BUYING A BUSINESS

Disclaimer

This document has been prepared as an introductory guide for those considering taking the step into small business and does not have any regard to any particular person's investment objectives, financial situation and needs. Accordingly, no recommendation (express or implied) should be acted upon without first obtaining specific advice from your adviser.

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BUYING A BUSINESS - An Introductory Guide

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BUYING A BUSINESS

An Introductory Guide

Introduction

The step of owning your own business and investing your own time and money is not to be taken lightly. Many small businesses fail within their first few months of operation. In general, buying and running a business:

- Can tie up large amounts of your money
- Can involve many more hours of work than simply working for someone else
- Can be difficult to sell quickly if you need to
- Means taking a risk

But with careful investigation and planning the risk involved can be reduced.

Before Deciding To Buy A Business

Before jumping in and deciding to buy a business you should consider a few things regarding yourself. For instance:

- **What motivates you**? Do you enjoy dealing with people, or running a business, or the concept of hard work and reward? Try to buy a business that will fit in with your aspirations so that it keeps you motivated.
- **Your lifestyle**. Do you enjoy family time or holidays or perhaps like your weekends spare? Consider the length of business hours you may have to work. The choice of business should fit as much as possible within your lifestyle otherwise you will miss doing the things you enjoy.
- **Examine your strengths and weaknesses**. Do you have managerial skills, and are you comfortable dealing with people? Try to choose a business that will utilise your strengths. Be aware of your weaknesses.
- **Examine your reasons for buying a business**. Are you buying yourself a job, buying an investment, wanting to work for yourself or chasing higher income potential? Examine your reasons carefully, for if you venture into a business for the wrong reasons you may regret it later.
- **Are you comfortable in taking the risk?** You will need sufficient equity in the business, which may mean a mortgage on the house or perhaps using a substantial part of a redundancy payment or superannuation. Be aware that you could lose substantial amounts if the business does not work – and it may be through no fault of your own.
- **Will the business produce the income that you look for?** This will depend on whether you are buying the business as an investment or as a means of employment.

General Business Investigation

Remember you will be investing a large amount of your time and money into the business so it is important you make the right purchase decision. When investigating a business you should consider the following broad points.

- Find out the demographics of the business area, the number of competitors, the potential customer base etc.
- Have an appreciation of the local economic conditions that may affect the business or its potential.
- Are you considering a “well run” or a “run down” business? There may be more potential in a business that has been run down while a well-run business may cost you top dollar but lack future potential. On the other hand, a business may be run down because the industry is not profitable.
- Consider technological or political changes that may affect the potential of the business.
- Is the industry healthy, i.e. economically
- Check out the location of the business. Is it suitably located?
- Ask the vendor why he or she is selling.

Many answers to these points are found simply by asking questions of other nearby businesses, industry associations, potential competitors, the Australian Bureau of Statistics etc.

This process will give you a superficial but not unimportant overview of the business. At this stage if you have found one or more businesses that look attractive it is time to look more closely at them.

Have I Found the Right Business? - Due Diligence Investigation

The best time to change your mind is before you sign the contract – so please take as much time as you need to carefully obtain and consider all information about the relevant business.

No information should be considered “private” – if it relates to the business then it should be made available for review. If information is being withheld – be very careful. If necessary an undertaking of confidentiality can be signed prior to viewing any information.

The due diligence process involves taking a critical analysis of the business. It is not possible to completely predetermine how a due diligence investigation will proceed. The only certain thing is that you need to remain flexible and inquisitive (and sometimes sceptical) during the collection of all information. Some pointers to this process are:

1. Seek details of the business for sale from either the vendor or agent. Details you should seek include the following:

    - **Purchase price -** What does the vendor want for the business? Nominated amounts should be given for the component parts, eg stock, plant & equipment and goodwill.
    - **What is being sold**? – check what you are buying eg. Segment of the business, a walk-in walk-out arrangement including debtors and creditors. Are all ongoing business commitments being accepted eg equipment leases.
    - **Leases -** details of any leases, expiry date, rent, escalation clauses, outgoings, review dates etc and details of the landlord – obtain copies of all lease documents (both equipment and premises).
    - **Liabilities -** details of any liabilities or outstanding claims against the business. Ensure all staff entitlements are paid up to date, for example, group tax, superannuation, annual leave, long service leave, workers compensation etc.
    - **Financial information -** usually prepared by an accountant, including profit and loss, balance sheet, depreciation schedule, cashflow projections if they are available etc. At least the last three years figures should be obtained (and more if any further questions are raised).
    - **Contract -** obtain a copy of the proposed sale contract.
    - **Plant and equipment -** where possible seek a second opinion on the value of all plant, equipment and vehicles being purchased. This may be as simple as quoting the relevant details to a second hand dealer.
    - **"Missing" information -** look for missing information, for example, establish if a private motor vehicle is needed in the business, establish the actual hours required to run the business, not just the opening hours etc.
    - **Independently verify all information -** attempt to independently verify all information e.g. – obtain insurance quotations, estimate motor vehicle running costs, verify the need and costs of any licences.
    - **Industry comparisons -** obtain copies of industry comparison information; we will be able to help here.
    - **Verify the Sales -** where possible attempt to verify sales. Consider counting the actual customers coming through the door. Consider obtaining bank statements to check bankings.
    - **Verify actual wage costs -** ensure family members working in the business are being paid fair wages, e.g. are family members running the business on weekends for no remuneration. Obtain copies of the relevant State and Federal Awards to check if the employees are being paid correctly.

- **Examine the business documentation** – does the business have a quality manual or systemised approach to business? The more business documentation the better the business!
- **Look carefully at results that appear to be "window dressed"** – consider the performance of the business over a number of years and be very sceptical if a sudden improvement in gross margin or net profit occurs in the most recent year. This may simply be the result of an overestimation of stock on hand or debtors or an understatement of creditors. A sudden reduction in repairs & maintenance may simply be an attempt to improve the bottom line by avoiding critical maintenance.
- **Special Licences or Franchise Agreements** – obtain full details of any licences or franchise agreements – you may not qualify for some minor reason.
- **Brands or Trademarks** – check how any brands or trademarks have been protected.
- **Quality Staff** – determine which key staff will remain with the business (remembering that their entitlements e.g. annual leave, long service leave also continue)
- **Review stock for obsolete or slow moving stock** – consider the quality of the stock being acquired.
- **Examine the debtors** – look at the credit terms the business offers its customers and the quality of its customers. Make sure the business is not heavily reliant on one single customer.
- **Restrictive Covenant** – it will usually be appropriate to ensure the exiting owner is restricted from competing with you for a reasonable period of time.
- **Look at the actual contribution of the owner to the business** – examine the amount of effort contributed to the business by the existing owners and their family e.g. hours worked, skills used, after hours work (e.g. bookkeeping), weekend work etc. Is all the success of the business tied to the owner and thus leaves when the business is sold?
- **Cash** – remember the old saying, "if you don't bank it – you can't sell it" – ignore any references to the benefits of a so called "cash business".
- **Examine Critical Tasks** – check if all critical maintenance is being undertaken, customer deadlines are being met, staff are being correctly remunerated, proper insurance cover is held, all relevant licences are held. Consider workplace health and safety risks, compliance with health department requirements.
- **Technology Life Cycle** – remember that all computer and information technology has a very short lifetime. Are you buying at the beginning or the end of the technology life cycle?

- **Know the Equipment and Vehicles**– ensure all equipment and vehicles have been properly maintained and understand the potential costs of major failure.
- **Know your industry** – check what threats the business may face in the future either from competitors or regulators.
- **Suppliers** – determine if the suppliers will continue to supply or if they could represent a threat of competition to the business e.g. the wholesaler becoming a retail competitor.
- **Quality Financial Records** – if the business's financial record keeping is poor – this could result in either misleading or deceptive information being provided.
- **Insurance** – does the business have adequate insurance? Will you be able obtain adequate insurance? Check with an insurance broker first.

2. Seek help and advice in the analysis of the information from us, and your legal adviser.

Your advisor should be able to provide you with an analysis as to whether the business is viable or at least identify its potential.

<u>Is The Business A Viable Proposition?</u>

The viability of a business depends on whether you see it as an investment and want an adequate return as well as a salary, or whether you treat it as buying a job and a reasonable income is acceptable. A viable business could mean any of the following for example:

- Return a salary (perhaps equivalent to what you would pay a manager) and an appropriate return (eg 25% plus) on the capital investment.
- Return a salary (perhaps equivalent to what you would pay a manager) and a return, at least as high as bank interest rates, on the capital investment.
- Return a salary and some return on capital invested.
- Return simply a salary.

While these options do not encompass all returns, the important point is whether the business is able to return financially what you want from it.

Determining the viability of a business should be done in conjunction with us. This decision goes very much in hand with what the business is worth and what you may have to pay for it.

Buying a Job

How much should you pay to buy a job – arguably nothing!

Unfortunately, many people are forced to become self employed to earn income.

The price paid simply for a job may be as high as $100,000 depending on the equipment and vehicles involved and the quality of business. However, we often see amounts equivalent to the earnings e.g. if the business earns $30,000 p.a. (before paying the owner/operator) then the amount paid for the business would be in the vicinity of $30,000.

But remember, there is no value in nothing.

So You Are Going To Buy

Having made the decision that the business meets your criteria both from a personal and financial point of view, it is now time to consider the steps taken to actually buy the business.

Legal Considerations

Firstly, when buying a business you should engage a solicitor. It is important from a legal point of view that the purchase is thoroughly checked – failure to do so could cost you your investment. Normal legal process would generally involve:

- Ensuring the vendor actually owns the business, including checking for silent partners
- Ensuring the assets sold with a business are owned by the vendor
- Checking franchise agreements
- Checking the sales contract generally
- Checking the validity of any contracts sold as part of the business
- Checking the business meets with government regulation
- Checking what you are actually purchasing in the business

The above list is not exhaustive; however, your solicitor will be able to provide assistance here.

Engaging a solicitor should not be seen as an alternative to doing your own investigations – merely as an additional source of information.

How Much Do You Pay For The Business?

Essentially a business is made up of tangible assets (e.g. freezer, welder, furniture) and intangible assets commonly known as goodwill.

While there are many methods used to calculate what a business is worth, the most often used is the Capitalisation of Future Maintained Earnings Method.

To establish the future maintainable earnings it is necessary to look back at the past to estimate what may happen in the future. This takes into account the inconsistencies of the past and "smooths" the results for fluctuations.

Adjustments need to be made to remove finance costs (ie interest), unrelated costs, fair allowances for payments to owner/managers, depreciation versus a proper allowance for future capital replacements, notional rent in relation to owner occupied premises etc.

Once these adjustments are made it is then possible to average the results to try and predict future maintainable earnings.

This method of valuing a small business is similar to the way commercial property is valued. A commercial property earning net income of say $50,000 p.a. may be valued at $500,000 applying a capital rate of say 10%.

The principal is the same for small business except that investing in a small business is much more risky than investing in commercial property. Typical capital rates may be 25% to 30% depending on the type of business, industry, inherent risks etc etc.

Thus if a business returned a net profit (after all adjustments including an owner/managers allowance) of say $50,000 p.a. and a capital rate of 25% was applied the business would be valued at approximately $200,000.

This method of valuation takes into account all the assets of the business, including goodwill, plant and equipment, stock and working capital.

Therefore to establish the value of goodwill, all that is necessary is to deduct the component parts from the total valuation.

From this point the final valuation (or more accurately the price) will be decided by negotiation between you and the seller.

Apportionment

It is extremely important to include the apportionment of assets acquired in the final version of the contract. A careful and well considered apportionment could result in a significant "tax break" to a purchaser.

A prospective purchaser is always keen to see plant and equipment apportioned as high as possible whereas the seller has the opposite view. The reason for these differing views is the taxation effect of depreciation.

We believe the apportionment is a vital negotiating point and should not be ignored.

Please do not be fooled (either by the agent or your solicitor) into ignoring the significant importance of including the apportionment in the contract. You may even be told to simply leave the apportionment to the accountants involved – once again do not be fooled.

Will You Need Finance?

If you will require finance from a lending institution they will require the detailed information that you have gathered so far. They will also look at the amount of equity you are willing to put into the business and may ask for material such as:

- Copies of the vendor’s financial statements
- Cashflow projections for your anticipated first 12 months or so of operation
- Statements of your personal assets and liabilities
- A business plan

On the basis of this and other information they will decide whether you are a good risk and whether to lend you the money. You should have us help with the cashflow projections, maybe produce a business plan and perhaps visit the bank with you.

As always you should seek quotes on interest rates and borrowing costs.

Unfortunately, most banks do not consider small business a “good” risk. Therefore, it is highly likely that they will require a real estate mortgage.

What Business Structure Should I Use To Buy The Business In?

From an operational, legal and taxation viewpoint the choice of business structure in which you will operate is important. Your own situation and the type of business will in most cases determine your most advantageous structure. The most common structures are:

- Sole trader
- Partnerships
- Private companies
- Family trusts

We will be able to assist here. For further information obtain a copy of our booklet 'Business Structures'.

Other Considerations

There are a number of other costs associated with buying a business. Some of these are, for example:

- Establishment costs, e.g. electricity deposits, telephone connections
- Professional costs, e.g. legal expenses
- Licences and permits
- Borrowing costs (including business overdrafts)
- Stamp duty
- Working Capital
- Insurance

There are also a number of other things to consider such as:

- ABN, TFN and GST registration
- Registration as an employer (PAYG withholder)
- Registration for Payroll Tax
- Registration for Workcover
- Workplace Registration
- Other Government Registration (e.g. health department, City Council)
- Registration in relation to employee superannuation
- Insurance (life, loss of profits, trauma, sickness and accident, building, stock and equipment, public liability, products liability, professional indemnity etc)
- Establishing trade accounts with suppliers and revised accounts with customers
- Register a business name
- Trademark and patent applications

Conclusion

In conclusion there are many elements to consider when buying a business, and they are not all outlined in this booklet. If you require further assistance, please take the time to talk to us.