THE BUYERS GUIDE

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KEY STEPS TO **SUCCESSFULLY BUYING A BUSINESS**

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Things to think about pre buying

Buying a business is major investment decision, so it is critical you prepare yourself properly for this process so that you make the right decisions along the way. The majority of people never complete because they just don't understand how much is involved.

So here are some tips on how to approach the search for identifying the right business for you so that you don't become overwhelmed by the process:

- Commit to a deadline. If you don't want the process to turn into an endless search, stick to this timeline and be disciplined in your search efforts.
- Set aside time every day to work on finding a business. Nearly 90% of all searches are done via the internet. Work out how much time you must commit to fully investigate what opportunities are available.
- Assess your strengths and weaknesses and identify only the businesses that you know will be right for you and focus your efforts accordingly on those types of businesses.
- Get your financial position established early, understand how much you can invest in a business and produce a statement of personal financial worth from the outset. List your assets and liabilities and assess your net worth. Any funder you approach will require this information.
- Establish with absolute certainty how much of your cash you are prepared to invest.
- Don't look at businesses you can't afford. As the majority of business purchases involve an element of funding, understand how much cash you have and how much funding you can raise and only look at businesses in that range.
- Educate yourself on the buying process and invest the time and energy to ensure you have the knowledge to buy the right business. Properly prepared, well informed buyers are the ones who acquire the good businesses, the others get the lemons.
- Talk to business brokers, tap into their database of business that are available and get a clear understanding of the value of any businesses you are interested in and how that value was arrived at.

Understanding how different business appraisal and valuation methods work will help you in determining your offer price for a business. Your financial advisor should be able to assist you in this regard but it is important you also understand how buyers and sellers typically approach the price setting process.

Here are some of the valuation and appraisal tools that are used:

Capitalisation

A common method of valuing a business is called the Capitalisation of Earnings (or Capitalised Earnings) method.

Capitalisation refers to the return on investment that is expected by a buyer. Earnings is the figure that is left after all the expenses necessary to run the business (including owner/operators wage allowance) are deducted from all the income generated by a business. The earnings figure capitalised by a percentage figure represents the Return on Investment (ROI). For example, a business producing annual earnings of $100,000 capitalised at 10% represents a purchase price of $1,000,000, whereas at 20% the purchase price is $500,000. A buyer will look at as high a percentage as possible, the seller as low as possible.

However, this takes no consideration of the value of plant, fixtures and fittings (the tangible assets of a business) or goodwill (the intangible asset). These have to be assessed as part of determining the total price as do risk factors and historical earnings.

Rates of 20% to 25% are common for small business capitalisation calculations. Any less and the business must have a rock-solid earnings history with little risk of retrenchment or high depreciation factors. Any more will generally indicate greater risk involved.

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Cash flow

This method looks strictly at the numbers and how much of a loan to buy the business the cash flow will support. The buyer will look at the bottom-line, factor in any add-backs (depreciation, personal drawings and the like) and then deduct an estimated amount for any plant replacements etc along with an acceptable figure for an owner's salary. This adjusted bottom-line figure is then used to determine how much of a loan the business will support over a given period.

The price arrived at is obviously affected by different loan terms and interest rates. From a buyer's perspective this valuation method makes sense. The seller, however, may take an entirely different view.

Tangible asset value

This is applied when a business is losing money or simply not returning a fair amount to the owners for the work put into running the business. It assumes the business is worth no more than the value of the plant, fixtures and fittings plus any stock-in-trade associated with the business.

Cost to create approach

It may sometimes be worth paying a premium to purchase an existing business just to avoid the difficulties of starting from scratch. Logically, if it were cheaper to start a business from scratch why wouldn't you? This is why franchised business systems can do well as, generally, much of the hard work has been done.

In general, the more difficult, expensive, and/or time consuming the startup is likely to be, the higher the value would be based upon this method.

Rule of thumb approach

One of the most common approaches to small business valuation is the use of industry rules of thumb. They are mainly based on turnover rather than earnings and financial analysts cringe at their use. They do have their place, but only as an adjunct to other more bottom-line based methods.

The problem with these, and all rule of thumb formulas, is that they are statistically derived from the sale of many similar businesses. They are averages and are only accurate for average businesses. Above and below average performing businesses will sell for more or less. It is inappropriate to apply the rule of thumb to a business that varies significantly from the average.

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Multiples of EBITDA method

This method is used for valuing larger businesses by simply multiplying the Earnings Before Interest, Taxes, Depreciation and Amortisation (EBITDA) by a factor, typically in the 3 to 6 range. It is a straightforward approach best used for businesses with sales in the multiple millions that have management structures in place.

Advantages are:

- It avoids the issue of depreciation and amortisation, since most companies use depreciation and amortisation schedules that take best advantage of the prevailing tax laws. It also avoids the issue of taxes, which will vary.
- It is uncomplicated and most useful for businesses that are well established, with earnings that are consistent and likely to be predictable going forward.
- It lends itself to comparisons with similar businesses.
- It is most suitable for businesses with large turnovers especially businesses where variations in tangible assets do not significantly affect the value of the business.

Disadvantages are:

- It makes no distinction between businesses that have large working capital requirements and those with smaller working capital requirements.
- It makes no distinction between businesses that have large fixed asset needs, versus those with small fixed assets.
- It makes no provision for businesses that have very substantial real depreciation (eg, transport companies, where the vehicles rapidly decrease in value) as opposed to companies where actual decrease in asset value is less than the IRD depreciation allowance. In some cases EBIT is used instead of EBITDA when there are large, recurring depreciation expenses.

Even when the EBITDA method is appropriate for valuation, certain adjustments and allowances need to be made before the simple formula can be applied. And of course, the actual multiplier used (whether 3 or 4 or 5 or some other number) is likely to be vigorously negotiated between buyer and seller and will be influenced by market conditions.

This is by no means an exhaustive list of valuation methodologies and is meant for guidance purposes only. Further financial and legal advice should be sought.

THE BUSINESS BUYING PROCESS

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The Business Buying Process

Once you have investigated what businesses are available for sale and identified which one or ones might be right for you, and how to go about determining a price, then the serious work begins. An understanding of the sales process is important to achieve a successful outcome so here's how it works in general terms:

What steps has the seller taken before listing a business for sale

Under the Real Estate Agents Act 2008, Bayleys agents are required to appraise a business for sale prior to entering into an agency agreement to sell it.

An appraisal is different from a valuation but uses similar methodologies. In preparing an appraisal, a business broker will use various approaches and methods to establish a value for the business and often the range at which offers are likely to be received. A range is relevant because every business buyer has a different motivation. A potential purchaser's assessment of the value of a business will be based on how they intend to use it.

This appraisal will then be discussed with the vendor to gain agreement on the value of the business and the possible range within which the business may sell. While the appraisal is confidential between the agent and the seller, it does mean that all businesses listed with Bayleys have gone through a rigorous assessment and appraisal process. Rest assured, Bayleys' experienced business brokers will not be wasting theirs or your time with vendors who have unrealistic expectations re their business' worth.

How an agency agreement works

Bayleys cannot list a business for sale without an agency agreement which requires us to act in the vendor's best interests at all times. The vendor pays us commission should a sale be achieved. If you are the successful purchaser there will be no commission or fees payable by you to Bayleys. Your main costs will be in obtaining the necessary financial and legal advice, in addition of course to the cost of buying the business.

All dealings with the vendor must be done through the agent. Agents will be happy to facilitate dialogue with the vendor should you wish to investigate or receive further information on specific aspects of the business.

Methods of sale

A wide variety of methods are used to sell businesses depending on their type and whether it is a business only sale or freehold going concern also involving property. More businesses are sold with an asking price than is the case for properties.

However, sometimes marketing without a price, by negotiation, or through some other method of sale with a deadline, may be more appropriate. In this situation, you may be asked to provide your own assessment of what you think the business is worth.

Whatever the method of sale, you should seek professional advice from a trusted accountant or business adviser with experience in this field and/or a qualified business valuer before making an offer.

What information can you expect to receive?

Bayleys' business advisers will prepare an Information Memorandum on the business for qualified buyers to assess. It generally contains:

- an executive summary;
- history of the business, what it is and how it works;
- what products and services it has;
- who its customers, suppliers and competitors are;
- a summary of financial performance to enable purchasers to assess the company to make an offer;
- other information on stock, assets, staff and property (leased or owned).

THE BUSINESS BUYING PROCESS

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We will only release detailed financial and customer information to qualified potential buyers who we consider have a genuine interest in acquiring the business. You will normally be required to sign a detailed confidentiality agreement that protects a vendor's business interests. You must take this confidentiality commitment seriously as any breach is likely to have legal consequences.

Presenting offers

Once you have undertaken your initial investigation of a business, have made an assessment of its value and decided you wish to buy it, then you need to make an offer. Offers will be presented to the vendor through an Agreement for Sale & Purchase of a Business as prescribed by the Auckland District Law Society. At this point your legal advisers will also get involved to review the agreement and advise you before you sign anything. The vendor can accept or reject the offer or may make a counter offer at a different price.

Due diligence

Once a price has been settled on and an agreement has been signed by both parties, there will generally be a period of due diligence. This provides the purchaser with an opportunity to review in detail the books and records of the company to ensure they are actually getting what they believe they are acquiring.

This can take considerable time which will be determined to an extent by the amount and quality of information supplied by the vendor. Don't rush this process or be pressured into a timeframe that may not provide you with the degree of comfort you need to reassure yourself you are making the right decision. Remember buying a business will generally be one of the biggest financial outlays you make in a lifetime.

Most vendors will understand that selling and buying a business generally takes months rather than weeks, particularly if they are being advised by an experienced broker. They may also be prepared to give you a time extension if issues crop up that may need further investigation and they can see you are serious in your interest.

Also please don't hesitate to talk to the Bayleys broker if you are unsure about anything or you discover something that concerns you. An important part of an agent's role is to act as an intermediary and "sounding board" during the due diligence process and to endeavour to ensure it goes as smoothly as possible.

Have your advisors at the ready and listen to their advice during the purchasing process but always remember it won't be their money that is being handed over. Understand it's your decision. You need to be confident that it is the right decision.

Concluding the sale

Once due diligence is completed to your satisfaction and you are prepared to go unconditional, you will normally be required to pay a deposit into the Bayleys Deposits Trust Account where it is held until settlement.

The agent will then assist the vendor to get the business ready for takeover and finalise what needs to be handed across on settlement date. Your solicitors will also advise on settlement matters and any issues that will need to be resolved.

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Who is the typical vendor of a business?

There will be a number of reasons why a business is up for sale and there isn't any one typical seller. However, around two thirds of the vendors that Bayleys deals with are "baby boomers" aged over 55 looking for an "exit strategy" from businesses that they will in many instances have owned for a long time. In many cases, they will have built up a very successful business and have a wealth of knowledge and important contacts within their industry. In some instances, they may be prepared to stay on and help with the transition process or continue on a consultancy basis.

As the baby boomer bulge gets bigger, they are likely to make up an even larger proportion of sellers - offering some great opportunities for buyers.

Will I able to secure finance to buy a business?

Most business acquisitions involve a degree of leveraging and banks are currently competing aggressively in the business sales market given the economy is performing well which means the business sector is generally also performing well.

However, expect financiers to want to undertake a substantial amount of their own "due diligence" both on the business you are looking to buy and on yourself. They will want details on your past business experience and what sort of assets you have should they require additional security.

Bayleys business brokers have built up strong relationships in the banking sector and can assist with introductions if required.

What sort of advice should I get before buying a business?

Obviously getting good legal and accounting/business/financial advisory advice is essential.

We would recommend you use a lawyer or firm specialising in commercial law with a well-established track record in business sales and acquisitions.

Likewise it is important to utilise an accountant/business adviser experienced in this area to assist you with your due diligence. A good financial adviser is "gold" both in guiding you through the acquisition process and then in adding value to that business once you have bought it.

Again, Bayleys can assist with introductions to advisers who we know from experience are good operators and will offer sound advice.

What else can I expect from a Bayleys business broker?

We are vendors' agents which means we act, and have a fiduciary responsibility to act, on their behalf and in their best interests.

However, every successful transaction requires two parties and satisfying buyers' requirements as far as is practicably possible is an important part of the equation. We will listen to and take on board what you are wanting to achieve in the negotiation process and relay this to the vendor.

An important part of our role as negotiators is to endeavour to get the possible result for both parties.

LAURENT ISOREZ

EXPERT BUSINESS BROKER, MIAMI DADE, BROWARD, PALM BEACH, SOUTH FLORIDA

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