Buying an established business can reduce the risk of the entrepreneurial experience.
Source: © Manor Photography/Alamy.

Buying an Existing Business

Advantages of Buying an Existing Business

1.
Understand the advantages of buying an existing business.

The following are some of the most common advantages of purchasing an existing business.

SUCCESSFUL BUSINESSES OFTEN CONTINUE TO BE SUCCESSFUL A business that has been profitable for some time often reflects an owner who has established a solid customer base, developed successful relationships with critical suppliers, and mastered the day-to-day operation aspects of the business. All of these factors are positive and may be keys to continued success. When things have gone well, it is important for a new owner to make changes slowly and retain the relationships with customers, suppliers, and staff that have made the business a success. This advantage often accompanies the second advantage, using the experience of the previous owner.

LEVERAGING THE EXPERIENCE OF THE PREVIOUS OWNER In cases in which the business has a history of success, a new owner may negotiate with the current owner to stay on as a consultant for a time. This allows a smooth transition during which the seller introduces the new owner to customers and suppliers and shows the new owner the secrets of making the company work. The previous owner can also be very helpful in unmasking the unwritten rules of business—whom to trust, expected business behavior, and many other critical intangibles. Hiring the previous owner as a consultant for the first few months can be a valuable investment for both parties. Learning from the previous owner's experience is extremely helpful.

OWNING A BUSINESS GUARANTEES A JOB As long as you work for someone else, you are at the mercy of that employer and that business. Businesses can be sold or closed down, leaving employees in a state of uncertainty or out of work. Owning a business puts the entrepreneur in charge of his or her own destiny.

ENTREPRENEURIAL PROFILE: Linda Jamerson and Ken McDonald: Aluminum Case Company Linda Jamerson and her husband, Ken McDonald, had been trying to purchase a business for three years. Although they wanted to work for themselves, they needed high profits rather quickly to generate the income they needed to meet their personal monthly expenses. That is why they chose to buy an existing business rather pursue a start-up. During their search, two promising deals to buy companies fell through. However, when they found the ideal opportunity, the Aluminum Case Company, they were eager to move ahead. "Our criteria were a manufacturing company with a good reputation and growth potential that had been ignored," said Jamerson. "Aluminum Case Company had a large and varied customer base, a unique product niche, a good reputation and capacity for huge growth. They had no Web presence and had not automated their engineering or equipment, so we felt we could make a quick impact on sales." However, they ran into a roadblock on the purchase when they tried to find traditional bank financing to help fund the purchase. "We were discouraged at how little funding our regular bank—and a few others—were willing to lend," says Jamerson. Then they came across a company that specializes in self-directed IRAs and alternative small business financing. Jamerson and McDonald set up a new retirement plan through which they were able to buy Aluminum Case Co. The company's sales grew 60 percent the first year after the couple purchased the business.[4]

THE TURNKEY BUSINESS Starting a company can be a daunting, time-consuming task, and buying an existing business is one of the fastest pathways to entrepreneurship. When things go well, purchasing an existing business saves the time and energy required to plan and launch a new business. The buyer gets a business that is already generating cash and perhaps profits as well. The day the entrepreneur takes over the ongoing business is the day revenues begin. Tom Gillis, an entrepreneur, and management consultant in Houston, Texas, says, "Acquiring an established company becomes attractive in three situations: when you haven't found 'the idea' that really turns you on and you find it in an existing business; when you have more money than you have time to start a business from scratch; and when you want to grow but lack a compatible product, service, location or particular advantage that is available from an owner who wants out." According to Gillis, the critical question is, "What do I gain by acquiring this business that I would not be able to achieve on my own?"[5]

SUPERIOR LOCATION When the location of the business is critical to its success, purchasing a business that is already in the right location may be the best choice. In fact, the existing business's greatest asset may be its location. A location that provides a significant competitive advantage may be reason enough for an entrepreneur to decide to buy instead of launch. Opening a second-class location and hoping to draw customers often proves fruitless.

EMPLOYEES AND SUPPLIERS ARE IN PLACE Experienced employees who choose to continue to work for the business are a significant resource because they can help the new owner learn the business. In addition, an existing business has an established set of suppliers with a history of business transactions. Vendors can continue to supply the business while the new owner assesses the products and services of other vendors. Thus, the new owner can take the time needed to evaluate alternate suppliers.

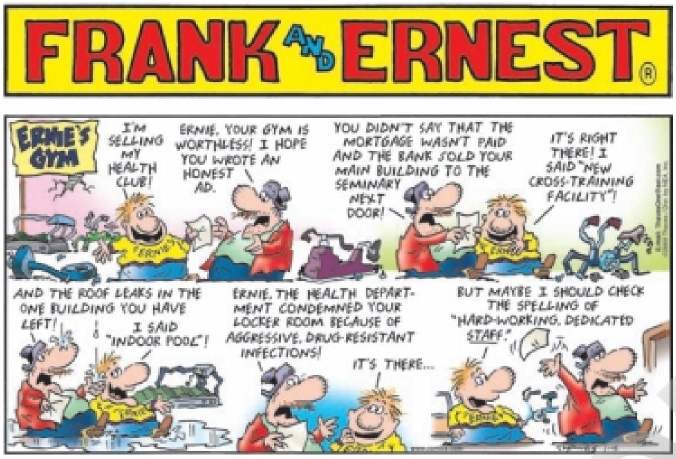
INSTALLED EQUIPMENT WITH KNOWN PRODUCTION CAPACITY Acquiring and installing new equipment exerts a tremendous strain and uncertainty on a fledgling company's financial resources. The buyer of an existing business can determine the condition of the plant and equipment, its capacity, its life expectancy, and its value before buying the business. In many cases, the entrepreneur can purchase the existing physical facilities and equipment at prices that are significantly below their replacement costs. In some businesses, purchasing these assets may be the best part of the deal.

INVENTORY IN PLACE The proper mix and amount of inventory is essential to both cost control and sales volume. A business with too little inventory imposes limitations on satisfying customer demand, and too much inventory ties up excessive amounts capital, increases costs, reduces profitability, and increases the likelihood of cash flow problems. Many successful established business owners have learned a proper balance of inventory. Knowing the "right" amount of inventory to keep on hand can be extremely valuable, especially for buyers of businesses that experience seasonal fluctuations, that sell perishable items, or that must meet the needs of high-volume customers.

ESTABLISHED TRADE CREDIT Previous owners also have established trade credit relationships of which the new owner can take advantage. The business's proven track record gives the new owner leverage in negotiating favorable trade credit terms. No supplier wants to lose a good customer.

EASIER ACCESS TO FINANCING Investors and bankers often perceive the risk associated with buying an existing business with a solid history of performance to be lower than that of an unknown start-up. This may make it easier for the new owner to secure financing. A buyer can point to the existing company's track record and to the plans for improving it to convince potential lenders to finance the purchase. Many lenders will finance 50 to 75 percent of the purchase price of a business, depending on a number of factors such as the industry in which it operates, its track record of success, and it profits, cash flow, assets, and collateral.[6] In addition, in many business purchases, buyers use a built-in source of financing: the seller.

HIGH VALUE Some existing businesses are real bargains. If the current owner must sell quickly, he or she may have established a bargain price for the company that is below its actual worth. Any special skills or training required to operate the business limit the number of potential buyers; therefore, the more specialized the business is, the greater the likelihood is that a buyer can find a bargain. If the owner wants a substantial down payment or the entire selling price in cash, there may be few qualified buyers, but those who do qualify may be able to negotiate a good deal.



Source: Bob Thaves/Universal Uclick.

Disadvantages of Buying an Existing Business

Buying an existing business does have disadvantages that are important to consider.

2. Understand the disadvantages of buying an existing business.

CASH REQUIREMENTS One of the most significant challenges to buying a business is acquiring the necessary funds for the initial purchase price. "[Because] the business concept, customer base, brands, and other fundamental work have already been done, the financial cost of acquiring an existing business is usually greater then starting one from nothing," observes to the Small Business Administration.[7]

THE BUSINESS IS LOSING MONEY A business may be for sale because it is no longer—or never has been—profitable. Owners can use various creative accounting techniques that make a company's financial picture appear to be much more positive than it actually is. The maxim "let the buyer beware" is sound advice in the purchase of a business. Any buyer who is unwilling to conduct a thorough analysis of the business usually ends up paying a much higher price down the road when the business turns out to be struggling.

Although buying a money-losing business is risky, it is not necessarily taboo. If a business analysis indicates that the company is poorly managed, suffering from neglect, or overlooking a prime opportunity, a new owner may be able to turn it around. However, buying a struggling business without a well-defined plan for solving the problems it faces is an invitation to disaster.

ENTREPRENEURIAL PROFILE: Philip Schram: Buffalo Wings and Rings While working for an auto parts maker in Cincinnati, Ohio, Philip Schram learned that a coworker's father was selling an underperforming restaurant franchise, Buffalo Wings and Rings, that he had started in 1988. After analyzing the six-store chain and developing a plan for turning it around, Schram purchased the chicken wings and onion rings franchise. "Since I was a boy, I dreamed of owning a business," he says. Schram worked with franchisees to increase the company's marketing, promotion, and branding efforts; refurbished the chain's stores to give them a fresher, consistent look; and expanded the menu. The changes worked. Within two years, the number of outlets had grown to 43, and sales increased to $20 million from $6 million. Schram continues to expand the chain across the Midwest and recently opened a new franchisee training headquarters in Cincinnati.[8]

Unprofitable businesses often result from at least one of the following problems:

- Excessively high wage and salary expenses due to excess pay or inefficient use of personnel
- Excessively high compensation for the owner
- Excessively high rental or lease rates
- High-priced maintenance costs or service contracts
- Poor location or too many locations for the business to support
- Inefficient equipment
- Intense competition from rivals

- Prices that are too low
- Low profit margins

If the business is profitable but does not have adequate cash flow, the following potential problems often are the cause:

- High inventory levels
- Inadequate accounts receivable collection efforts
- Losses due to employee theft, shoplifting, and fraud

Like Philip Schram, a potential buyer usually can trace the causes of a company's lack of profitability by analyzing a company and its financial statements. The question is, Can the new owner take steps to resolve the problems and return the company to profitability and positive cash flow?

PAYING FOR ILL WILL Just as proper business dealings can create goodwill, improper business behavior or unethical practices can create ill will. A business may look great on the surface, but customers, suppliers, creditors, or employees may have negative feelings about their dealings with it. Too many business buyers discover—after the sale—that they have inherited undisclosed credit problems, poor supplier relationships, soon-to-expire leases, lawsuits, building code violations, and other problems created by the previous owner. Vital business relationships may have begun to deteriorate, but their long-term effects may not yet be reflected in the company's financial statements. Ill will can permeate a business for years. The only way to avoid these problems is to investigate a prospective purchase target thoroughly *before* moving forward in the negotiation process.

CURRENT EMPLOYEES ARE UNSUITABLE If a new owner plans to make changes in a business, current employees may not suit the company's needs. Some workers may have a difficult time adapting to the new owner's management style and the new vision for the company. Previous managers may have kept marginal employees because they were close friends or had been with the company for a long time. The new owner, therefore, may have to make some very unpopular termination decisions. For this reason, employees may feel threatened by new ownership. In some cases, employees who may have wanted to buy the business themselves but could not afford it are resentful. They may see the new owner as the person who "stole" their opportunity. Bitter employees are not likely to be productive workers and may have difficulty fitting into the new management structure.

LOCATION HAS BECOME UNSATISFACTORY What was once an ideal location may no longer be because of changing demographic patterns. Recently opened malls and shopping centers, new competitors, or traffic pattern changes can spell disaster, especially for a small retail shop. Prospective buyers must evaluate the current market in the area surrounding the business as well as its potential for future growth and expansion. Researching all zoning, traffic, and land development plans with appropriate jurisdictions, such as the city, county, or state, is important as well.

OBSOLETE OR INEFFICIENT EQUIPMENT AND FACILITIES Potential buyers sometimes neglect to have an expert evaluate a company's building and equipment before they purchase it. They may discover too late that the equipment is obsolete and inefficient, which increases operating expenses to excessively high levels. Modernizing equipment and facilities is seldom inexpensive.

CUSTOMERS MAY BE LOYAL TO PREVIOUS OWNERS Customers can base their purchasing decisions on personal loyalties to the owner of the business. For some businesses, this can have a modest impact on the performance of these businesses after they are sold. For example, customers of restaurants and retail businesses may have gotten to know the previous owners over the years and may be skeptical about how the new owners will operate the business going forward. In other businesses, customer loyalty and trust of previous owners can make the retention of old customers highly uncertain. This is particularly true with service businesses in which the owners are highly active in the day-to-day operation of the company and interact directly with the customers. For example, businesses providing ongoing services such as lawn care, bookkeeping, house cleaning, car repair, and others often experience a high rate of turnover in customers when a business is sold to new owners. It is important to understand the degree of any personal relationship that the previous owner has with customers and their loyalty to the previous owners before making a final decision to buy a business.

THE CHALLENGE OF IMPLEMENTING CHANGE Planning for change is much easier than implementing it. Methods and procedures the previous owner used create precedents that can be difficult or awkward for a new owner to change. For example, if the previous owner granted volume-based discounts to customers, it may be difficult to eliminate that discount without losing some of those customers. The previous owner's policies—even those that are unwise—can influence the changes the new owner can make. Implementing changes to reverse a downward sales trend in a turnaround situation can be just as difficult as eliminating unprofitable procedures. Convincing alienated customers to return can be an expensive and laborious process that may take years.

OBSOLETE INVENTORY Inventory has value only when it is salable. Too many potential owners make the mistake of trusting a company's balance sheet to provide them with the value of its inventory. The inventory value reported on a company's balance sheet is seldom an accurate reflection of its real market value. A company's inventory may reflect the value at the time of purchase, but inventory, especially technologically related inventory, can depreciate quickly. The value reported on the balance sheet reflects the original cost of the inventory, *not* its actual market value. In fact, inventory and other assets reported as having value may be completely worthless because they are outdated and obsolete. It is the buyer's responsibility to discover the *real* value of the assets before negotiating a purchase price for the business.

VALUING ACCOUNTS RECEIVABLE Like inventory, accounts receivable rarely are worth their face value. The prospective buyer should age the accounts receivable to determine their collectability. The older the receivables are, the less likely they are to be collected and, consequently, the lower their actual value. Table 7.1 shows a simple but effective method of evaluating accounts receivable once the buyer ages them.

THE BUSINESS MAY BE OVERPRICED Most business sales involve the purchase of the company's assets rather than its stock. A buyer must be sure which assets are included in the deal and what their real value is. Many people purchase businesses at prices far in excess of their true value. If a buyer accurately values a business's accounts receivable, inventories, and other assets, he or she will be in a better position to negotiate a price that will allow the business to be profitable. Making payments on a business that was overpriced is a millstone around the new owner's neck, making it difficult to keep the business afloat.

Purchasing an existing business can be a time-consuming process that requires a great deal of effort and is often difficult to complete. Repeated studies report that more than half of all business acquisitions fail to meet the buyer's expectations. This statistic alone should provide a warning about the need to conduct a systematic and thorough analysis prior to negotiating any deal.

TABLE 7.1 Valuing Accounts Receivable

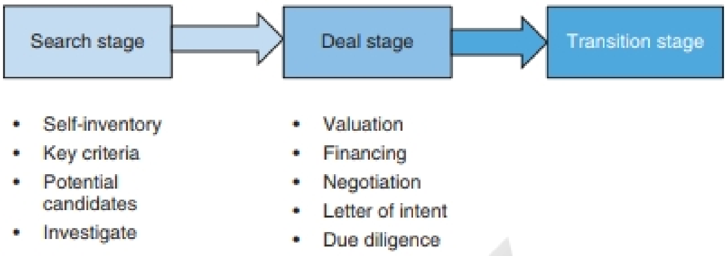
A prospective buyer asked the current owner of a business about the value of her accounts receivable.

The owner's business records showed $101,000 in accounts receivable. However, when the prospective buyer aged them and then multiplied the resulting totals by his estimated probabilities of collection, he discovered their *real* value.

Age of Accounts (Days)	Amount	Probability of Collection	Value (Amount × Probability of Collection)
0–30	$40,000	95%	$38,000
31–60	$25,000	88%	$22,000
61–90	$14,000	70%	$9,800
91–120	$10,000	40%	$4,000
121–150	$7,000	25%	$1,750
151+	$5,000	10%	$500
Total	**$101,000**		**$76,050**

Had he blindly accepted the "book value" of these accounts receivable, this prospective buyer would have overpaid by nearly $25,000 for them!

FIGURE 7.1
Process of Buying a Business



The remainder of this chapter examines the stages that entrepreneurs go through when buying a business: (1) search stage, (2) deal stage, and (3) transition stage (see Figure 7.1).

The Search Stage

3.
Explain the four steps in the search stage for buying the *right* business.

When buying a business, entrepreneurs must search for a business that fits best with their background and personal aspirations. There are four steps to conduct an effective search for the right business to buy:

- Conduct a self-inventory.
- Develop a list of the key criteria that define the "ideal business."
- Seek the help of others in developing a list of potential candidates for acquisitions that meet your criteria.
- Thoroughly investigate the potential acquisition targets that best meet your criteria.

Self-Inventory

The first step in buying a business is conducting a "self-inventory" to determine the ideal business. The following questions produce valuable insights into the best type of business an entrepreneur should consider buying. The answers to these questions provide an important personal guide that help avoid a costly mistake:

- What business activities do you enjoy most? What activities do you enjoy the least?
- Which industries interest you most? Which interest you the least?
- What kind of business do you want to buy?
- What kinds of businesses do you want to *avoid*?
- In what geographic area do you want to live and work?
- What do you expect to get out of the business in terms of income, wealth, and the ability to meet your nonfinancial goals in life?
- What are your long-term goals for work and retirement? What types of businesses will help you meet these goals?
- How much time do you want to set aside for your interests outside of work—family, hobbies, volunteer work, community organizations, and so forth—and how well will different kinds of businesses allow you to continue with these activities?
- How much can you put into the business—in both time and money?
- What business skills and experience do you have? Which ones do you lack?
- How easily can you transfer your existing skills and experience to other types of businesses? In what kinds of businesses would that transfer be easiest?
- How much risk are you willing to take?
- What size company do you want to buy?
- How much can you afford to spend on a company?

Answering those and other questions *beforehand* will allow you to develop a list of criteria that a company must meet before it becomes a purchase candidate.