

Three Stages in a Buyer's Process

Stage 1

Part 1: FINDING and VALUING a Business - 8 Key Considerations

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STAGE 1 (Parts 1, 2 and 3)

Finding and Valuing, Offering, Due Diligence

This is a series of actions that allow you ample time to review all information PRIOR TO BUYING. It is a right of the buyer to obtain information and seek disclosure of facts already presented by the seller. It is your right as a buyer to be informed. Take the necessary time to complete the process to your satisfaction.

STAGE 2

Financing

A separate series of actions is required to obtain the financing. Some of the required information for banks is included in the due diligence processes and will "overlap". Usually the financing steps will take place prior to accomplishment of full due diligence, but remember that obtaining necessary financing is usually a prerequisite before a seller is willing to disclose all operational information. If you cannot finance the business, the seller is not willing to share all the information with you.

STAGE 3 (Parts 1, 2 and 3)

Operational Licensing and Closing

The legal transferring of ownership, title and equity in the business. Includes all of the necessary steps prior to your first day of ownership so that you can operate legally in Idaho. The steps should take place during the financing and due diligence stages and do overlap in both areas. As an example, you must have your federal identification number prior to accepting any SBA loans; therefore, you will need to file for the number early in the process so that you can close on the indicated date of closing. Another example is insurance. It is necessary to obtain insurance information for financial proforma as well as liability protection during ownership.

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1. Look for Liquidity. Can the assets and/or the operation be sold again? What are the potentials for protecting your purchase through a future sale? Is this business in the mainstream of business segments?

2. Look for Capacity. What is the overall capacity for this business to expand? Markets? Needs? What are the physical limitations for immediate expansion? Is the current income based upon a maximum usage of all available assets?

3. What is a Fair Return on the Assets. Look at the total dollar amount that would be invested in the tangible assets. How much of that total can be converted to working capital within one year (receivables, cash, inventory)? Do these "current assets" turn over according to reasonable expectations? Is there too much inventory? Too little? What is the fair market value for fixed assets? What is an expected return (percentage) for investing your cash in a dollar-for-dollar comparison? A fair return would be to assume that you can get five percent (5%) in a secure investment. But what about risk? Are the assets at risk such as obsolete or poor repair and maintenance? Fair market value (FMV) is not the book value on the balance sheet. FMV is what it would take for you to replace the equipment assuming that the business makes enough money to warrant replacement.

4. Look at a Fair Return on the Cash Down Payment. Because there is some risk in an operational business, you can expect fair return to be somewhere between 20% and 35% of the down payment. That return should be expressed as earnings before taxes (EBT). You simply divide the EBT by your down payment amount—is it between 20-35%?

5. Can You Stand Doing This Type of Business for 3, 7, 10 Years?

Although this is not as important as the financial returns, you certainly will put more effort into something you enjoy. Making money is a necessity - - but liking the business is a luxury.

6. Look at Realistic Return and Ratios on the Business. Study the national and regional returns for similar businesses. You will need to know "real" returns, not including an owners' salary, that you should expect as a bare-bones minimum. Most businesses net only about 4.5% after everything, including yourself, were paid a fair wage. What was the internal rate of return over a stated period? Most business cycles last only about seven to eight years.

7. Have an Out Plan as Part of the In Plan. Look at the potential return to you if you were to grow the business, pay into equity, retire some debt, pay yourself a fair salary and sell the business in seven years. Use a net present value (NPV) formula. Then compare the final net(s) to you to the original realistic returns. Did you make better than 20-35% on the initial investment? Did you net more than 4.5% per year? Did you?

8. Working Capital—Do You Have Enough? The majority of business failures are caused by too little capital (\$) when it was needed most. How can you determine what you might or should need in the first year? Consider adding up the following amounts in each category and have that much available in outside funds. The following is ideal:

- 3-6 months personal income needs
- One complete inventory turn—If your cost of goods is 33%, then you should turn three inventories a year, so you have the ability to purchase one
- One year's taxes (personal property and sales)
- One year's replacement/repairs
- Loan reserves—sixty days is not too uncommon
- Two times the normal advertising budget.

This is by no means a comprehensive list but can be used to establish some basic criteria for a business investment. Other resources are immediately available for your research. A list of local non-profit resources can be obtained. To begin with, the Small Business Administration offers "free" counsel and advice for investors.

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Part 2: The OFFERING

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trends. Ask questions of the sellers but don't be surprised if they are not too helpful at this stage. They are usually busy running their business and they really do not know who you are or if you are really serious. Use what they give you but don't pester them.

3. Make an Offer and Remember "Offering is not Buying". The actual buying will take place only after you have considered all the relevant information. The buying process requires several steps, the first being an agreement to sell called a Purchase and Sale Agreement. Additional documents outlining the final buy will come later. The offer should be in the form of a Contingent Purchase and Sale Agreement

4. Draft a Contingent Purchase and Sale Agreement. Which is a contractual "agenda" of important contingent actions taken by the buyer and seller that might end in a sale. Buying a business should take a fair amount of due diligence time and the agreement(s) should spell out all of the concerns, referred to as contingencies and conditions of sale, from both the buyer and seller that will be analyzed, reviewed and approved prior to a final sale. Your broker/agent or representative should assist you with professional advice as to what is appropriate for contingencies. Remember to ask for a clarification of agency. You will most likely agree that the agent representing the client (seller) also provides professional services to you the customer (buyer), but you should remember that in most instances the agent is representing the seller.

The most difficult buying decisions you will make are: "When should I offer and how much?" In order to make a rational decision about something as serious as "buying your business", I would suggest that you consider the following:

1. What to Offer and When? The initial questions I receive stem from when to offer and what is a fair price? Remember that no decision is made without information. Ask for the most current information available but be prepared to make an offer on the information given. As an example, I might have 1/2 of the current year's profit and loss and a complete previous tax year information. It is to your advantage to offer on the information provided (1/2 year) with contingencies for price changes, should the current information be different. Give yourself some areas for final negotiations.

In business operations, the day-to-day incomes and expenses will change your offer anyway so "don't be hesitant or too tardy to offer" – remember, the offer is not the purchase, it is only an agenda to purchase later. I see many individuals holding off in the offer process awaiting minute information only to lose out on the due diligence process to another individual. Another point in support of early offers suggests that sellers are somewhat reluctant to provide up to the minute information (which can cost accountant's time and money) only to find out that the buyer wasn't very serious.

If you are interested in the business, offer early and ask for as much time and due diligence as you want and believe me, you will get all the time and information you need...just remember that offering isn't buying.

How much to offer varies with the amount of investment (capital/cash) you are willing or capable of investing. There are many formulas and ratios that express an appropriate return on your down payment after a normal return on the business. Other concerns to buy or not to buy are within you and are the motivation to be your own boss and control your own future. Please let the agent express some financial information and investment criteria that you might not have thought of.

2. Ask for Information. Initially you need tax statements and current income and profit and loss records. Three to five years are best. Build a proforma using year-to-year totals expressed in percentages. Look at

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Buyer Due Diligence

Under the terms of a Purchase and Sale Agreement and a seller's listing contract, due diligence will be required. The term signifies a "process" in which all pertinent information can be substantiated to the full satisfaction of both buyer and seller (client and customer). It is the legal obligation of both Buyer and Seller to remove all doubt and to review and approve any and all information relative to the sale. Under those requirements, the following suggested check-list is provided:

1. Make a written list of all the financial, historical and relative information you will ask to review. This list will be given to the SELLER and, at a minimum, should include verification of all information previously provided. In addition, the list MIGHT INCLUDE some of the following:
 - a) Income tax reports (three to five years)
 - b) After tax period reports or current business income statements, such as:
 1. Daily cash register receipts
 2. State sales tax reports
 3. Withholding tax reports
 4. Profit and Loss statements
 5. Current balance sheet
 6. Billings/payable receipts
 7. Bank accounts
 - c) Current payable and expenses (actual billings)
 - d) Review of all contracts
 - e) Review and approval of a new lease or assignment of lease
 - f) Thorough inventory and an agreement of valuation method(s)
 - g) Thorough review and approval of receivables
 - h) Thorough review, inspection and approval of all equipment
 - i) Review of any and all maintenance contracts associated with the equipment being sold
 - j) Customer lists/client reviews
 - k) Real estate inspections. (Ask for a Seller's Disclosure statement)
 - l) Legal issues/law suits/returns/bad debts
 - m) Review all liabilities/seek assumption information
2. If real estate is a part of the sale, include the following:
 - a) Appraisal reports
 - b) Tax records
 - c) A building inspection
 - d) Complete inspection and approval of all building HVAC
 - e) Review all utilities bills associated with the building
 - f) Environmental issues. Check with local EPA authority
 - g) Sellers disclosure statement(s)
3. License and permit review – Check with all agencies for compliance and requirements
 - a) Past inspections

Seller Due Diligence

The seller should require information about the buyer. The following would be typical buyer information being provided, especially:

1. Information about the buyers
 - a) Financial statements/credit reports
 - b) Tax or other income verification
 - c) A credit check and review of a financial statement and resumes, especially if the buyer is requesting an owner loan or carry-back financing or if the buyer will be asking for an extended closing date
 - d) Partnership or corporation agreements

Non Conforming Diligence

The following items are not part of customary Due Diligence processes:

- a) Working in the operation prior to closing
- b) Talking directly to any customer, supplier, vendors, contractors, and/or employee without consent of the seller
- c) Copies of operational manuals, procedures, or written daily activities
- d) Taking sample products from the site
- e) Buyer/seller breach of confidentiality (talking to outside parties without prior consent)
- f) Training for any individuals prior to closing
- g) Discussing your purchase with anyone other than those individuals approved by the seller. Do not use words like "I'm buying the... or "we're the new owners", etc. prior to the actual purchase
- h) Performing Due Diligence prior to an accepted offer