## Lecture 15

## Starting new business or buy firms

Start from scratch, buy a business, or buy a franchise? Once you've decided to start a business and have a good idea of what kind of business, you have these three basic start-up options. Each has advantages and disadvantages.

### Starting a Business

Most entrepreneurs start their business from scratch. Why is this so? Many do not even consider the two other options.

Here are a few of the most common advantages to starting your business from scratch:

- You can create a business, image, and reputation that reflect your personality.
- It gives you the opportunity to provide a unique service or product to the market.
- Customer contacts and relationships are new. There is no prior ill will.
- You can evaluate and choose new suppliers.
- You can evaluate and choose new employees.
- You can identify and acquire or lease an optimum location
- No equipment, supplies, or inventory exist, so you can choose exactly what you want.
- You can develop and nurture new credit and banking relationships.

On the other hand, be aware of these disadvantages:

- Starting a business is riskier than buying an existing business.
- Starting and organizing a new business takes more time and energy than buying an existing business.
- Capital and credit may be more difficult to obtain because of lack of history and experience.
- It may take time to develop a solid customer base.
- You may need supplemental income in the early years, until the business becomes profitable.
- You are less sure of the marketability of your product or service.
- Talented and experienced employees may be difficult to obtain and compensate adequately.
- Costs are more difficult to estimate.

### Buying a Business

Buying an existing business might be the way for you to go. Even if you have clearly decided to start a business from scratch, you can learn a great deal by investigating and analyzing similar businesses for sale. The more information you can obtain, the more businesses you look at, and the more questions you ask, the more likely your start-up will be successful. Take the time to search. You may even find a gem.

The major advantages of buying an existing business are:

- You can buy at a bargain price and bargain terms because the owner is often eager to sell.
- You can inherit proven inventory, supplies, equipment, and a facility at a bargain price.
- You can inherit good employees and loyal customers.
- You can be the beneficiary of goodwill and a positive reputation.
- There is less risk because the business has a track record.
- You can be profitable sooner.
- You can obtain a good proven location.
- You can save time by obtaining everything in one transaction.
- You can take advantage of established credit and supplier relationships.
- The financial records of the business can be a valuable starting point in running and growing the business.
- The seller may be available for valuable future assistance.
- You eliminate one competitor.

The major disadvantages of buying an existing business are:

- The price may be too high.
- The business or owner may have a bad reputation.
- The personality and decor of the business may not reflect your tastes.
- You may inherit incompetent or inflexible employees.
- The business may be in a poor location or facility.
- You may inherit antiquated or obsolete inventory, fixtures, and equipment.
- The existing policies and procedures may be ineffective.
- You may inherit inappropriate customers or be unable to retain the valuable customers.
- You may not get along well with the existing landlord.
- You may be liable for contracts entered into by the prior owner.

- There may be some hidden debts and liabilities that unexpectedly show up later.
- The owner may take the customer base and goodwill to a new business or location.

Where do you find businesses for sale? Here are a few sources to consider:

- your local business or legal newspaper
- Check the classified ads in the business Journals.
- Check the classified ads in trade and industry magazines.
- Contact real estate brokers and business brokers.
- Visit or call your local Chamber of Commerce. They may maintain lists or may know of interested sellers.
- Talk to trade sources such as suppliers, distributors, manufacturers, and trade associations.
- Check with advocates, accountants, bankers, friends, and acquaintances. Let them know that you are looking for a business opportunity.
- Directly contact business owners and ask whether they, or someone they know, want to sell.
- Keep an eye open for opportunities that suggest a business may be for sale. Examples include death, divorce, illness, bankruptcy, and co-owner disagreements.

**Factors to be considered before buying a business**

**Personal criteria:**

- Identify your personal goals for purchasing the business. Will the business you are considering match these goals? Think about your expertise. What are your strengths and weaknesses? Do they complement the venture? Will your knowledge and skills be of help in operating the business?
- Consider your lifestyle. Does this business fit your status and image needs?
- Decide about location. Is the location convenient for you? Does it have enough traffic flow? Is the location convenient to your target customers? What is the history behind the location?
- Look at the surroundings and physical conditions. Do you need to remodel? What are the estimated costs?

- Consider your financial needs. How much money do you want to make? How much money will you need to purchase the business?

**Business criteria:**

- Obtain past and projected profit and sales figures. Ask for the past 3 to 5 years of audited financial statements, if they have them. Have your accountant review them.
- Review the business' operating ratios. How do they compare with industry ratios. Ask the owner to explain any significant deviations.
- Obtain a list of all assets and liabilities. Examine the age and condition of inventory, equipment, and other assets. Evaluate debts and other liabilities. Are there any pending legal actions? Is product liability a concern? Analyze the number, amount, and ages of the receivables. How many did they write off as uncollectible in the past three years?
- Review the past 3 to 5 years' tax returns. Obtain income tax, sales tax, and other tax returns. Have your accountant review them. Compare them for consistency with each other and with the financial statements. If you doubt that these are the filed returns, obtain written authorization from the seller to obtain copies directly from the taxing agency.
- Obtain copies of all current contracts, including leases, loans, supplier and customer agreements, and insurance policies.
- Review all legal issues with your attorney.
- Review corporate minutes. If the entity is a corporation, obtain copies of all relevant corporate documents to review.
- Determine the value and legal protection of names, logos, trademarks, patents, and copyrights that are necessary for continued business success.
- Run necessary background and credit checks.
- Assess the current staff. If there are current employees, check their personnel files and interview them individually. Analyze compensation, skills, training, fringe benefits, union obligations, and turnover.
- Evaluate local economic and political conditions. What are the industry trends for this business? Is the market increasing or decreasing? What is the growth potential? What is the competitive environment?

- Meet with customers. Determine their level of satisfaction with the business. Talk to walk-in customers and former customers.
- Deal with a cooperative seller. Will the seller be willing to assist with an orderly transition? If you don’t get along with the seller, or if the seller is reluctant to disclose all the information you request, be concerned. Don’t be afraid to walk away from the deal. There are many more opportunities out there.
- Good price and good terms are essential when you finally decide to buy. Knowing the seller’s motivation is imperative for you to negotiate the best deal.

Why do people sell businesses? The reason they volunteer is often not the real underlying reason. Remember that the seller wants to paint a bright picture to obtain the best price and terms. However, people don’t generally sell businesses that are doing well, have a bright future, and are enjoyable to own and run. Your job is to determine the real reason for selling before you go too far in the transaction. It will put you in a much stronger bargaining position. Recognize that the seller has only one business to sell. You have many possible businesses you could buy, if you even do buy. You should be in the power negotiating position.

Here are some of the most common reasons owners claim that they are selling the business:

- Owner wants to retire.
- Owner wants to collect his winnings and enjoy them.
- Owner wants to live somewhere else.
- Illness is pressuring the owner to leave the business.
- Owner needs to deal with estate and inheritance problems.
- Owner is not happy with the line of business.
- There is a dispute between co-owners.

Here are some reasons owners are less likely to volunteer:

- Owner has family pressures.
- Owner has marital problems.
- Owner sees a better business opportunity.

• Owner dislikes coping with unions, regulations, taxes, consumer groups, stockholders, inflation, or insurance costs.
• Company needs more financing than the owner can raise.
• The market for what the company sells is currently depressed.
• Company is losing money for reasons the owner cannot diagnose.

Here are some reasons owners will rarely volunteer:
• Bigger companies are squeezing out smaller companies.
• New zoning laws are too restrictive.
• Competitors are moving in with more effective products or methods.
• Union settlements are cutting into profit.
• Owner wants to start a competitive firm with greater potential.
• Plant has become worn out or obsolete.
• New government regulations are too expensive.
• Supply sources have become restricted or eliminated.
• Location is becoming obsolete.
• Product or service the company sells is becoming obsolete.
• Franchise is being canceled.
• Company needs more cash than operations can justify.
• Key employees are leaving, perhaps as competitors.
• There is an impending threat of a major lawsuit.
• Major customer returns are likely from previous sales.
• There is a backlog with major built-in losses.

The key for you is to determine the real reason or reasons. Some reasons may necessitate walking away from the deal. Others may signify a great opportunity. You will decide, but do so knowing all the facts.

What is the value of a business? Entire books describe valuation techniques in great detail. This section discusses highlights of the major techniques. There is no single correct approach to valuation. Professional business appraisers will apply several techniques. However, what a business eventually sells for is often dependent on the buyer's and seller's subjective views and negotiating skills.

The three generally accepted methods of valuation are:

1. Balance Sheet Method: Assets minus liabilities give a value to the business. Variations include pure book value (historic cost), adjusted book value (fair market value), and liquidation value (immediate sale).
2. Income Statement Method: Capitalize earnings or sales with a chosen capitalization rate. Make decisions on what years to average for earnings or sales, what adjustments to make to earnings (taxes, interest, depreciation, owner compensation), and what growth and capitalization rates to use.
3. Discounted Cash Flow: Project cash flow of the business into the future, choosing an appropriate discount rate, and discounting the cash flows back to today's present value.

You need accurate data from the seller to perform a proper analysis. You may want to hire an accountant or a specialized business appraiser to perform a detailed analysis. Now that you have found a great business at a great price, don't forget the terms. They can often be more important than the actual price. Generally you want to put as little down as possible and have the owner carry the balance at a low interest rate for as long as possible. This serves two purposes. One, you improve your cash flow position. Two, if there are any future problems that you feel the seller did not disclose and should be liable for, you have substantial leverage since you are still paying the seller.

Locate a good lawyer and a good arbitrator to help you close the transaction. If you and your lawyer can draft the contract, do it. If the seller drafts the contract, have your lawyer carefully review it.

Here are some typical provisions to include:

1. Names and addresses of all parties and their spouses
2. Total price
3. Complete detailed description of all tangible and intangible assets with price allocation
4. Payment terms with interest rate and due dates
5. Adjustments to make at closing
6. Contracts and liabilities the purchaser assumes

7. Seller’s warranties as to ownership, liabilities, disclosure, and authority
8. Duration of seller’s warranties
9. Conduct of business up to closing
10. Buyer’s rights as to cancellation of contract
11. Non-compete agreement by seller detailing type, time, and location
12. Employment or consulting agreement with seller
13. Responsibility for closing details
14. Indemnification of buyer by seller
15. Broker compensation payment
16. Arbitration agreement and attorneys’ fee agreement
17. Approval of contract with all parties signing and indicating their signing capacity