

## 7 Steps to Buying a Business

Buying business should be the best thing you have ever done for yourself. Many people want to buy a business but really don't know how. If you are sure you want to buy a business rather than start from scratch, then follow these steps so you feel at ease in the process.

### **1. Make the decision that you are going to buy.**

There are many resources out there to help you decide that buying a business is the right step for you. A currently operating business is much less risky than starting one from scratch. So, if you have decided that buying an established business is the way you are going to make your dream of being a business owner come true, then make the commitment to do your part in the buying process and be a motivated buyer. This means that you are determined to buy the *right* business for you, and will do everything you can to make it happen.

The first thing you will need to do is contact the broker who has the business listed. The broker will ask you to sign several forms. This is because the seller usually doesn't want everyone to know his/her business is for sale, and doesn't want just anyone looking at their financial records. So, be a good buyer and fill out the forms and get them back to the broker. They will then pre-qualify you, want to talk to you in person or on the phone, and then will start giving you a little bit of information. You will get some information and give some and this cycle will repeat itself until you decide the business is or is not right for you.

### **2. Pre-Qualify Yourself**

In order to buy a business you will most definitely need some cash to put down. There is no such thing as 100% financing in any business purchase. The minimum down is 10%, but more likely you will need about 20%. That cash needs to be liquid, meaning you can have it in your hands in 10 days (like a mutual fund, loan on retirement, savings, stocks, cds, etc.). One of the newest ways for a buyer to come up with cash is to use their retirement money. Retirement money is just a mutual fund that invests in company stock, right? Well, through this type of program the company that the money gets invested in is yours! Your retirement money gets invested in your company. If you want more information on that call or email Sandy at 814-784-3417 or [sandy@abadvisors.biz](mailto:sandy@abadvisors.biz).

The next thing you will need to have is relevant experience. This could mean that you owned a business like it before, or worked in that type of business, or at least have sales and marketing experience.

One other thing you need to have if you expect financing is good to great credit, generally a credit score 680 or better. So, find out what your credit score is before you start filling out the forms the broker will send you. If you can prove this score to the broker, all the better.

Some tips on financing:

- Some sellers will finance part of the purchase for you and others will not. It is their decision and not yours.
- If the seller is willing to finance be prepared to qualify yourself to the seller just like you would any other financing source.
- You will not need to make any type of “deposit” in order to get financial records from the seller. This is an old, unethical trick.
- The bank will usually not take you seriously until you have an offer in place. This way they know the purchase price up front.
- Be prepared to disclose all sources of down payment money up front. No “sandbagging”. Be honest.
- There are lots of ways to get financing, with various terms. Most all of them will require collateral on their loan, including personal guarantees. Be prepared for this. The business hopefully will have enough assets to collateralize the loan, but if it doesn't be prepared to offer personal assets or more down money.

### **3. Analyzing the Business**

You do not need to be an “expert” business buyer. Most brokers will help you through the process because it benefits their client, the seller. Know this, though: It is up to you to ask for the information you want in order to make the decision. The broker will get you the information you request and you do the analysis. Here is the process:

- a. Fill out and return forms to broker
- b. Receive “profile” or “marketing memorandum” on the business
- c. Ask initial questions to the broker
- d. Schedule a visit to the business to meet the owner. Ask the owner any and all operational questions, but save the financial questions for the broker later.
- e. Review financial records (tax returns, etc.)
- f. Request any additional information from broker.
- g. Put offer in or decline this business. And, if you have decided this business is not for you- please tell the broker this! Their job is to keep asking you until you put an offer in or tell them you are passing on the opportunity. If you

decided not to buy a particular business admit it so everyone can move on and not waste any more time.

Now, about the offer. If you are committed to buying a business this part should be very exciting for you. As soon as you are ready, go ahead and make the offer. This usually means sitting down with the broker and filling in an official “offer to purchase” agreement. This is where you tell the broker all the terms in your offer: the purchase price, how you will pay, and any contingencies you request. A contingency means that the offer becomes void if the contingency is not waived. A typical contingency is financing. It means the offer becomes void if the financing does not get approved. Although it protects you as a buyer, some sellers may not accept any contingencies because their business is taken off the market while you are trying to get financing.

You will also need to write a check with the offer. Usually this amount is determined by the seller. Your check will be cashed and held in an escrow account until closing IF the offer is accepted. If your offer is rejected your check will be returned to you. IF all contingencies are removed and you back out, you probably will lose your deposit.

After the offer is accepted, you will have a certain amount of time, as specified in the offer, to perform “due diligence”, which means to verify the tax returns and run everything through your accountant and attorney. If something was misrepresented you can cancel the offer. This is not a time to nitpick; it is to verify the information you have already received. Then, one by one, all contingencies (if any) get removed and the deal goes to closing.

As far as closing goes, there are several options. The seller’s attorney may prepare the documents, or request that the buyer do them. Another option is to use an escrow attorney, who represents the transaction versus either the buyer or seller. This usually is the least expensive way to go because if either the seller’s or buyer’s attorney prepares the documents the other attorney will almost always have issues with it and the attorney’s fees go way up. Your attorney will have a chance to review the documents prepared by the escrow attorney.

If you are waiting to find the PERFECT business, then you will be waiting a long time. It just doesn’t exist. Put an offer in on the business that meets your financial needs or investment requirements, you like, and can grow. Simple. You will not find the perfect business in your backyard, so be flexible. Often, filling out one of the forms the broker sends you helps you focus on what it is you want.

#### **4. Analyzing the Financials**

This area more than any other causes more confusion to a buyer. They often get so confused they just say they are not interested in buying anymore. Or they are

afraid of offering too much or too little. Following is a simple way to analyze the financials and come up with your offer. Yes, you have to come up with the amount you will offer. The broker will not (or at least should not) do that.

a. Ask the broker how the asking price was determined.

If he or she says "It is what the seller wanted" then you will have to do your own determination on what the selling price should be.

If the broker says they used rules of thumb or multiples of cashflow then all you have to do is duplicate what they have done to see if they are correct in their pricing.

A business is priced using a range of values. Different accountants use different methods in determining a value, so we are left to do all of them to come up with a range of values and pick one value that makes the most sense. Of course a seller almost always over values their business and a buyer almost always undervalues it. Hopefully there is a number that both can agree on.

The first thing a broker does in determining a selling price is to get the tax returns from the business for the last 3 years. The most recent tax return carries the most weight, but all are analyzed. The broker will look at the returns and will "add back" expenses such as depreciation, interest, amortization, and health insurance of the owners to the bottom line of the tax return. This number is the SDC, or SDE (Seller's Discretionary Cashflow or Sellers Discretionary Earnings). This number represents the income of the business WITHOUT the current owner. It is what you will make without doing anything different once you are the owner.

Once this number is calculated a broker will look for a rule of thumb to calculate one potential selling price. A rule of thumb for a particular business was calculated based on actual sales of that business type over the last several years. It is kind of an average. So a broker will take the SDC, multiply it by a rule of thumb and get a number.

Example: SDC= \$114,234  
Rule of thumb= 5 times SDC

So, a suggested selling price would be \$114,234 times 5 or \$571,170

Inventory is usually added to that number as well.

Another rule might say to take the annual sales and multiply it by a rule of thumb.

Say, Annual Sales times .75

So if a business has annual sales of \$454,335 a suggested selling price may be \$340,751.

A broker may also keep it simple by taking the SDC times a multiple of say 1.5 then add furniture, fixtures, equipment, inventory and real estate and use that number as the asking price.

Ask the broker how they came up with the SDC and what the rules of thumb were so you can calculate the asking price yourself. Also ask them what “comps” they used. Comps are businesses of the same type either for sale or have sold. This is the basis of what you decide to offer. This number is a realistic number that will get the financing. If the asking price is too high the business won't sell unless the owner finances it, and even then it is difficult.

Here is a simple way to calculate SDC:

1. Take the net profit or loss from the tax return (the Bottom line)
2. Add depreciation, amortization, and interest
3. Add owners compensation or salary
4. Add expenses that were personal in nature (ask the broker or owner)
5. Add expenses that were not necessary to run this business (ask the broker or owner).

Remember, a broker is not a business valuation expert. Most are not certified to provide a single “value” of a business, only a range. This is much like a real estate salesperson who is allowed to provide a “Competitive Market Analysis” but only an appraiser is allowed to provide a value of a home. You can pay for a certified valuation if you wish.

Now that you know the cashflow, you need to take a look at the expenses.

Most buyers look at gross sales and ignore cashflow. You need to find out if this particular business is within industry averages. You can ask the broker or use a website like [www.bizstats.com](http://www.bizstats.com) to compare the business you are looking at to the industry average. Don't rule out the business because it is less than industry average. This is just one tool to help you know the strengths and weaknesses of the business.

## **5. Calculate your ROI or Return on Investment**

People buy businesses for many reasons. One is as an investment. Just like buying stocks, they buy a business intending on the money they invest to give them a return on their investment. Savings accounts give a certain percentage, as do stocks, as do businesses.

A realistic return on investment, meaning you recoup the dollars you invested in the business is about 2-3 years. ROI is determined by looking at the business's current cashflow. Each year, the net profit is the return on the investment of the owner. So, if an owner invests \$100,000 cash into the business and makes a \$10,000 profit the first year, it is a 10% ROI and it will take the owner 10 years to recover his investment. If the net profit is \$50,000, then that is a 50% ROI and will take the owner 2 years to recover his investment. Increasing sales and profits will decrease the time it takes to recover the initial investment.

### General Rules of Thumb

- 100% Cash= 5 Year ROI but no loan payments
- 80% cash= 4 year ROI and small loan payment
- 60-70% cash= 3 year ROI and manageable loan payment
- 40-50% cash= 2 year ROI and high loan payment
- 20-30% cash= 1-2 year ROI and very high loan payment

So, the more cash put down the better return rate- less debt expense  
The more financed, the quicker the ROI

If more than 25% of revenue is going to go to loan payments it is very risky!

### **6. Other important questions you need to ask the broker or seller**

- a. Why is the seller selling? Have the seller explain it to you.
- b. Is the seller willing to finance?
- c. Will the broker help obtain financing?
- d. Has the business been "pre-approved" for financing?
- e. Is the seller willing to help with the transition or work for the new owner (if desired)?
- f. Will the seller sign a non-compete agreement?
- g. Is the lease assignable and what are the terms?
- h. Could I get copies of the tax returns when the time is right?
- i. Could I have a valuation done, or equipment appraiser help me?
- k. Can I get an actual copy of the tax returns directly from the IRS?
- l. What is the best thing about this business?
- m. What is the worst thing about this business?
- n. If you were staying what is the next thing you would do in this business?
- o. Do I need any special training or license to run this business?

### **7. Some common practices, whether ethical or not**

#### **NON ETHICAL**

- a. No financials until AFTER the offer is accepted
- b. No explanation on how the business selling price was determined

- c. Sellers telling you they want more for their business because it gives them a lot of CASH in their pockets. Hey, they can either cheat you or the government, but not both. Only recognize cash that can be proven.
- d. Inventory that is overpriced and obsolete
- e. Asking for a deposit to review the financials
- f. Any broker that tells you he or she has other offers coming in and pressures you to put one in. Multiple offers rarely happen.

### **ETHICAL**

- a. Reviewing tax returns and financials only AFTER a personal visit is made
- b. Getting a check with the offer of usually about 10% of the offered price
- c. Deposits held in the brokers escrow account or the seller's attorney's escrow account.
- d. Closing schedule 6-8 weeks after the offer is accepted

Armed with this knowledge and your determination to buy the American dream, go out there and BUY YOUR NEW BUSINESS!

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