Chapter 5: Buying a Business

Buying an Existing Business

Average business acquisition requires 19 months from starting the search to closing the deal.

Important questions:
- Does the business meet your lifestyle and financial expectations?
- Do you have the ability to operate the business successfully?

Advantages
- Business may continue to be successful
- Leverage the experience of previous owner
- "Turn key" business
- Superior location
- Employees and suppliers in place
Buying a Business

**Advantages:**
- Equipment installed
- Inventory in place
- Trade credit established
- Easier access to financing
- High value

**Disadvantages:**
- Cash requirements
- Business is losing money
- Paying for “ill will”
- Unsuitable Employees
- Unsatisfactory location

**Disadvantages:**
- Obsolete equipment and facilities
- Change and innovation challenges
- Obsolete inventory
- Value of accounts receivable
Chapter 5: Buying a Business

Valuing Accounts Receivable

<table>
<thead>
<tr>
<th>Age of Accounts (days)</th>
<th>Amount</th>
<th>Probability of Collection</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+</td>
<td>$5,000</td>
<td>.10</td>
<td>$500</td>
</tr>
<tr>
<td>Total</td>
<td>$101,000</td>
<td></td>
<td>$76,050</td>
</tr>
</tbody>
</table>

Buying a Business

- Disadvantages
  - Obsolete equipment and facilities
  - Change and innovation challenges
  - Obsolete inventory
  - Value of accounts receivable
  - Business may be overpriced

How to Buy a Business

- Analyze your skills, abilities, and interests
- Develop a list of criteria
- Prepare a list of potential candidates
  - Remember the hidden market of companies that may be for sale but are not listed as “for sale”
How to Buy a Business

- Investigate and evaluate candidate businesses and select the best one
- Negotiate the deal
- Explore financing options
- Ensure a smooth transition

Five Critical Areas for Analyzing an Existing Business

1. Why does the owner want to sell...the real reason?
2. What is the physical condition of the business and its assets?
3. What is the market potential for the company's products or services?
   - Customer characteristics and composition
   - Competitor analysis
4. What legal aspects must I consider?

The Legal Aspects of Buying a Business

- Lien - creditors' claims against an asset
- Bulk transfer - protects business buyer from the claims unpaid creditors might have against a company's assets
Chapter 5: Buying a Business

**Bulk Transfer**
- Seller must give the buyer a sworn list of creditors.
- Buyer and seller must prepare a list of the property included in the sale.
- Buyer must keep the list of creditors and property for six months.
- Buyer must give notice of the sale to each creditor at least ten days before he takes possession of the goods or pays for them (whichever is first).

**The Legal Aspects of Buying a Business**
- Lien - creditors’ claims against an asset.
- Bulk transfer - protects business buyer from the claims unpaid creditors might have against a company’s assets.
- Contract assignment - buyer’s ability to assume rights under seller’s existing contracts.

**The Legal Aspects of Buying a Business**
- Covenant not to compete (restrictive covenant) - contract in which a business seller agrees not to compete with the buyer within a specific time and geographic area.
- Ongoing legal liabilities - physical premises, product liability, and labor relations.
Five Critical Areas for Analyzing an Existing Business (continued)

5. Is the business financially sound?
   • Income statements and balance sheets for the past three to five years
   • Income tax returns for the past three to five years
   • Owner’s Compensation (and that of relatives)
   • Cash Flow

Determining the Value of a Business

- Balance Sheet Technique
  - Variation: Adjusted Balance Sheet Technique
- Earnings Approach
  - Variation 1: Excess Earnings Approach
  - Variation 2: Capitalized Earnings Approach
  - Variation 3: Discounted Future Earnings Approach
- Market Approach

Balance Sheet Techniques

"Book Value" of Net Worth = Total Assets - Total Liabilities

= $278,990 - $114,325
= $164,665
**Balance Sheet Techniques**

"Book Value" of Net Worth = Total Assets - Total Liabilities

\[ \text{Book Value} = 278,990 - 114,325 = 164,665 \]

Variation: Adjusted Balance Sheet Technique:

Adjusted Net Worth = \( \text{Adjusted Net Worth} = 264,638 - 114,325 = 150,313 \)

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**Earnings Approaches**

Variation 1: Excess Earnings Method

Step 1: Compute adjusted tangible net worth:

\[ \text{Adjusted Net Worth} = 264,638 - 114,325 = 150,313 \]
Variation 1: Excess Earnings Method

Step 1: Compute adjusted tangible net worth:
Adjusted Net Worth = $264,638 - $114,325 = $150,313

Step 2: Calculate opportunity costs of investing:
Investment: $150,313 x 25% = $37,578
Salary: $25,000
Total: $62,578

Step 3: Project earnings for next year:
$74,000

Step 4: Compute extra earning power (EEP):
EEP = Projected Net Earnings - Total Opportunity Costs
    = $74,000 - $62,578 = $11,422
**Excess Earnings Method**

(Continued)

**Step 4:** Compute extra earning power (EEP):

\[ \text{EEP} = \text{Projected Net Earnings} - \text{Total Opportunity Costs} \]

\[ = \$74,000 - 62,578 = \$11,422 \]

**Step 5:** Estimate the value of the intangibles ("goodwill"):

\[ \text{Intangibles} = \text{Extra Earning Power} \times \text{"Years of Profit" Figure}^* \]

\[ = 11,422 \times 3 = \$34,299 \]

* Years of Profit Figure ranges from 1 to 7; for a normal risk business, it is 3 or 4

---

**Excess Earnings Method**

(Continued)

**Step 6:** Determine the value of the business:

\[ \text{Value} = \text{Tangible Net Worth} + \text{Value of Intangibles} \]

\[ = \$150,313 + 34,299 = \$184,612 \]

**Estimated Value of the business = $184,612**

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**Capitalized Earnings Method**

**Variation 2:** Capitalized Earnings Method:

\[ \text{Value} = \frac{\text{Net Earnings (After Deducting Owner's Salary)}}{\text{Rate of Return}^*} \]

* Rate of return reflects what could be earned on a similar-risk investment
Chapter 5: Buying a Business

Capitalized Earnings Method

Variation 2: Capitalized Earnings Method:

Value = \frac{\text{Net Earnings (After Deducting Owner's Salary)}}{\text{Rate of Return}}

* Rate of return reflects what could be earned on a similar-risk investment

Value = \frac{\$74,000 - \$25,000}{0.25} = \$196,000

Discounted Future Earnings Method

Variation 3: Discounted Future Earnings Method:

Step 1: Project earnings five years into the future:

3 Forecasts:
- Pessimistic
- Most Likely
- Optimistic

Compute a weighted average of the earnings:

\frac{\text{Pessimistic} + (4 \times \text{Most Likely}) + \text{Optimistic}}{6}

<table>
<thead>
<tr>
<th>Year</th>
<th>Pess</th>
<th>ML</th>
<th>Opt</th>
<th>Weighted Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$65,000</td>
<td>$74,000</td>
<td>$92,000</td>
<td>$75,500</td>
</tr>
<tr>
<td>2</td>
<td>$74,000</td>
<td>$90,000</td>
<td>$101,000</td>
<td>$89,167</td>
</tr>
<tr>
<td>3</td>
<td>$82,000</td>
<td>$100,000</td>
<td>$112,000</td>
<td>$99,000</td>
</tr>
<tr>
<td>4</td>
<td>$88,000</td>
<td>$109,000</td>
<td>$120,000</td>
<td>$107,333</td>
</tr>
<tr>
<td>5</td>
<td>$88,000</td>
<td>$115,000</td>
<td>$122,000</td>
<td>$111,667</td>
</tr>
</tbody>
</table>
**Discounted Future Earnings Method**

(Continued)

**Step 2:** Discount weighted average of future earnings at the appropriate present value rate:

Present Value Factor = \( \frac{1}{(1+k)^t} \)

where...

- \( k \) = Rate of return on a similar risk investment
- \( t \) = Time period (Year - 1, 2, 3,...n)

<table>
<thead>
<tr>
<th>Year</th>
<th>Weighted Average</th>
<th>PV Factor</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$75,500</td>
<td>.8000</td>
<td>$60,400</td>
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<tr>
<td>2</td>
<td>$89,167</td>
<td>.6400</td>
<td>$57,067</td>
</tr>
<tr>
<td>3</td>
<td>$99,000</td>
<td>.5120</td>
<td>$50,688</td>
</tr>
<tr>
<td>4</td>
<td>$107,333</td>
<td>.4096</td>
<td>$43,964</td>
</tr>
<tr>
<td>5</td>
<td>$111,667</td>
<td>.3277</td>
<td>$36,593</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td></td>
<td><strong>$248,712</strong></td>
</tr>
</tbody>
</table>

**Discounted Future Earnings Method**

(Continued)

**Step 3:** Estimate the earnings stream beyond five years:

\[
\text{Weighted Average Earnings in Year 6} \times \frac{1}{\text{Rate of Return}} = \text{Present Value}
\]

\[
= \$111,667 \times \frac{1}{25\%} = \$446,668
\]
Step 3: Estimate the earnings stream beyond five years:

Weighted Average Earnings in Year 5 x \( \frac{1}{\text{Rate of Return}} \) =

\[ \text{Weighted Average Earnings in Year 5} = \$111,667 \]
\[ \frac{1}{\text{Rate of Return}} = \frac{1}{25\%} = \$446,668 \]

Step 4: Discount this estimate using the present value factor for year 6:

\[ \$446,668 \times .2622 = \$117,116 \]

Discounted Future Earnings Method

Step 5: Compute the value of the business:

Value = Discounted earnings in years 1 through 5 + Discounted earnings in years 6 through ?

\[ \text{Discounted earnings in years 1 through 5} = \$248,712 \]
\[ \text{Discounted earnings in years 6 through ?} = \$117,116 \]

Estimated Value of Business = \$365,828

Discounted Future Earnings Method

Market Approach

Step 1: Compute the average Price-Earnings (P-E) Ratio for as many similar businesses as possible:

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

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**Market Approach**

*Step 1: Compute the average Price-Earnings (P-E) Ratio for as many similar businesses as possible:*

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<td>4.7</td>
</tr>
<tr>
<td>4</td>
<td>4.1</td>
</tr>
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</table>

Average P-E Ratio = 3.975

*Step 2: Multiply the average P-E Ratio by next year’s forecasted earnings:*

Estimated Value = 3.975 x $74,000 = $294,150

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**The Art of the Deal**

- Establish the proper mindset
- Understand the rules of successful negotiations
- Develop a negotiating strategy
- Be creative
- Keep emotions in check
- Be patient
- Don’t become a victim

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**The Five Ps of Negotiating**

- **Preparation** - Examine the needs of both parties and all of the relevant external factors affecting the negotiation before you sit down to talk.
- **Patience** - Don’t be in such a hurry to close the deal that you end up giving up much of what you hoped to get. Impatience is a major weakness in a negotiation.
- **Persistence** - Don’t give up on your position or sound of conviction in your position, especially if it makes sense. This helps to keep your position.
Exit Strategies

- Straight business sale
- Sell controlling interest
- Restructure the company
- Use a two-step sale
- Family limited partnership (FLP)
- Establish and employee stock ownership plan (ESOP)
- International buyer