

Early Decisions

Chapter 6

Taking Over an Existing Business

After reading this chapter, you should be able to:

- Compare the advantages and disadvantages of buying an existing business.
- Propose ways of locating a suitable business for sale.
- Identify ways to measure the condition of a business and determine why a business would be sold.
- Differentiate tangible and intangible assets, and assess the value of each.
- Calculate the price to pay for a business.
- Understand factors that are important when finalizing the purchase of a business.
- Describe what makes a family business different from other types of business.

2 Source: Hatten, Small Business Management, 4th Edition

Table 6.1: The Advantages and Disadvantages of Buying a Business

<u>Advantages</u>	<u>Disadvantages</u>
Established customer base	Image may be difficult to change
Location already familiar to customers	Employees may be ones whom you would not choose
Planning can be based on known historical data	Business may not have operated the way you like and could be difficult to change
Supplier relationship already in place	Possibly obsolete inventory and equipment
Inventory and equipment already in place	Financing costs could drain your cash flow and threaten the business's survival
Experienced employees	Business's location may be undesirable, or a good location may be about to become not so good
Possible owner financing	Potential liability for past business contracts
Quick entry	Misrepresentation (the person selling the business may be lying.)
Control systems already in place (e.g. accounting, inventory, and personnel controls)	
Image already set in minds of customers	

3 Source: Hatten, Small Business Management, 4th Edition

How Do You Find a Business for Sale?

- Your current employer
- Newspaper advertising
- Word of mouth through friends and family
- Bankers, lawyers, and accountants
- SBA representatives
- Real estate brokers
- Trade associations
- Directly approach a business owner
- Business broker
- Online sources

Caution: Business Opportunities Scams
"There's a sucker born every minute" – P. T. Barnum

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Source: Hatten, *Small Business Management*, 4th Edition

What Do You Look for in a Business? (cont'd)

- How long has the business existed?
- What is the profit record?
- What is the condition of the business?
- How long does the lease run?
- Are there dependable sources of supply?
- Is there a distribution network and sales force?
- What about present and future competition?
- What is the condition of the area around the business location?

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Source: Hatten, *Small Business Management*, 4th Edition

What Do You Look for in a Business? (cont'd)

- What is the condition of the area around the business location?
- Does the owner have connections important to the success of the business?
- Why does the present owner want to sell?
- Are existing personnel satisfactory?
- How does this business compare with one that you could start and develop?

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Source: Hatten, *Small Business Management*, 4th Edition

Due Diligence: Fact Finding

- Concerns of Overall Financial Health:
 - What trends have occurred with revenues, expenses, and profit margins? Have they grown, stagnated, or declined?
 - Will the products become obsolete in the near future?
- Facts for Review:
 - Check financial statements and insist on seeing the owner's tax returns.
 - Check for litigation or liens against the business or owners.
 - Check for past or current complaints at BBB.

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Source: Hatten, Small Business Management, 4th Edition

Buying Out an Existing Business

- General Considerations
 - Talk to the firm's banker to verify account balances with major customers and creditors.
 - Get verbal understanding in writing from the seller.
 - Put earnest money in escrow with trusted third party.
 - Have all papers checked by an accountant and attorney before the purchase agreement is signed.
 - Comply with UCC bulk sales provisions by issuing notices to creditors that the business is changing ownership.

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Source: Hatten, Small Business Management, 4th Edition

Why is the Business Being Sold?

- Prospective Buyers Should:
 - Understand that the owners are not likely to be forthcoming about negative prospects for the firm.
 - Meet with the firm's customers and suppliers.
 - Check with city planners about proposed changes that would affect the viability of the business.
 - Analyze the market, judge the competitive situation, and estimate the profit potential from business rather than relying on the owner's reason for selling.
 - Compare investing the firm to other investment alternatives.

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Source: Hatten, Small Business Management, 4th Edition

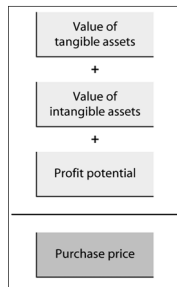
Financial Condition

- What is the True Value of the Firm?
 - Inspect bank deposits.
 - Examine owners' tax returns and compare them with financial statements of the firm.
 - Ascertain that all back taxes have been paid.
 - Request an independent audit to identify the condition of financial statements.
 - Compare the firm's profit, expense, debt, working capital, operating, cash flow, and net worth ratios to industry averages.
 - Consider what similar businesses have sold for.

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Source: Hatten, Small Business Management, 4th Edition

Figure 6.1: What Should You Pay?



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Source: Hatten, Small Business Management, 4th Edition

Buying Your Business

- The Terms of Sale
 - Lump sum payment
 - Installment payments to the seller
- Thinning Assets
 - Making the business more affordable to the buyer:
 - Separate real estate ownership from business ownership—new owner leases rather than purchases the asset.
 - Lease equipment and/or fixtures in the same manner as real estate.
 - Sell off excess inventory prior to purchase.
 - Factor accounts receivable or carry the old accounts.

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Source: Hatten, Small Business Management, 4th Edition

Table 6.2: Calculating the Purchase Price of an Existing Business

1.	Adjusted value of tangible net worth	\$224,000
2.	Earning power at 15 percent	33,600
3.	Reasonable salary for owner or manager	<u>40,000</u>
		73,600
4.	Average annual net earnings before subtracting owner's salary	83,600
5.	Extra earning power of business (line 4; total of lines 2 and 3)	10,000
6.	Value of intangibles using four-year profit figure for moderately well-established firm in (4 years; line 5)	<u>40,000</u>
7.	Offering price (line 1; line 6)	\$264,000

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Source: Hatten, *Small Business Management*, 4th Edition

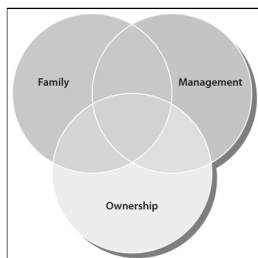
Taking Over a Family Business

- Family Businesses
 - Characterized by two or more members of the same family who control, are directly involved in, and own a majority of the business
- What Is Different About Family Businesses?
 - The complex interrelationships of family members interacting with one another and interacting with the business
 - The intricate succession planning needed.

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Source: Hatten, *Small Business Management*, 4th Edition

Figure 6.2: Family Business Perspectives



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Source: Hatten, *Small Business Management*, 4th Edition

Taking Over a Family Business (cont'd)

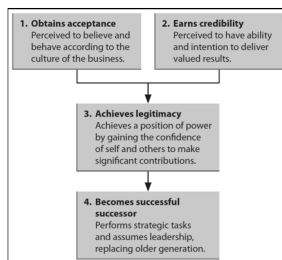
- Difficulties That Owners Have in Planning Succession

1. Are reluctant to address own mortality.
2. Are not confident in the next generation's commitment to the business and its success.
3. Are fearful of transfer of control because of concern for personal long-term financial security.
4. Are too personally tied to the business and lacking in outside interests to be attracted to retirement.

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Source: Hatten, Small Business Management, 4th Edition

Figure 6.3: Succession Model of Family Business



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Source: Hatten, Small Business Management, 4th Edition

Taking Over a Family Business (cont'd)

- Family Business Policies

- Family members must meet the same hiring criteria and performance review standards as nonfamily employees.
- Family members should be supervised by nonfamily employees when possible.
- If under age 30, family members are only eligible for "temporary" employment (less than one year)
- No family members may stay in an entry-level position permanently.
- All family positions will be compensated at fair market value.
- For family members to seek permanent employment, they must have at least five years' experience outside the company.

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Source: Hatten, Small Business Management, 4th Edition
