Buying a small to mid-sized business

JPAbusiness

Advice • Valuations • Transactions

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Chapter 1: Fools rush in – planning your business purchase

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Whether we're assisting a client to buy a business, providing advice or due diligence, or fielding enquiries on businesses we're marketing for sale, one of the first things I tell people is **the price of the business should not be their primary concern.**

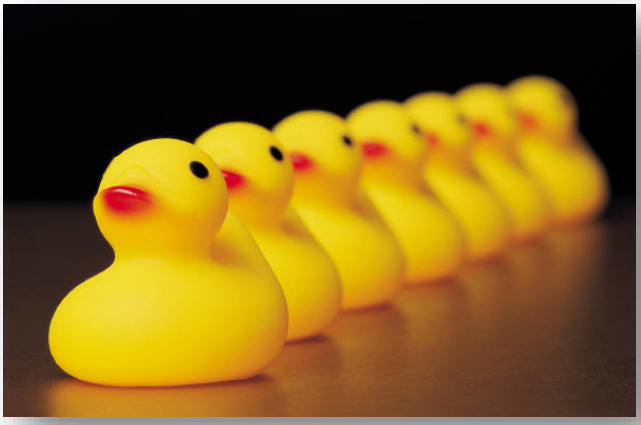
Now that sounds a bit strange, I know, because **price is obviously important** – it would be silly to enquire about a business worth $5 million, for example, when you have $500,000 maximum to invest.

But, and I'm very serious about this, set the price of the business aside in your initial discussions and investigations **because the first questions you should consider are:**

- **What do I want from the business venture?** Will this business allow me to achieve that?

- **Do I feel there is a close alignment between my core skills, experience and expertise and the business I'm looking to buy?** What is that alignment – what are those skills?

- **Do I feel passionate about working in, owning and managing this business** and confident in my ability to do so?



Take the acid test

Those are the acid test questions you should ask whether you're moving from an employed environment and buying or starting your first business, whether you're looking at a second business to add to a portfolio, or adding a business line to an existing operation.

The reason we ask these questions is that **buying a business is an investment class that is not as liquid as many others.**

Buying a business is an investment that usually has a longer term cycle – it's not a straight-forward, simple investment in a blue chip company on the stock exchange.

Have passion for the opportunity

Your answer to the 'passion' question is just as important whether you are seeking to work in the business day to day, or planning to act as an investor with oversight.

You have to be comfortable and confident with the fabric of the enterprise you're looking to invest in and take a risk in.

Ignore these acid test questions at your peril

These are very 'soft' concepts and not ones you'll necessarily get from a purely finance or numbers-based assessment, but all too many times I've seen people go into opportunities where they didn't have positive answers to those acid test questions.

Usually, one of two things happen:

1. Six to 12 months down the track they have an 'oh no' moment and think 'why am I here', 'why am I doing this', 'this is not what I expected', 'I don't feel comfortable with this'; or
2. They move into the business and suddenly it doesn't perform as it did for the last owner, and then they're starting from behind.

So, first up, **you must have passion for the business opportunity** you're considering and **you must have an alignment of skills and capability**. Everything else should flow from that.

If you **can't answer a full and wholehearted 'yes, yes, yes'** to those questions, you should **seriously question why you're spending your time assessing this opportunity.**

The JPAbusiness Buyer's Checklist

A good business purchase is about planning and ensuring you have plenty of information to base decisions on, rather than rushing in and letting emotions take over.

Use our Buyer's Checklist to help you 'make a match' between your requirements and risk profile, and the business you are assessing.

The JPAbusiness Buyer's Checklist:

1. What are the core reasons you want to purchase this business?
2. Do you have a strategic plan to guide and shape your personal and business objectives (for e.g. your expected return on investment, growth aspirations, lifestyle plans etc.)
3. Why will you succeed in this business?
4. Is the business you are potentially going to invest and work in for an extended period the right fit for you?

5. Does the vendor's asking price represent value for money?
6. How does the asking price compare to a market appraisal of recent sales and market trends?

7. What due diligence have you done to assess if your investment will see you generating a return in line with your objectives?
8. Have you sufficient cash or equity that can be easily borrowed against to pay the purchase price?
9. Does your business plan assess and project the working capital and cash flow requirements to operate?
10. Have you considered the most flexible and effective commercial finance option for your circumstances?
11. Do you fully understand the requirements of the lease relating to your potential business purchase?
12. Have you considered other locations for the business and how that might impact performance?
13. Have you compared a number of businesses against your requirements? A business finder can sometimes help.
14. Do you need 'arms length' assistance with purchase negotiations?

Be diligent about your assessment and also **be prepared to 'walk away'** if the business or the deal doesn't stack up.

If there is one business that interests you, there are bound to be others. You just need to find the right one!

Buying a franchise – a specialised purchase

We've talked about buying a business and provided some principles which apply across the board, whether you're buying a franchise or an independent, owner-operated business.

However there are **four critical questions for people considering buying a franchise:**

1. Are you clear on the pros and cons of buying a franchise?
2. Do you understand the **candidate assessment process** and what the franchisor is looking for in a franchisee?
3. Have you considered the risks and opportunities associated with a **greenfield franchise opportunity** (at a new site) versus purchasing an existing business?

4. Have you factored in all the **costs and benefits** of the franchise opportunity (for e.g. franchise fees, marketing expenses or contributions, reviews, refreshes or fit-outs, reporting and systems obligations and restrictions, product supply and ordering requirements etc)?

Chapter 2: Finding the right business – where should you start?

Many businesses are advertised in print media and on internet sites.

However **sometimes the business you are interested in might not be advertised.**

In our experience in working for clients who are looking for businesses to purchase, you're really not doing yourself justice if you just look at businesses advertised for sale in the print media or online.

Look at the broader market, not just what's on the shelf!

Making a confidential enquiry

Some people will find it confronting to approach a business owner directly and query whether their business is for sale. It's quite a leading question and it's not easy to do.

We provide a service to clients whereby we, as a third party, confidentially approach business owners who might not have their businesses for sale and query their interest in exploring a business sale opportunity.

We often find there is, in fact, interest in selling.

If you don't ask the question you will never, never know.

The sifting process – identifying the right business for you

The sifting process refers to the way you assess potential business opportunities against your requirements.

When talking to clients about how to analyse business opportunities, I tell them to imagine this sifting process as a funnel.

At the top, the funnel is wide and it has a screen 'sifting against your requirements'.

This is where you look broadly at businesses that might fit your requirements. These requirements might be geographic based, size and turnover based, earnings based, product or customer requirements, and so on.

You'll also have a view about price range, but keep that view wide; you're at the top of the funnel.

10 stages of the funnel

1. Initial scan of market for businesses that meet your requirements.
2. Preliminary critical assessment information.
3. Decide on non-binding offer and/or advice on market value, or not to proceed.
4. Non-binding offer and negotiations.
5. In-principle offer acceptance.
6. Detailed due diligence.
7. Contract documentation and negotiations.
8. Contract exchange.
9. Final pre-completion transfer processes and requirements.
10. Contract completion, and post-completion transfer processes.

Basic information gathering

While you're at the top of the funnel secure some initial information on the business that helps you and your advisor, if you're utilising one, assess the performance of the business.

In particular, find out:

1. Does this business have a **positive earnings performance**?
2. Are **earnings on an upward trend or a downward trend**?
3. Is there a **point of difference** in the business that goes to achieving business maintainable earnings (or sustainable earnings)?

As you uncover more information, remember to keep asking yourself:

- Would I be **passionate about and feel confident in** operating this business?
- Is there a **close alignment between my skills and this business**?
- Is there **value in purchasing this business versus starting a similar business myself?**

Taking the next step – a non-binding offer

The next step is to ask the threshold question: 'Based on the information I have, **do I feel confident to put in a non-binding offer on this business**, or are there gaps in the information I have received which makes it difficult to assess the real value of the business?'

If you feel confident, then put in a non-binding offer – this will test the expectations of the vendor. If you put this in writing it will emphasise your credibility and serious intent to the business owner.

If you're not confident, you may need to seek additional advice, such as an independent valuation or market appraisal on the business.

But remember you're still at the top of the funnel – **don't get lost in the detail at this stage.**

Why make a non-binding offer?

You can put a lot of effort into due diligence, looking at specific detail around customers, suppliers, products, profitability, statutory reporting and payments, financial statements – the list goes on and on.

But **why go into the detail and spend your valuable time and money on that assessment if the vendor is not aligned with your expectation on business value?**

A non-binding offer will test their expectation and allow you to weed out businesses that don't match your requirements on price, and progress the ones that do.

A non-binding offer is subject to due diligence, so you can confirm all those important details later, when you're further down the funnel.

Moving down the funnel

So, you've got to **your first offer and acceptance stage**.

You've put forward a non-binding offer, the vendor has come back and said 'I would accept that but only on the basis of X and Y' or 'I wouldn't accept that, but I'd accept this'.

Then there's **a brief period of negotiation – still in a non-binding sense** – about a price and key terms.

If you can get agreement at that stage, you can **proceed to a period of investigation and due diligence where you can utilise your advisors**, be they a business advisor, an accountant or a solicitor, or all three, to assist you investigate the core due diligence requirements.

In the next chapter we'll take a look at the due diligence process.

Chapter 3: Due diligence – uncover those skeletons before it's too late

A successful business purchase is about **doing your homework up front** and **making sure you are well prepared**.

In business circles this is called **'doing your due diligence'** – it's about making sure you know what you are getting yourself in for, before you commit to purchasing.

You don't want any **nasty surprises** after you take over - it's best to know about skeletons in the closet before it's too late to address them!

Using the JPAbusiness Due Diligence Checklist

As advisors we regularly prepare custom due diligence checklists for our business purchase clients.

Over the coming months we plan to share with you an example of a due diligence checklist for a case study business purchase.

In this eBook we will deal with **the main, over-riding areas of focus relevant to conducting due diligence** on a business purchase and share some of our top tips.

Independent advice critical

A couple of eBooks ago, when we spoke about employing staff, we said it's best if, in assessing the quality of a potential employee, you have someone other than yourself involved.

Similarly, when looking at a business investment, **it is critical that you engage someone you can trust** for independent advice on the veracity and robustness of the business you're looking to purchase.

That's usually in the due diligence process and it might be a business advisor, accountant, solicitor, or all three.

The concept of the funnel is that **as the funnel closes, you're spending your valuable time and effort, and any investment in advice and assistance, on a business that has a close match with your requirements**.

You're not defraying those resources across a range of opportunities.

Ask the right questions

Work through the due diligence process in an effective way, providing the vendor and their representative with an **Information Request Checklist** that is **aligned to your Due Diligence Checklist**.

Make sure everything critical to the value of the business, and the requirements you set right from the start, stacks up before you exchange a contract and pay a deposit.

Information – does it stack up?

The business purchase **due diligence process is about checking and verifying information** relating to the basic operations and performance of the business.

It's not really about finding holes or gaps for the sake it, or in order to renegotiate the purchase price, terms or conditions.

It is about identifying risks, issues and any material differences between what has been represented in information provided previously on the business and what you or your advisor identify in due diligence process.

If this is the case there is an opportunity for you, as a purchaser, to vary your offer, terms and so on, to protect your risk.

Due diligence – 3 core focus areas

If you **know the risks before you jump** (buy the business), then you can **plan your landing** (mitigate and manage the impact) during the business transfer. This is what the due diligence process is all about.

A robust due diligence process should cover **three core areas:**

- **Financial**
- **Commercial**
- **Legal**

For every business, the extent of focus and specific verification process in each of these three areas will vary.

The extent of investigations will also vary greatly if you are purchasing the ordinary share capital in a Pty Ltd company, as against the business assets and going concern. Your advisor should help you focus wisely and not waste time and effort in areas that are less of a priority.

While we will examine a due diligence checklist in more detail in a future eBook, here is a **Summary Checklist of key aspects to check and verify** in the process. Please note this list is not exhaustive!

Due Diligence Summary Checklist:

Financial Due Diligence

- Financial performance
- Business maintainable earnings
- Debtors
- Creditors
- Work in progress
- Salaries and wages
- Employee entitlements
- Guarantees and bonds
- Pre-payments
- Insurance

Commercial Due Diligence

- Real property/premises
- Plant and equipment
- Stock and inventory
- Systems and processes
- Employees
- Customers
- Products and services
- Suppliers
- Business IP and other assets
- Market trends and issues
- Contracts and agreements

Legal Due Diligence

- Claims and warranties
- Patents and trademarks and business names
- ATO and other statutory audits and risks
- ATO and other statutory payments
- Unrealised legal claims/risks
- Contingent and other potential liabilities
- Transfer of employee entitlements
- Contract terms, conditions including vendor warranties and indemnities

Having confidence in the information you are provided about the business is critical right through the business purchase process and particularly in the due diligence phase.

Top tips when conducting due diligence

1. **Watch for material discrepancies** – Once I asked for some information on sales by key customer by month.
When I tried to tie the information back to overall sales reported in the financial statement, they were out by more than 20%.
During further queries I received three different reports responding to the same question, all with different sales figures.
I was left frustrated and lacking confidence as to the real position.

2. **No information is a bad sign** – If the business owner or their advisor is not willing to provide information in a timely manner to satisfy your due diligence requests, this is a sure sign something is wrong – caution is best!
Of course, if they simply can't provide the information because they don't record it in the format you want, then be flexible – there are often alternative ways to satisfy your analysis.
If the business owner is suggesting the information is commercially sensitive and therefore won't provide it, again this might be a legitimate reason, but sometimes your query can be satisfied by sanitised summary information, or provision of remaining material post contract exchange.

Golden rule of buying a business – be prepared to walk away

If the core premise of the business opportunity substantially diverts from your critical requirements at any time during the process, **be prepared to walk away.**

The last thing you want to be is right at the bottom of the funnel, about to sign the contract, and thinking: "Even though it doesn't meet my requirements, I'm here now and have spent all this money and time, I'd better go ahead."

If, at any time, **you don't feel you can say 'yes' to those core requirements** of passion, skill and capability alignment, and what you want to achieve, **do not proceed.**

Chapter 4: Managing the risks of a business purchase

Risk and return are two sides of the same coin and most people looking to purchase a business, if it's not simply to replace full-time employment, should be targeting a return of between 20% and 50%, over time, on their investment, depending on the business and other factors.

In our experience, the risks associated with business purchases fall into three categories:

1. **People**
2. **Customers, Suppliers and Market Dynamics**
3. **The Value Exchange**

Managing the 'People' risks

There are some common risks associated with business purchases, particularly in small to middle-sized businesses that are **substantially dependent on an owner or a few senior employees** for their success.

Two things can happen if those personnel aren't retained in the business in an active way:

1. The business's **relationships with customers and suppliers may deteriorate**; and
2. The employees' **know-how and corporate knowledge will be lost.**

As part of the due diligence processes you need to identify the extent to which a business is reliant on individuals and protect against those risks in the final contract terms.

Here's an example of how purchasers can use a **'hard' provision** in the final contract to mitigate this risk:

> A business you're considering buying has very strong earnings, 20-25 employees, and is managed by a single director who founded the company 10 years ago. **Relationships with key suppliers and customers are still heavily managed by that director.**
>
> A 'hard' provision in the final contract may **require the vendor to agree to enter into a one-, two- or three-year full-time or part-time employment agreement**, to stay with the business and share his or her expertise.
>
> An alternative would be to **make the sale conditional on some of the senior staff, such as the sales manager or operations manager, signing an employment contract** and transferring as part of the sale.

Taking a softer approach

You can also include **'soft' provisions** to protect against 'people' risk:

> While doing due diligence you find your potential business purchase is *not* heavily reliant on one individual, but you do want to **tap into the corporate knowledge, expertise and relationships of the previous management or owner as a 'sounding board'**.
>
> In that case, it's common to have **an agreed period post-completion and transfer** that might see the manager or owner be on-hand for one week, one month or three months.
>
> That's usually on a **complementary basis** as part of the sale process, however anything outside an initial period may be on a **paid consultancy basis**.

It's a jungle out there

It's a competitive market and **not all vendors are retiring and moving out of the industry**.

Both the owners and senior people in the business can leave with a lot of knowledge and expertise that can be useful in a competitive environment, so **it's often wise to consider restraint of trade** as part of the terms and conditions of any purchase contract.

Restraint of trade is a mechanism **to prevent owners going into direct competition with the business post transfer.**

It's a difficult legal area and, as a purchaser, **you'll need to get some legal advice.**

Managing the 'Customer, Supplier and Market Dynamic' risks

This risk relates to key customers and/or suppliers taking flight from the business you've purchased in the early stage of the transfer.

In doing your due diligence **it's very wise to look at both supplier and customer concentration risk.**

Where you have a significant concentration of one particular supplier or customer, you should try and protect against that risk.

Here's an example of how purchasers can use a 'hard' provision in the final contract:

> The business has five major customers. Customer A is responsible for 60% of sales. Customer A spent $1.5 million on average for the last three years with the business.
>
> The provision in the contract allows the purchaser to hold back in trust 20% of the purchase price of the business for 12 months and pay this on the basis that Customer A's sales level, for the first 12 months after transfer, does not fall below $1.5 million.

That is a 'hard' measure and it's up for negotiation – **some vendors will accept such a provision** because they are prepared to back their business, where there is a big risk around concentration of customers.

Other vendors will not, as they will cite that **they are no longer in control of the outcome.**

It's then a matter for negotiation. Try and achieve a fair and reasonable win-win compromise. If that smells commercially sound, then you have mitigated the risk – to the extent you can.

A **'soft' means of protecting against this risk would be to agree on a very detailed transition and relationship transfer process** between the current owner, the important customers and the new owner, for e.g. joint introduction meetings and a phased handover process with old and new owners involved.

Managing the 'Value Exchange' risks

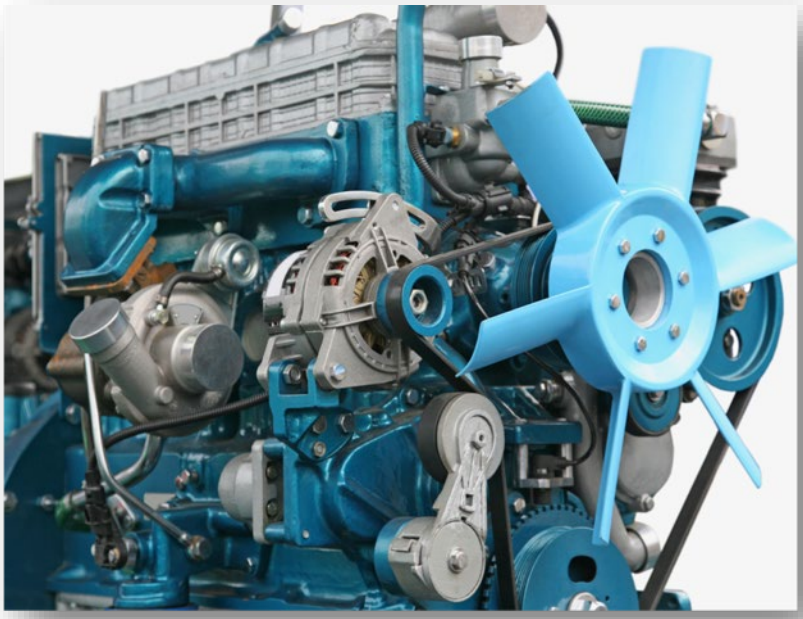
This is the ultimate risk; the doubt a purchaser may have regarding: **Am I paying fair market value for this business?**

The answer here lies in ensuring you have good advice and a sound market valuation and, more importantly, the extent to which you have confidence the **business maintainable earnings (BME)** are likely to be repeated in the first 12 months to two years of your ownership.

We've discussed BME – also known as Sustainable Earnings – in a previous eBook, How to Assess Business Value in Small to Mid-Sized Businesses. (Remember the diesel engine analogy?)

BME is not about what you do to drive the earnings through investing more money, finding new opportunities or growing the business in different ways.

BME is about what the business is likely to generate in the first 12 months if you just move in and do pretty much what the current owner is doing.



What are the risks regarding BME?

Here's an example of a **low 'value exchange' risk:**

> We recently sold a business for approximately $8 million.
>
> The business had a turnover of about $12 million and was sold with a pipeline of work that was committed with customers, but not yet invoiced, of about $5.5 million.
>
> The business had significant forward earnings projections for the next 12 months, so it rated as a relatively low risk in terms of the value exchange risk.

Alternatively**, a business relying on day-to-day jobs**, without any work committed into the future, **has a higher risk.**

It's okay to pay a fair market value – a multiple of BME, or sustainable earnings – on such a business, but you may also **negotiate some risk protection.**

Here's an example of how to **protect against that risk:**

> During the due diligence process you assessed a business as having a BME of $300,000. You agree to pay a multiple of 3 x BME for the business – $900,000 – excluding stock.
>
> However you negotiate that on contract completion you'll pay 2 x BME and, should the BME be 90% or better than $300,000 in the first year of your operations, you'll pay the final $300,000 at the end of the 12 months.

I've used a very simple example there to introduce the concept; in real life I've negotiated lots of permutations of this and there are pros and cons:

- **For a purchaser**, it adds complexity to a sale process;
- **For a vendor**, it means you're sharing risk in a business you no longer have any legal right over;
- If there is a fair deal negotiated, **it can represent a win-win** and allow the transfer to go ahead with confidence for both parties.

You can't protect against all risks, but …

You need to be prepared to stand your ground in terms of what your requirements are and whether the risks are being well managed to ensure those requirements are being met.

Remember, **being in business is about taking risk** in order to deliver a return; **but successful business is about taking sound and considered commercial risks**, ones that are analysed, assessed and understood.

Ultimately, commercial judgement plays a role here, and if you have passion, alignment of skills and capabilities, and a clear view as to how your original requirements are likely to be met, chances are you'll make a successful business purchase.