while working as an engineer at Hughes Aircraft. In 1986, having built Meade into a successful company with annual sales of nearly $14 million, Diebel sold out to Harbor Group, a St. Louis-based leveraged buyout firm, but agreed to stay on as president to manage the company. It was a move he began to regret almost immediately. The new owners cut R&D spending and new product development efforts, imposed a rigid structure on the previously nimble company, and demanded endless reports from Diebel. “John was used to reporting to himself,” says Meade’s former chief operating officer. “If he had a good idea, he wanted to do it. He didn’t want to make a plan.” Within five years of the sale, the new owner had pushed the once successful company to the brink of bankruptcy. That’s when Diebel stepped in and repurchased the company for just $1,000 and the assumption of $2.4 million in existing debt. Diebel has since rebuilt Meade and restored it to profitability, making his ownership stake worth more than $30 million.
Form a Family Limited Partnership  Entrepreneurs also can transfer their businesses to their children but still maintain control over them by forming a family limited partnership. The entrepreneur takes the role of the general partner, and the children become limited partners in the business. The general partner keeps just 1% of the company, but the partnership agreement gives him or her total control over the business. The children own 99% of the company but have little or no say over how to run the business. Until the founder decides to step down and turn over the reins of the company to the next generation, he or she continues to run the business and, with proper planning, can set up significant tax savings when the ultimate transfer of power takes place.

Sell a Controlling Interest  Sometimes business owners sell a majority interest in their companies to investors, competitors, suppliers, or large companies, retain a portion of the ownership themselves, and agree to stay on after the sale as managers or consultants.

That’s just the kind of deal Frank Happ, who worked his way up the ranks at a company that made coin-operated games before purchasing the business, was able to negotiate with Pfingsten Partners, a private equity firm in Deerfield, Illinois. After purchasing the business in 1986, Happ bought out several competitors, expanded into the business of distributing games, and brought his two children into the business. When Happ reached his late 50s, he decided to sell the company, which had reached annual sales of $68 million. He considered a straight business sale but instead decided to sell a controlling interest in Happ Controls to Pfingsten Partners for eight times the company’s earnings and retain 8.2 percent of the business. Happ now works just 30 days a year for the company (where he reports to his son, whom Pfingsten Partners named president), leaving him plenty of time to play golf and watch his grandchildren grow up.

Restructure the Company  Another way for business owners to cash out gradually is to replace the existing corporation with a new one formed with other investors. The owner essentially is performing a leveraged buyout of his or her own company. For example, assume that you own a company worth $15 million. You form a new corporation with $12 million borrowed from a bank and $3 million in equity: $1.5 million of your own equity and $1.5 million in equity from an investor who wants you to stay on with the business. The new company buys your company for $15 million. You net $13.5 in cash ($15 million minus your $1.5 million equity investment) and still own 50 percent of the new leveraged business (see Figure 7.5).

Sell to an International Buyer  In an increasingly global marketplace, small U.S. businesses have become attractive buyout targets for foreign companies. Foreign buyers—mostly European—buy more than 1,000 U.S. businesses each year. England leads the list of nations acquiring U.S. companies, but China is coming on strong.
Robert Parker, owner of Adams Pressed Metals, a small, family-owned company in Galesburg, Illinois, that makes stamped metal parts, saw his company struggle when John Deere, his largest customer, began buying parts from Tri-Star International, a Chinese manufacturer. Transforming a significant threat into a substantial opportunity, Parker negotiated a deal with Tri-Star to sell a majority interest in the family-run business for $1 million. Tri-Star recognized that Adams Pressed Metals had a solid reputation among its customer base, access to important distribution channels, and a skilled workforce. “Adams will provide Tri-Star with a U.S. platform to expand its global operations,” says Parker. “We saved 40 jobs, and [Tri Star] got American know-how in sales.”23

As Robert Parker’s experience shows, it is not unusual in today’s global economy to find companies across the globe with substantial financial resources looking to acquire small businesses in the United States. In many instances, foreign companies buy U.S.-based companies to gain access to a lucrative, growing market. They look for a team of capable managers, whom they typically retain for a given time period. They also want companies that are profitable, stable, and growing. Selling to foreign buyers can have disadvantages, however. They typically purchase 100 percent of a company, thereby making the previous owner merely an employee. Relationships with foreign owners also can be difficult to manage due to cultural and philosophical differences.

**Use a Two-Step Sale** For owners wanting the security of a sales contract now but not wanting to step down from the company’s helm for several years, a two-step sale may be ideal. The buyer purchases the business in two phases—getting 20 to 70 percent today and agreeing to buy the remainder within a specific time period. Until the final transaction takes place, the entrepreneur retains at least partial control of the company.

**Establish an Employee Stock Ownership Plan (ESOP)** Some owners cash out by selling to their employees through an employee stock ownership plan (ESOP). An ESOP is a form of employee benefit plan in which a trust created for employees purchases their employer’s stock. Here’s how an ESOP works: The company transfers shares of its stock to the ESOP trust, and the trust uses the stock as collateral to borrow enough money to purchase the shares from the company. The company guarantees payment of the loan principal and interest and makes tax-deductible contributions to the trust to repay the loan (see Figure 7.6). The company then distributes the stock to employees’ accounts based using a predetermined formula. In addition to the tax benefits an ESOP offers, the plan permits the owner to transfer all or part of the company to employees as gradually or as suddenly as preferred.

To use an ESOP successfully, a small business should be profitable (with pre-tax profits exceeding $100,000) and should have a payroll of more than $500,000 a year. Generally, companies with fewer than 15 to 20 employees do not find ESOPs beneficial. For companies that prepare properly, however, ESOPs offer significant financial and managerial benefits. Owners get great flexibility in determining their retirement schedules. An ESOP allows all parties involved to benefit, and the transfer of ownership can be timed to meet the entrepreneur’s personal and financial goals.

Table 7.5 offers tips to help business sellers prepare their companies for sale to get maximum value from them.  

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**FIGURE 7.6**

A Typical Employee Stock Ownership Plan (ESOP)

TABLE 7.5 Preparing Your Company for Sale: How to Maximize Its Value

David Lobel, managing partner in a private equity firm that has purchased dozens of small companies, says that getting a company into shape to sell “can’t be done overnight, but it can be done.” What steps can business sellers take to prepare their companies for sale so that they can get maximum value from them? The following tips will help.

1. **Clean up the company’s financial records.** Too many business owners are careless about keeping their books in pristine condition. A common excuse is “I’m too busy running my business to worry about keeping up with all of those financial records.” However, a company’s financial records are the raw materials from which potential buyers will establish the price they are willing to pay for a company. Make your company’s financial records as tidy and as transparent as possible.

2. **Catch up on basic housekeeping.** People who are selling their houses know that cleaning and organizing their homes and eliminating clutter can add to the appeal—and to the price—of their houses. The same is true for businesses. Clean up all of the clutter that tends to build up over time, spruce up the physical appearance of the place, and put things in their proper places.

3. **Stop running personal expenses through the company.** Some business owners seek to minimize their company’s tax bills by running personal expenses—for instance, gas for the family car—through the company. Tricks such as these make buyers nervous.

4. **Prepare a customer list for prospective buyers.** Buyers want to know that a company’s sales will continue after they close the deal. Providing a list of important customers, including details such as how long each one has been buying from the company, how much each one has spent, key contacts (if business customers are involved), and the quality of the relationship, will add value to your business.

5. **Prepare a list of your company’s key suppliers.** Which ones are most reliable? What kinds of contracts does your company have with them?

6. **Be prepared to show prospective buyers how much it costs to deliver your product or service to a customer.** Buyers want to know that the company’s cost estimates are realistic.

7. **Prepare an employee policy manual.** The manual should include a job analysis for each position in the company, complete with a job description and job specifications. What rules of expected behavior does the company have?

8. **Prepare a document that describes how all of the machinery and equipment in the business works.** A list of service and repair contacts also is important.

9. **Consider removing from the payroll family members who are not essential to the operation of the business.** Many small businesses include family members whose contributions to the company are minimal.

10. **Take the time to conduct a business valuation at least every two years.** In many cases, when prospective buyers approach business owners with unsolicited offers for their companies, the entrepreneurs have no basis for making a deal because they have never taken the time to determine the value of their businesses. Seeing what makes up the real value in your business might enable you to operate it more effectively.

11. **Be prepared to stay on after the sale to help the new owner through the transition period.** In many instances, the business founder and his or her knowledge is the most important asset a company has.

12. **Take the steps listed here at least three years before you plan to sell your company.**

   **Remember:** It takes time to prepare a company for sale.


**Negotiating the Deal**

Although determining the value of a business for sale is an important step in the process of buying a business, it is not the final one. The buyer must sit down with the seller to negotiate the actual selling price for the business and, more important, the terms of the deal. The final deal the buyer strikes depends, in large part, on his or her negotiating skills. The first “rule” of negotiating a deal is to avoid confusing price with value. *Value* is what the business is actually worth; *price* is what the buyer agrees to pay. In a business sale, the party who is the better bargainer usually comes out on top. The buyer seeks to:
Get the business at the lowest possible price.
Negotiate favorable payment terms, preferably over time.
Get assurances that he or she is buying the business that he or she thinks he or she is getting.
Avoid putting the seller in a position to open a competing business.
Minimize the amount of cash paid up front.

The seller is looking to:
Get the highest price possible for the business.
Sever all responsibility for the company’s liabilities.
Avoid unreasonable contract terms that might limit his or her future opportunities.
Maximize the cash he or she gets from the deal.
Minimize the tax burden from the sale.
Make sure the buyer will be able to make all future payments.

One factor that makes the process of negotiating the purchase of a business challenging is that many business founders overestimate the value of their companies because of all of the “sweat equity” they have poured into their businesses over the years. One entrepreneur recalls a negotiation he was involved in for the potential purchase of a rival’s business. The company had $4 million in sales but had incurred losses of more than $1 million in the previous two years, owed more than $2.5 million in unpaid bills, and had no machinery that was less than 30 years old. Much to the prospective buyer’s amazement, the owner was asking $4 million for the business! To deal with this reality, buyers must understand the negotiation process.

**Factors Affecting the Negotiation Process**

Before beginning negotiations, a buyer should take stock of some basic issues. How strong is the seller’s desire to sell? Is the seller willing to finance part of the purchase price? What terms does the buyer suggest? Which ones are most important to him or her? Is it urgent that the seller close the deal quickly? What deal structure best suits your needs? What are the tax consequences for both parties? Will the seller sign a restrictive covenant? Is the seller willing to stay on with the company for a time as a consultant? What general economic conditions exist in the industry at the time of the sale? Sellers tend to have the upper hand in good economic times, and buyers will have an advantage during recessionary periods in an industry.

**The Negotiation Process**

On the surface, the negotiation process appears to be strictly adversarial. Although each party may be trying to accomplish objectives that are at odds with those of the opposing

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“*To be a successful negotiator, you’ll need courage, cunning, and stamina. If that doesn’t work, try rock, paper, scissors.*”
party, the negotiation process does not have to turn into a nasty battle of wits with overtones of “If you win, then I lose.” The negotiation process will go much more smoothly and much faster if both parties work to establish a cooperative relationship based on honesty and trust from the outset. A successful deal requires both parties to examine and articulate their respective positions while trying to understand the other party’s position. Recognizing that neither of them will benefit without a deal, both parties must work to achieve their objectives while making certain concessions to keep the negotiations alive.

To avoid a stalled deal, a buyer should go into the negotiation with a list of objectives ranked in order of priority. Once you have developed your list of priorities, it is useful to develop what you perceive to be the seller’s list of priorities. That requires learning as much as possible about the seller. Knowing which terms are most important (and which are least important) to you and to the seller enables you to make concessions without “giving away the farm” and without getting bogged down in “nit-picking,” which often leads to a stalemate. If, for instance, the seller insists on a term that the you cannot agree to, you can explain why and then offer to give up something in exchange. You also should identify the one concrete objective that sits at the top of that list, the one thing you absolutely must come away from the negotiations with. The final stage of preparing for the actual negotiation is to study your list and the one you developed based on your perceptions of the seller to determine where the two mesh and where they conflict. The key to a successful negotiation is to use this analysis to look for areas of mutual benefit and to use them as the foundation for the negotiation.

**Hands on ... How to**

**Become a Successful Negotiator**

Buying or selling a business always involves a negotiation, and so do many other business activities, whether an entrepreneur is dealing with a bank, a customer, or a vendor. “Everyone negotiates something everyday,” says Roger Fisher and William Ury in their book, Getting to Yes. “All of us negotiate many times a day.” That’s why negotiating skills are among the most important skills that entrepreneurs can learn. How can you become a more successful negotiator? The following advice will help.

1. **Prepare.** Good negotiators know that the formula for a successful negotiation is 90 percent preparation and 10 percent bargaining. What you do—or don’t do—before the actual negotiation ever begins is a primary determinant of how successful your negotiation will be. The key is to learn as much as possible about the party with whom you will be negotiating, the issues that are most important to him or her, and his or her likely positions on those issues. Leo Riley, president of a training and consult-

Negotiating the purchase of a business can test the will, patience, and stamina of any entrepreneur. What steps can entrepreneurs take to “get to yes?”

“Knowledge of their hobbies, families, dietary habits, religious beliefs, and [other traits] can be used as ice breakers or to avoid making embarrassing mistakes.”
Your preparation for a negotiation also should include a statement of the outcome you desire from the negotiation. “Write down exactly what your goals are and then edit this description furiously until it is laser-focused and precise,” advises John Patrick Nolan, a negotiation specialist. Then you should write down what you think your counterpart’s goals from the negotiation are. This encourages you to look at the negotiation from a different perspective and can be a valuable and revealing exercise.

2. **Remember the difference between a “position” and an “interest.”** The outcome a person wants from a negotiation is his or her position. What is much more important, however, is his or her interest, the reason behind the position he or she hopes to achieve. Focusing strictly on their positions usually leads two parties into a win–lose mentality in a negotiation, in which they try to pound one another into submission. When the parties involved in a negotiation focus on their interests rather than on their positions, however, they usually discover that there are several different solutions that both will consider acceptable and reasonable.

   The Parable of the Orange provides an excellent lesson on the difference between the two. Two parties each want an orange, but there is only one orange. After much intense negotiating, the two agree to cut the orange in half. As it turns out, however, one party wanted only the rind of the orange to make cookies, and the other party wanted the orange to make orange juice. If the parties involved in the negotiation had focused on their interests and taken a problem-solving approach, they each could have gotten exactly what they wanted from the negotiation!

3. **Develop the right mindset.** Inexperienced negotiators see a negotiation as a zero-sum, win–lose game. “If you win, then I lose.” Entrepreneurs who want or need to maintain ongoing relationships with the other party (e.g., buying a business from the company founder, whom you want to convince to stay on through a transition period to help you learn the business) must see negotiations in a different light. Their goal is to work toward a mutually beneficial agreement that both parties consider to be fair and reasonable.

   Successful negotiations almost always involve compromise on both sides, which means that neither party gets everything that he or she wanted. “Sometimes the best deal you are going to get won’t leave you jumping with joy,” says Mike Staver, a negotiation consultant. In other words, successful negotiators see a negotiation not just as deal making but also as problem solving.

4. **Always leave yourself an escape hatch.** In any negotiation, you should be prepared to walk away without making a deal. Doing so, however, requires you to define what negotiation experts call a best alternative to a negotiated agreement (BATNA), which is the next-best alternative to a negotiated agreement. You cannot determine whether a negotiated agreement is suitable unless you know what your alternatives are, and one alternative (although not always the best one) is to walk away from the negotiation without an agreement—your BATNA. One writer explains, “You may never need [your BATNA], but just knowing it’s in your back pocket gives you peace of mind. Without one, you can become anxious, appear desperate, and settle for a less-than-ideal solution.”

   Having a BATNA increases your power in a negotiation, but you should use that power judiciously. Do not use your BATNA as a threat to coerce an agreement. In addition, don’t kill the deal just because you can. Instead, use your BATNA as the baseline against which you measure your negotiated alternatives.

5. **Keep your emotions in check.** Negotiations can become emotionally charged, especially if those involved allow their egos to enter into the process. It is always best to abide by the Golden Rule of Negotiating: Treat others the way you want to be treated in the negotiation. Be fair but firm. If the other party forgets the Golden Rule of Negotiating, remember that you can always walk away from the negotiation and fall back on your BATNA.

6. **Sometimes it’s best to remain silent.** A common mistake many people make in the negotiation process is talking too much. Not only does remaining silent allow you to listen to the other party, but it also encourages the other party to make the first offer. Some people are disconcerted
by prolonged periods of silence and begin talking, only to erode the strength of their negotiation base.


Chapter Summary by Learning Objectives

1. Understand (A) the advantages and (B) the disadvantages of buying an existing business.

The advantages of buying an existing business include the following: A successful business may continue to be successful; the business may already have the best location; employees and suppliers are already established; equipment is installed and its productive capacity known; inventory is in place and trade credit established; the owner hits the ground running; the buyer can use the expertise of the previous owner; and the business may be a bargain.

The disadvantages of buying an existing business include the following: An existing business may be for sale because it is deteriorating; the previous owner may have created ill will; employees inherited with the business may not be suitable; its location may have become unsuitable; equipment and facilities may be obsolete; change and innovation are hard to implement; inventory may be outdated; accounts receivable may be worth less than face value; and the business may be overpriced.

2. Define the steps involved in the right way to buy a business.

Buying a business can be a treacherous experience unless the buyer is well prepared. The right way to buy a business is to analyze your skills, abilities, and interests to determine the ideal business for you; prepare a list of potential candidates, including those that might be in the “hidden market”; investigate and evaluate candidate businesses and evaluate the best one; explore financing options before you actually need the money; and, finally, ensure a smooth transition.

3. Explain the process of evaluating an existing business.

Rushing into a deal can be the biggest mistake a business buyer can make. Before closing a deal, every business buyer should investigate five critical areas: (1) Why does the owner wish to sell? Look for the real reason. (2) Determine the physical condition of the business. Consider both the building and its location. (3) Conduct a thorough analysis of the market for your products or services. Who are the present and potential customers? Conduct an equally thorough analysis of competitors, both direct and indirect. How do they operate and why do customers prefer them? (4) Consider all of the legal aspects that might constrain the expansion and growth of the business: Did you comply with the provisions of a bulk transfer? Negotiate a restrictive covenant? Consider ongoing legal liabilities? (5) Analyze the financial condition of the business, looking at financial statements, income tax returns, and especially cash flow.

4. Describe the various techniques for determining the value of a business.

Placing a value on a business is partly an art and partly a science. There is no single “best” method for determining the value of a business. The following techniques (with several variations) are useful: the balance sheet technique (adjusted balance sheet technique); the earnings approach (excess earnings method, capitalized earnings approach, and discounted future savings approach); and the market approach.

5. Understand the seller’s side of the buyout decision and how to structure the deal.

Selling a business takes time, patience, and preparation to locate a suitable buyer, strike a deal, and make the transition. Sellers must always structure the deal with tax consequences in mind. Common exit strategies include a straight business sale, a business sale with an agreement for the founder to stay on, forming a family limited partnership, selling a controlling interest in the business, restructuring the company, selling to an international buyer, using a two-step sale, and establishing an employee stock ownership plan (ESOP).
6. Understand how the negotiation process works and identify the factors that affect it.

The first rule of negotiating is to never confuse price with value. In a business sale, the party who is the better negotiator usually comes out on top. Before beginning negotia-


tions, a buyer should identify the factors that are affecting the negotiations and then develop a negotiating strategy. The best deals are the result of a cooperative relationship between the parties based on trust.

Discussion Questions

1. What advantages can an entrepreneur who buys a business gain over one who starts a business from scratch?
2. How would you go about determining the value of the assets of a business if you were unfamiliar with them?
3. Why do so many entrepreneurs run into trouble when they buy an existing business? Outline the steps involved in the right way to buy a business.
4. When evaluating an existing business that is for sale, what areas should an entrepreneur consider? Briefly summarize the key elements of each area.
5. What is goodwill? How should a buyer evaluate a business’s goodwill?
6. What is a restrictive covenant? Is it fair to ask the seller of a travel agency located in a small town to sign a restrictive covenant for one year covering a 20-square-mile area? Explain.

7. How much negative information can you expect the seller to give you about the business? How can a prospective buyer find out such information?
8. Why is it so difficult for buyers and sellers to agree on a price for a business?
9. Which method of valuing a business is best? Why? What advice would you offer to someone who is negotiating to buy a business about determining its value?
10. Outline the different exit strategy options available to a seller.
11. One entrepreneur who recently purchased a business advises buyers to expect some surprises in the deal no matter how well prepared they may be. He says that potential buyers must build some “wiggle room” into their plans to buy a company. What steps can a buyer take to ensure that he or she has sufficient “wiggle room”?

Business Plan Pro

This chapter has addressed acquiring an existing business. If this is your situation, determine whether the company has a business plan. If so, how recent is that plan? Is it representative of the current state of the organization? Do you have access to other historical information including the financial statements such as the profit and loss, balance sheet and cash flow statements? These documents may be a valuable resource to help you to better understand the business you may purchase.

Business Plan Exercises

On the Web

If the business has a Web site, review that site to assess the “online personality” of the business and to gather as much information as you can about the business. Does it match what you have learned about the business through the owner and other documents you have reviewed? Do a search for the business name and the owners’ names on the Web. You may find that Google.com offers the most robust results. Note what you find and, again, determine if this information correlates with information from other sources.

Sample Plans

Review the executive summaries of these ongoing business plans through the Sample Plan Browser in Business Plan Pro:

- Machine Tooling
- Salvador’s Sauces
- Sample Software Company
- Take Five Sports Bar
- Web Solutions, Inc.

Scan the table of contents and find the section of the plan with information on the company’s past performance. What might this historical information tell you about the future potential of the venture? Which of these businesses would you expect to present the greatest profit potential based on their past performance? Which business represents the greatest risk based on these same criteria? How might this impact its purchase price?

In the Software

If the company that you are considering to buy has a business plan, enter this information into Business Plan Pro. First, select the “Existing” business plan option in the opening window. If you have access to an electronic version of the company’s plan you are considering purchasing, you can
copy and paste text from a word processing document directly into Business Plan Pro by using the “Paste Special” option and then selecting the option “Without Formatting.” This step will help to keep your formatting in order. Go to the “Company Summary” section and include the results of the due diligence process. The financial statements of the business, including the balance sheet, profit and loss, and cash flow statements for the last three years will be valuable historical data. This will set a baseline for you as you enter sales and expense scenarios into this plan. This process may help you to better assess the business’s future earning potential and its current value.

**Building Your Business Plan**

One of advantages of using Business Plan Pro is the ease of creating different financial scenarios for your business. This can be an excellent way to explore multiple “what if” options. Once your business is in motion, updating the plan during the fiscal year and on an annual basis can be a quick and easy process. This will be an efficient way to keep your plan current and, by saving each of these files based on the date, for example, offer an excellent historical perspective of your business.

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**Beyond the Classroom . . .**

1. Ask several new owners who purchased existing businesses the following questions:
   A. How did you determine the value of the business?
   B. How close was the price paid for the business to the value assessed prior to purchase?
   C. What percentage of the accounts receivable was collectible?
   D. How accurate were their projections concerning customers (sales volume and number of customers, especially)?

2. Visit a business broker and ask him or her how he or she brings a buyer and seller together. What does he or she do to facilitate the sale? What methods does he or she use to determine the value of a business?

3. Invite an attorney to speak to your class about the legal aspects of buying a business. How does he or she recommend a business buyer protect himself or herself legally in a business purchase?