Buying an Existing Business

What are the advantages of buying an existing business?

The advantages of buying an existing business include:

- Established product or service
- Established "goodwill"
- Management team in place
- Existing collateral
- Reduced start-up time and cost

Unlike a new business, an existing business will likely have a product or service that is familiar to consumers, suppliers, lenders, and employees. Similarly, the business will, hopefully, have established "goodwill": the intangible value of an esteemed business, typically measured by the amount of money for which the business is sold beyond the cost of its assets. In other words, a business's goodwill is the goodwill that the business engenders among those with whom it conducts business. Goodwill adds value to the business, and for this, you pay extra. A further advantage is the business's management team. Since the business will likely have experienced managers already employed, you will save time and money in training, and if you are unfamiliar with the business, you will have an invaluable source of business knowledge at hand. An existing business can also provide the collateral to secure the necessary funds for your purchase. Last but not least, primarily because of the advantages discussed, is the reduced start-up time and cost involved in buying an existing business. Since the business is already established, you will likely need only to infuse the funds required to continue operation.

What are the disadvantages of buying an existing business?

Buying an existing business is not without its disadvantages, however. These disadvantages may include:

- Low supply of qualified businesses for sale
- "Negative goodwill"

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- Poor or technologically antiquated assets
- Buying the seller's headaches
- Difficult-to-change business culture

A primary problem with buying an existing business is finding a good one that's for sale. Many businesses that are for sale are not good buys for the same reasons for which they are being sold. Just as a business may have goodwill, it may have "negative goodwill." The business may not be very highly esteemed within its business community. Sometimes, a seller fails to update his or her equipment because of the expense required to do so. If this is the case, the business may have become inefficient. Indeed, a seller may be getting rid of a headache, the cause of which may include the problem of antiquated equipment (or other assets). Furthermore, an existing business will likely have a difficult-to-change business culture. If this culture hinders rather than promotes productive practices, you will have to change it for the better. These disadvantages must be considered.

Pre-purchase considerations

Deciding to buy

When deciding to purchase a business, there are some questions you should consider:

- How will you select a business?
- How will you find a business that matches your needs?
- How will you identify potential sellers?

Selecting the right business is far from simple. The right business for you is the one that fits with your personal, business, and financial goals. To select the right business for you, consider your strengths and weaknesses. Are you confident and persistent? Do you have good organizational, management, and professional skills? Compare your skills and traits with the needs of your target industry and company. Do you have a match? Once you have evaluated your strengths and weaknesses, you'll need to seek out potential sellers. To do so, you should consult the following sources, among others

- Attorney
- Accountant
- Insurance agent

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- Real estate agent
- Financial professional (e.g., financial planner)
- Banks
- Small Business Administration (SBA)
- Trade associations

Preparing to buy

When you have chosen your target business, you will need to make some preparations before you buy:

- Identify financial resources
- Assemble a team of professionals
- Develop goals and a timetable
- Conduct a due diligence review

Lack of financing is probably the most common obstacle to buying a business. You will need to make an initial assessment of the funding sources. Next, you will need to assemble a team of professionals. This team should include an attorney and an accountant. It may also include experts from other fields, such as real estate and finance. Then, you will need to prioritize the process involved with the purchase by setting the dates by which specific tasks are to be accomplished. Furthermore, you must conduct, with help from your team of professionals, a due diligence review--a review of the financial worthiness of your target business. This review should include, among other things, a review of the business's past and current financial data, internal control structure, management information systems, accounting policies and procedures, and all of its legal matters. Your investigation may involve interviews with the seller, competitors, management, and customers. It may also include a review of relevant trade literature.

Business valuation

There are two things you should know about business valuation. First, business valuation is extremely complex. This is especially so for buyers who may be unfamiliar with the business and the industry itself. For this reason, you should consider adding a valuation expert to your team of professionals. The second thing you

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should know about business valuation is that there are various methods by which you can value a business. Both of these issues are addressed in the following sections.

Selecting a valuation expert

Be sure that you hire an expert. Most importantly, get an expert who is aware of, and subscribes to, the Appraisal Standards Board (ASB), the American Society of Appraisers (ASA), and the standards they have issued: Uniform Standards and Principles of Appraisal Practice (USPAP) and Business Valuation Standards (BVS), respectively.

Where can you get a valuation expert? Call the following associations:

- CFA Institute (formerly known as Association for Investment Management and Research--(800) 247-8132
- Institute of Business Appraisers--(800) 299-4130
- Institute of Management Accountants--(800) 638-4427
- American Institute of Certified Public Accountants--(888) 777-7077
- American Society of Appraisers--(800) 272-8258

Valuation methods

Different standards or definitions of value have emerged. The most common definition, and the only one receiving mention here, is fair market value (FMV). This standard is widely recognized in business valuations. According to the IRS, FMV is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

So, how do you calculate the FMV of a business? There are various approaches and there are no set definitions for any. Generally, valuation can be determined using any of the following three general methods.

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A. Asset approach: Sometimes, a business is worth only what it owns. The asset approach is used to value such businesses, including:

    1. Businesses that do not engage in "significant activities" (e.g., investment or holding companies)
    2. Businesses that are generating losses
    3. Businesses that are in (or will be in) liquidation

The asset approach probably isn't appropriate for active businesses because such businesses are typically worth more than their assets. Some experts believe that the contrary is true, where the active business is not using its assets to their full potential and the business would be worth more if liquidated (all of its assets sold). There are some variations within the asset approach. They are:

1. The adjusted net assets method: This method determines the value of assets and then subtracts outstanding liabilities
2. The adjusted book value method: This method determines the book value (total assets minus total liabilities) of all tangible assets, then adds the value of intangible assets (e.g., copyrights, trademarks, patents)
3. The liquidation value: This method determines the price for which the assets could be sold in a liquidation sale (sale of all assets)

B. Income approach: This approach determines FMV by calculating the income that the business is expected to generate in the future. In most cases, this approach is the most effective. Therefore, the income approach is commonly used, especially in service-based businesses. As with the asset approach, the income approach has its variations:

    1. The capitalization of earnings method: This method determines value by capitalizing earnings. Past earnings are capitalized by dividing them by a capitalization rate, a number that represents the investor's perceived risks and the expected growth of the business.
    2. The discounted earnings method: This method uses expected future earnings rather than past earnings. Expected future earnings are calculated and then "discounted" to present-day dollars.
    3. The dividend paying capacity method: By comparing a company's working capital needs with those of public companies in the same industry, a company's dividend paying capacity or

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dividend rate can be calculated. This rate is based on a percentage of the dividends paid by the public companies relative to their earnings.

C. Market comparison approach: According to this approach, the FMV of a business is determined by comparing it with companies engaged in the same or similar line of business (called guideline companies). When seeking guideline companies, the valuation expert will likely consider the following characteristics:

1. Industry: The company operates within the same or very similar industry
2. Size: The company is similarly sized
3. Market activity: The trading activity of each company's stocks is similar
4. Availability of information: Adequate information is available for a proper comparison
5. Trends: Each company has had similar performance trends

Under the market comparison approach, comparisons can be made either to the market price of guideline company stock or to the sale price of guideline companies.

Structuring the purchase

How will you structure the purchase? Will you buy most or all of the company's stock, or will you instead purchase the company's assets? Where will you get the funds? Unfortunately, as a buyer, you may not get to structure the purchase entirely as you'd like. The seller will surely have his or her own ideas as to how the purchase should be accomplished. Nonetheless, the following is a list of your primary considerations when contemplating the structure of your purchase, followed by a brief discussion of each.

- Stock purchase
- Asset purchase
- Financing the purchase

Stock purchase

Since the corporate form is probably the most common, a stock purchase will be an option for many buyers. The advantages and disadvantages of such a purchase are discussed as follows. (This discussion assumes that the buyer is an individual and not a corporation.)

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Advantages--Most of the advantages (and disadvantages, for that matter) of a stock purchase arise from issues of tax, liability, accounting, and financing. The advantages may include the following:

- The business and its legal structure continue without interruption.
- The company's assets (tangible and intangible) remain intact.
- You, the buyer, will get a basis in the stock equivalent to its FMV. This can result in a lower capital gains liability when you sell the stock than if you had acquired the stock at its par value.
- The company's accounting systems continue uninterrupted.
- If you are buying a small business, you might be entitled to favorable tax treatment.

Disadvantages--The disadvantages of a stock purchase may include the following:

- Unless you elect otherwise (or are treated as having made such an election), the business may not get a step-up in basis for the assets of the acquired company. Basis is important for, among other things, depreciation calculations.
- You, not the business, will be borrowing the funds required for the purchase, and therefore both corporate and personal guarantees will likely be required.
- The corporation's contractual arrangements remain intact, including those you would rather do without.
- All corporate assets, including those that are unwanted, remain with the business.
- Liabilities carry over to you and any other new owner(s).
- Contracts and agreements, including leases, may require the consent of the other party before being transferred.

Special tax considerations arise when you are acquiring stock in an S corporation. A brief discussion follows.

A. Cash for stock in S corporation: You may exchange cash or property for stock in an S corporation. You do not have to pay taxes on the value of the stock that you received if you paid cash. Instead, the tax that you would otherwise have paid is deferred (postponed) until you decide to liquidate (sell) your asset. At liquidation, you would pay a tax on the profit you make (the price you were paid for the stock when you sold it minus the price you paid for the stock when you purchased it).

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Example(s): You decide to form a corporation with Ron. You contribute appreciated property and Ron contributes cash. In return, each of you receives 50 percent of the stock. You do not have to report as income the value of the stock you received. (You do not have to recognize gain.) You will pay taxes (or declare a loss) when you turn around and sell your stock later.

a. Property for stock in S corporation: You do not have to pay taxes on the stock you received in exchange for property if all of the shareholders who contributed property for stock (as a group) control the corporation immediately after the exchange. The contributors of property do not control the corporation if (combined) they do not own stock possessing at least 80 percent of the total voting power and at least 80 percent of the total number of all other classes of stock.

b. Services for stock in S corporation: If you contribute services for stock, you must recognize gain on the transaction equivalent to the fair market value (FMV) of the services.

Example(s): Assume the same facts as the preceding example except that in exchange for stock you contribute your services. In this case, Ron will recognize gain (report the stock as income to be taxed) on the exchange because he, as the sole contributor of property, owns less than 80 percent of the stock (no control). As you will see next, you too will recognize gain on the stock you received as compensation for your services.

D. Property for stock and other property: If you contribute property in return for stock in a corporation, plus other property or cash, you must recognize gain to the extent of the other property or cash. This other property or cash is known as boot. For example, you contribute an office building in exchange for both stock and cash. You are required to report the cash (not the stock) on your tax return as income.

Asset purchase

Unlike a stock purchase, in an asset purchase you must consider how you will allocate your purchase price among the company's assets. You may, for example, allocate your purchase price to depreciable assets with short lives. This is advantageous because it allows you to recoup a portion of your investment in the form of tax deductions over a short number of years. (Get advice from your tax or legal professional.) You may, if you choose, change the legal structure, or entity, of your new business. For example, if the acquired company was a corporation, you can instead form a limited liability company (LLC). However, this matter, like the allocation issue, is best left to your tax or legal professional. With that said, some of the advantages and disadvantages of an asset purchase are as follows:

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Advantages:

- You can choose your own type of entity (e.g., LLC)
- You do not have to buy unwanted assets
- You do not have to assume unwanted liabilities
- You will not be subject to the contracts or other agreements established by the acquired company (which could also be a disadvantage if such contracts or agreements were on favorable terms)
- You can structure the financing as you wish--use debt financing, equity financing, or any mix of both

Disadvantages:

- You may not be able to use the accounting methods employed in the acquired company
- Intangible assets such as copyrights and patents must be purchased separately
- There will be tax consequences for both buyer and seller
- If you buy the assets at "bargain prices," you may be subject to unfavorable tax treatment

Financing the purchase

The sources of financing are many. In addition to choosing from whom you will acquire financing, however--and sometimes as a prerequisite to doing so--you must decide how to structure the financing. Will you borrow (debt financing) or will you instead exchange ownership interests in your business for funds from investors (equity financing)?

Negotiating the deal

Before you begin negotiations, you should be prepared to:

- Assemble the negotiating team
- Document the agreement
- Consider legal issues

Before these matters are addressed, however, some initial points about negotiating are worth mentioning. First, as a buyer, you'll need to know your limitations. What terms will you never accept? What price is too high? Make sure that you know your ceiling--you will be a much more effective negotiator if you do. Second,

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know the seller's motives for the sale and understand his or her objectives in the negotiations. How can you do this? Simple--listen, that's how. Listen to all that the seller says and doesn't say. Third, dictate your terms: when, where, and how the negotiations are to be completed. Though the seller may have much to say on these issues as well, you should not be reluctant to assert your preferences. For example, you may wish to choose the location for any "home field advantage," establish a time frame beyond which negotiations will not continue, limit the persons allowed at the negotiating table, and prioritize the order in which issues are to be negotiated.

Assemble the negotiating team

An effective negotiator is one who is both well informed and in possession of the necessary skills to negotiate successfully. Only then can a buyer make informed decisions during the negotiation process. In addition to you (the buyer and primary negotiator), your negotiation team should, at the least, include the following:

- Financial professional: A certified public accountant or financial advisor experienced in business acquisition is definitely a plus. You should consider having this professional attend every negotiation session if possible.
- Attorney: Yes, you'll need a lawyer--an experienced one. An experienced attorney can be very helpful during the negotiation. The attorney can, for example, identify the legal consequences of the seller's proposals and assist in developing counterproposals.

Document the agreement

As negotiations progress, you will reach agreement on important issues. You and the seller should document one another's understanding of the terms agreed upon. Hence the letter of intent and the formal offer letter:

- Letter of intent: This document is usually written at either the early or later stages of the negotiations. When written at the early stages, the letter usually expresses the buyer's intent to purchase the business and represents a request for information that will be utilized in the due diligence review. When written at the latter stages--typically because general agreement has not been reached--the letter of intent restates the buyer's intent to purchase, memorializes previous discussions, and identifies significant issues to be resolved.
- Formal offer letter: This document is an offer to buy. If accepted by the seller, the formal offer letter becomes a legally binding contract. For this reason, an experienced attorney should prepare this document.

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Consider legal issues

Before negotiations are entered into, you must consider the laws and regulations--whether local, state, or federal--that may significantly affect the transaction. The following is a list of the primary legal issues that you'll need to be aware of:

- Securities laws and regulations: The federal government as well as each state regulates the purchase, sale, and exchange of securities (e.g., stocks and bonds).
- Employee health and safety regulations: You will have to abide by health and safety regulations once you've become the owner of your business. The Occupational Safety and Health Administration (OSHA) is one agency that regulates health and safety standards in the workplace.
- Banking regulations: Since you will be undergoing financing negotiations at some time, you should know that banks, from which you will likely be borrowing, are closely regulated by state and federal agencies. The type of loan offered and the documentation required by a bank are examples of conduct subject to regulation.
- Property taxes: To approximate your future property tax expense as a business owner, you may wish to examine past tax bills. Be aware, however, of any changes (e.g., the amount of tax) that have taken place since these bills were assessed.
- Zoning laws: Also pay close attention to the zoning laws in effect. Be sure that your future intentions can be fulfilled without impediment.
- Real and contingent liabilities: Be sure that you and your attorney carefully review the liabilities that you will incur with the purchase of the business. Retirement plans and pensions are examples of such liabilities, the continuation or termination of which may be expensive.

Preparing the business plan

The business plan is by far one of the most important keys to a successful business. The primary objective of a business plan is to develop a blueprint of your company. This blueprint will guide the future of the business as well as serve as a means to measure its success. The steps for preparing a business plan are as follows:

- Step 1: Identify your objectives.
- Step 2: Identify who will be using the plan (e.g., investors).

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- Step 3: Review the business's historical information (e.g., balance sheets, tax returns).
- Step 4: Conduct market research to determine the business's market potential.
- Step 5: Interview target company's key employees, suppliers, and customers.
- Step 6: Prepare financial projections and determine financing requirements.
- Step 7: Draft the business plan.

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