HOW TO BUY A BUSINESS

by John Martinka

Three people can keep a secret if two of them are dead.
Benjamin Franklin

Keith bought a small business. The company manufactured a handful of proprietary products. The business was overly dependent on the seller because of his product and manufacturing skills and it was marginally profitable (meaning there were small profits after paying the owner a fair market salary for his work). Bottom line, it was a great deal for both parties.

This was Keith's second acquisition. Three years prior he bought a decades-old manufacturing and distribution company from a 70-year-old seller. Sales of the company had peaked when the seller was 65. It was still profitable but trending downward. The first year Keith grew the business by one percent and considered it a major accomplishment. His second year sales and profits were five times the seller's trailing 12-months prior to the sale and the company made the local business journal's 100 fastest-growing businesses, placing in the top twenty.

The small manufacturing business that was Keith's second acquisition was one of the suppliers for the distribution side of his company. He knew the product, its potential, its weaknesses and how to sell more of it. This acquisition was also part of his overall exit strategy as it showed he could purchase a company, absorb it profitably into his operation, thereby increasing his rate of return on assets and sales.

For the seller, Keith was a lifesaver. Who else was going to buy a company so dependent on the owner's product development skills and product knowledge? Surely not an individual wanting to own his own business. And the seller got a consulting job with Keith to engineer the products he invented, and the products Keith's company already made.

This was truly a win-win deal.

The above story answers the first question every owner must ask when considering the possibility of growing by acquisition. That question is, why buy another business? In Keith's case there were numerous answers including increased sales, higher margins overnight and a product line. Automatically, he increased the value of his business and he took a big step in the formulation of his exit strategy. And he acquired a much needed employee . . . an engineer, the seller, to further develop his product line.

Growing by acquisition makes sense if you have specific reasons why you want or need to buy another company or you just want to increase sales and profits faster than growing organically. When there is a reason to consider this strategy, and the perceived risks of buying another business are less than the perceived benefits, it is worth looking into. However, do not fall into the trap of making an acquisition just for the sake of making one. A bad deal is infinitely worse than no deal. If an acquisition will allow you to make more money, improve your lifestyle and make exiting easier, why not do it? The key is usually making more money because other benefits may follow. When you make more money you have the option to hire top talent and maybe work less than before, because time is the one thing we can never create more of, and to many people it is the most precious commodity we all have. The additional profits may allow you to develop a management team that increases the value of the business in the eyes of prospective buyers.

Think of why it might make sense to buy another business. If you can come up good reasons it may make sense to proceed to the next step.

The Process

Preparation

I like to follow a 9-step process that is part of our overall 22-step acquisition sequence. The first and most important step is preparation. It starts with defining your criteria, which in this case is twofold. First are the basics such as, where do you want the business to be located, what size range is affordable and acceptable and what type of business makes sense?

When one business buys another the criteria include:

- Acquire hard-to-find, or hard-to-hire people
- Acquire a product line that complements or adds to your existing line
- Expand into a new geographic territory
- Increase your company's size and prove you can absorb another operation
- Eliminate competition

A few years ago I worked with two owners whose primary reason to buy another company was to find good people. They experienced difficulty in finding the qualified people they needed in order to grow their existing company. The fact that those employees came with a customer base was a bonus.

Keith's example demonstrates the strategy of adding to your product line. Even though he was one of the company's distributors, he now owns and makes the product himself. He increased his margins on it and feels he can grow sales faster than the seller did.

It's expensive to open an office in another city. In the late 1990s a client of mine purchased a "distressed" business from an owner who tried to move into another market and failed. It was just too expensive to build a base there. The buyer bought the original location so the seller could get out from under the debt from the second location. The buyer got a great deal and it would have probably never happened if the seller had found a company to buy in that second market and had taken over the operation, customers, employees, etc. In fact, in many cases the cash needed to buy a business in another city is less than the cash needed to start a branch office—and the balance is easier to finance.

The bottom line for all acquisition strategies is to grow. Maybe it makes sense to just get bigger. Perhaps you have capacity in your overhead—your accounting department won't need to increase in size to handle the additional employees, customers, and existing overheads can handle new volume and business. This absorption model greatly benefits strategic buyers.

What would it be like if you bought a competitor? Would it make day-to-day business life a little easier? Lessened price competition may allow you to not only charge more, but to provide better service that will tie customers to you.

There is another type of competition to consider and that is, the competitor who might be targeting to buy the same firm you've got in your sights. Is it an individual buyer who may naively bid up the price of the business because he doesn't know any better? Is it an equity group with deep pockets? Or perhaps it's another competitor with the same thoughts you have. The preparation period is the time to strategize on this. For example, it may be easier to "beat" an individual than to beat an equity group. This means you have to target companies below the size range that equity groups are interested in.

I like to ask owners who say they want to sell, "What will you do after you sell the business and the transition is over?" Recently an owner replied, very quickly, with five or six activities that included fishing, his model trains and his grandchildren. There was no doubt he was getting ready. When the owner can't answer that question you should expect seller remorse to set in before the deal closes. If the owner is not at retirement age and/or if the proceeds don't ensure a worry-free retirement, I recommend that you have a solution to this possible dilemma. Can the seller stay on as an employee? Do you need his expertise on certain issues that might make a consulting position viable and valuable to both parties? Again, think it through so you are prepared for all eventualities.

Before we move on to the mechanics of finding, evaluating and getting a deal done let's cover some statistics and trends. As of late 2008 there are (depending on the reports you believe), anywhere from 12,000,000 to 17,000,000 businesses in the USA. Many are too small to be acquired, or not salable to the public (a law firm for example).

Here are some facts and trends as reported in Kiplinger's and the *Wall Street Journal* in 2008:

- Starting in 2008, 8,000 Americans will turn 60 every day . . . many of them own businesses.
- One of every six businesses will be looking for buyers (a sixfold increase over 2001).
- Most companies will sell to strangers—only 15 percent make it to the third generation.
- Seven of ten midsize businesses will transfer ownership between 2008 and 2018 (Alliance of Merger and Acquisition Advisors).
- At least 90 percent of these firms have made no preparation to sell. If you are a potential seller you should begin to map out your exit planning strategy.

There has been too much money chasing too few deals in the mid 2000's. Given the above information, and the current economic market, this will change and will change faster at the lower levels (smaller deals) than at the midsize level. What does that mean for you as an owner looking to grow? Buy smaller companies, absorb them into your operation and position yourself to sell to the groups with more money who will still want deals. Because 95 percent of businesses in America gross under $5,000,000 in sales, you have more choices and the buyers of larger firms have fewer choices. Get yourself into that size range or more firmly entrenched in that range and improve your options in the future.

Searching for a business

This is the toughest part of the acquisition process. Too many buyers think buying a business is like buying a house. They are hoping to find a recently painted, fixed up, cleaned and modernized property with a sign out front and an owner welcoming them with open arms. As a business owner you know this is not the case.

Finding a business to buy means turning over every rock you come across to see if there's a motivated seller hiding underneath. A seller who wants to sell but is scared to death that somebody—anybody will find out the business is for sale. The fear is customers will flee, employees will get new jobs and vendors will cut off their credit. Often they're right, because these things do happen if not handled correctly.

The above points out that finding a business is hard work. It takes focus. It's not something you or your staff and/or your acquisition advisor do sporadically or haphazardly. Finding a company is a marketing effort. Just like marketing your product or service you have to work your system consistently and constantly. This is tough while running a business. That means assign tasks just like you would any growth effort, monitor it and track activities and results.

So, where are these businesses? Where are all these great acquisition candidates? They are everywhere, and that is why it is so tough to find them. There is no central listing like the Multiple Listing Service for real estate. Even if there were it wouldn't help you too much because only one in five small to medium-sized businesses are sold by a broker (this statistic is from the business brokers trade groups). This interesting bit of trivia means that you have to find the other 80 percent. That's why I say it's a marketing effort . . . actually it's a prospecting effort.

So instead of prospecting for new customers you are prospecting for business owners who will become sellers.

The first and easiest place to start is with the business brokers and M&A departments of investment banking firms i.e. the ones appropriate for your size deal. Call every intermediary you can find in every city in which you are willing to buy a company. Determine which ones work with the type and size of firms you are targeting. The key is to stay in touch. Call them once a month to let them know you're serious.

With intermediaries, it is very important to be focused and organized. They see too many tire-kickers who will never pull the trigger. Many intermediaries have told me that the buyer who comes to them with defined criteria, and the knowledge of what skills they bring to a business, and the features a business should have to make them happy and successful, rises to the top of the list. It doesn't matter if it's an individual or a business owner. Brokers want to believe you are serious.

If you want to buy a company in your industry or a related industry you probably have industry sources at your disposal. Trade groups, professional groups, accountants, consultants, attorneys and other professionals, etc. can all be good sources. This may mean individuals or the group itself may have vehicles to publicize what you seek. I recently had a trade group publish a notice in their newsletter about an acquisition a client seeks. They did this for free because they felt if one of their members was looking to exit they were doing the member a service by making him or her aware of a qualified and interested buyer.

Start by contacting the national, regional and local offices of any trade groups you belong to. If you aren't a member then join. If you aren't an active member then get active. Become known, especially to the executive director and key staff. When they see you do good work for the association they will feel much better about helping you and referring companies to you. Run an advertisement in their magazine, newsletter or on their Web site with a title that lets everybody know you are a buyer (the title could be like, "Distribution Business Wanted" or, "Acquisition Desired"). In other words, get the word out but be confidential in your dealings with owners who respond.

Tell everybody you know you are seeking to grow by acquisition. Don't be bashful, many deals are found because of the "people" factor. You never know who knows somebody who knows somebody who knows an owner wishing to retire or sell for other reasons. One client found the business he bought by sending an email flyer to an alumni group. One of his fellow alumni forwarded it to others and one of those recipients introduced him to an owner who not only wanted to sell but sold to him.

Finally, realize that finding a business to buy is a contact sport. The more contacts you make the better your chances of finding a company. Many years ago an investment banker told me that common knowledge of his profession was that it was always glamorous and exciting. He went on to say he spent most of his time at his desk "dialing for dollars." In other words, working his contacts and others who might be able to help him generate leads. Get a list of target companies and contact them. Whether you write or call, make contacts. The more the better.

Making contacts brings up an interesting point. Who makes all these contacts? You can. Or your management team can. But do you or your staff have the time? What about confidentiality? For example, if one of your competitors called you and asked if you were interested in merging or selling what would you say? If you're like most owners you would immediately say "Not interested," because it could be a fishing expedition and that competitor will be telling customers you are for sale. What if you didn't know who was calling, would you be any more relaxed about saying you'll discuss selling your business? I can tell you from experience, even a serious, well qualified buyer, will not be able to thoroughly engage in a meaningful conversation with an owner who may have been thinking about selling his company.

That's where an intermediary comes into play. Somebody who does this everyday can better protect a seller's confidentiality. When their business is based on keeping secrets it opens up doors to places you can't get into. Advisors of this type have different specialties. You may find someone who works primarily with companies the same size as yours. Or, perhaps one who is well known and knowledgeable about your industry (even if they don't do as much as others in the buy-sell area).

Finally, you could hire a transaction intermediary who does buy-sell work every day. I recommend you find an intermediary who does predominantly buy-side representation and works in the deal size range you are targeting. Industry knowledge often takes a backseat to transaction knowledge. In addition, someone too well known in an industry may know too much and/or too many people. As Benjamin Franklin said, "Three people can keep a secret if two of them are dead." Having an industry outsider on your team may be the smartest thing you do.

Perhaps the best reason to consider having an acquisition intermediary on your team is, as mentioned above, time and expertise. Buying a business includes the following time-taking activities:

- Daily prospecting
- Weekly prospecting
- Phone calls with sellers
- Meetings with sellers
- Management meetings to discuss each prospective company, the most recent communication and the status of each deal
- Review of initial information on the target companies
- Thinking and strategizing about each situation

All of these tasks must be done before you get to analysis, deal making, valuation, negotiations, financing and due diligence. Remember, you're also running a successful business with more than full time commitments to keep your cash flow positive and strong. Do not think about buying a business if your enterprise is not reasonably strong and you have well-seasoned management that will pinch hit for you when you get into the negotiation and time-absorbing phase of trying to close on an acquisition.

To summarize searching for a business; you have to approach it the same way you approach any sales or marketing function. There has to be a plan . . . you have to follow the plan, paying attention to the details. Your goal is to get in front of sellers in situations where you are the only buyer talking to them. That takes time, hard work and smart work. You'll intelligently kick a lot of tires but it can be well worth it when you find the right match.

Screening

The most important part of the screening process is screening the individual or individuals selling the business. While at some point you will do a credit check and related background research. What I mean here is that you need to find out if you are compatible with the seller. The buying and selling of businesses is a relationship game. Believe me, you won't buy from or sell to someone you don't like.

Not only will you be working with the seller for months or a year or more during the transition, but think about it from this perspective:

> The seller has relationships with customers, vendors and employees. If he or she gets along with them and you don't get along with the seller or your styles are completely different, then how are you going to relate to the customers, vendors and employees? That creates a culture clash, the issue that derails or at the very least, disrupts large corporate mergers.

This means your first job when you meet a seller is to build rapport. Find out if your styles and personalities are compatible. Not only can this make or break a deal it can make or break the post-deal success.

During the search process we defined acquisition criteria and the basic search criteria of location, size and type of business. You don't need to do too much more in this area as the objective is to cast a wide net and filter out those that don't meet your deeper criteria. Some of the criteria at the next level include:

- Cash flow or profit—do you need to buy a profitable company? Is it worth talking to a company at breakeven or losing money if you can absorb them and eliminate their overhead? Have an acceptable range and use it when screening companies. One caveat is not to eliminate companies too early. Many owners don't know their exact profit situation and some won't give an accurate number too soon in the discussions.

- What type of ownership structure are you willing to accept? In other words, are you looking for a pure acquisition or would a merger work especially if you have majority interest and control?

- What type of management team and key employees are you looking for? For example, if your company is great at operations and your weakest area is sales you may want to buy a firm with a strong sales department. Or, maybe you just want added volume or line workers. Know what you want going in.

Don’t be afraid to ask yourself and the seller thought-provoking questions like, “What do you do on a daily basis?” If you are buying a firm that is different than your firm even if it is one of your suppliers, or customers, ask about barriers to entry in their niche or how they attract customers; is it via relationship or marketing—there’s a big difference. Your objective is to eliminate candidates as soon as possible, for legitimate reasons.

To maximize your efficiency and not waste the time of sellers have a list of questions for each stage of the initial search and screening process. These questions should cover financial and non-financial subjects. Do things in stages because, for example, you can’t expect someone to share their most sensitive information on customers in your first meeting. Don’t be surprised if they don’t give you too much information on customers until you have agreed to a deal. There’s a big difference between a list of customers with all of the vital information and a list of customers ranked by volume but without their name so you can see that there is good diversity.

Just as important as having questions for each stage of the process is to actually ask them and use the answers appropriately. An equity group I worked with did a wonderful job of putting together its criteria. After interviewing the owner of a candidate company, the head of the equity group discussed the company and some of the positives and issues. I pointedly asked about three specific criteria. These important criteria were in violation of the stated features they wanted in a business they hoped to acquire. They were ready to spend a lot of time with analysis at the next level on a company they wouldn’t buy anyway because of these features.

Your situation drives the questions you will ask and when you will ask them. Some are general and apply to all situations. Concerns over customer concentration apply to all deals. For example nobody wants to buy a firm where the top three customers account for 73 percent of sales and they have a buddy-buddy relationship with the seller unless the buyer gets some protections against these customers leaving. As mentioned above, other questions are specific to your situation. At the expense of being repetitious, think through these issues and plan ahead.

And while you’re planning, put some time in to the answers you will give to questions you get from the seller. The right answer could solidify your deal. The wrong answer could kill it and who knows how long it will take to find another qualified company. And, you don't want to divulge too much about you and your business too soon. Confidentiality is a two-way street.

To summarize screening:

- Have a profile of a good acquisition candidate with questions to ask at each stage of the process

- Ask about your important criteria and be prepared to answer questions you get

- Use the information you get to say no and save time, or to move the process forward

Analyze

Analysis is the next step although at this point all the remaining "steps" in the process become intermingled, as we'll see. The other steps are valuation, negotiation, financing, deal structure and due diligence. There is a very good chance you will do from two to all six of these activities at the same time on one deal.

After defining criteria, meeting a qualified company, and working on building a relationship, this next step is where many deals unnecessarily lose momentum. Too often the buyer wants too much information too soon and it spooks the seller. Remember, you just met the seller a few weeks ago, so exposing all of his or her business secrets to you may be premature.

That's why I advise a stepped approach. It starts with taking a look at the financial statements and working with the seller to "recast" or adjust them so you can see the true profit picture of the business. By this I mean, you want to know what the bottom line would be if the business tried to show as much profit as possible, instead of paying as little tax as possible. This means looking for those unnecessary expenses that many business owners run through the company. It means adjusting the depreciation and anticipated capital expenditure categories and looking for expenses that will disappear or have to be added when you are the owner.

At the same time we ask some big-picture questions about the non-financial aspects of the business. For example, and there are all encompassing questions for all categories, the following is a question we ask about the technology side of the business.

Is your technology not up-to-date, are any subscriptions not current, are there any virus or security issues and does any hardware or software need upgrading *i.e. is the hardware less than three-years old? If yes, please explain the situation and the estimated cost to upgrade.*

A yes answer lets you probe deeper. A no answer lets you feel comfortable until it comes time to delve in deeper. As we ask these big picture questions, we let the seller know we will accept his answers, base a deal on those answers and then prove what he told us during due diligence. And, we'd prefer to hear any "bad news" now versus being surprised in due diligence, which is a time for confirmation not discovery.

Two other categories to cover during the analysis portion are the leases (real estate and equipment) and working capital needs. Leases should be available for review and a month-by-month cash flow statement should be created. Not a budget or forecast (those are handy to have, also) but a cash flow statement allowing for when monies are actually received and disbursed.

As mentioned above, you will base an offer on the initial analysis and then prove it during due diligence. What we are looking for are red flags. Is there too high a level of customer concentration? Are vendor contracts or relationships transferable? Are there sweetheart deals anywhere that you won't get, or family members leaving at the closing of the transaction?

A deal is in the works:

You're now ready to start working on a deal and will implement one or more of the next three actions, which are:

1. Work with an appraiser to get a ballpark or snapshot opinion of value based on the information you have.

2. Start talking to lenders about how they see their participation.

3. Formulate a value range with your acquisition advisory and management team.

As you can see, the steps in the process start intermingling. Actually I would be surprised if you didn't get involved with at least two of the above three steps. I know you will work internally to formulate a deal and, even if you don't need bank financing, you should talk to a few banks to get their opinion. Work with banks and bankers who regularly do acquisition loans (believe me, some banks love them and other banks do everything they can to avoid doing them; so find banks that actually do make these types of loans). Banks look at things differently than you do. Their only emotional attachment is "How will we get paid back?"

The banks will be a reality check. You don't want to make an offer contingent on bank financing only to find out you made an offer that is not bankable. There are two key components to any bank loan—they are assets for collateral and the cash flow. Assuming you are looking at a sound business model and you have a good character and business experience, it comes down to the cash flow to repay the loan and what the bank gets if you can't make payments. Some banks only care about assets, some only care about cash flow and many are in the middle, meaning they want some of both. Play the field, you don't want to get to the end and have a credit person giving final approval reject the deal for some obscure reason (like, "I never liked that industry").

Be aware that all banks are being stingy with their money. The credit market changed overnight in 2008. So, the harsh reality today is that unless the seller steps in as a primary lending source, the chances for a sale are remote. Buyers will have to come into the deal with more cash, and the seller will have to wait longer to cash out.

Value vs. Price

There have been volumes written on this subject. There are plenty of qualified business valuation people in every city and it is still as much art as science. What it comes down to is buyers need a certain rate of return. For most businesses under $5,000,000 in sales the rate of return is usually 25-35 percent. For larger businesses it may be 20-30 percent and maybe even a little lower. This rate of return is calculated after deducting the fair market salary for the job of running the company.

The factors that influence pricing within given ranges are:

- The non-financial factors including customers, vendors, the market, employees, management team, the lease, competition and others.

- Terms of the sale play a big role. Comparative sales studies indicate that the seller will generally enjoy a higher selling price if he finances the sale. The percentages of carry vary from deal to deal, but carrying some of the loan shows the buyer the seller has a viable operation, and trust that ongoing operating cash flows will fund the buyer's payments.

- If the deal structure is a stock sale, this usually results in a lower price than an asset sale as the buyer takes on more risk and loses a lot of write-offs. You need to speak to your intermediary and financial advisors on this subject.

Whether you are a buyer or a seller keep the following in mind. Too many owners think that because they read in the *Wall Street Journal* that

$300,000,000 (sales) company sold for 10 times "Earnings Before Interest Taxes Depreciation Amortization" EBITDA that their small business will sell for that same multiple. It won't happen, it will sell for a price that gives the buyer a 20-35 percent rate of return on investment.

Price is important and yet is only one of the components in a standard deal. The other two are terms and conditions. Price to a seller may become an ego trip or be based on practicality. By ego I mean some sellers will want bragging rights as in, "I sold my business $X million." In one deal the buyer paid part of the "price" in a consulting agreement and part as an employment contract. The seller would have netted more after tax by taking 80-85 percent of the stated price. Of course then, he wouldn't be able to brag as much.

After all, it's not what you get it's what you keep. The use of a good tax and transaction accountant on both sides will help. There are many ways to legitimately reduce taxes on a deal; you just have to get the expertise. However, to keep it simple remember that most deals have terms of a down payment amount and a note from buyer to seller for a set number of years. Once agreement on price and the basic structure of the seller financing is made you can get "creative."

On one end of the spectrum I saw a deal where the buyer said, "I'll accept your price, write you a check for half and you finance half, no bank," and it quickly closed. I have also seen consulting agreements, interest-only loans with a balloon payment, 5-year notes with a 7- or 10-year amortization, employment agreements, royalties, assumption of bank debt, the purchase of accounts receivables and accounts payable (the seller finances the buyer's working capital over a long term) and, of course, earnouts.

Earnouts are interesting. A conservative buyer, who really doesn't want to do a deal, will want the seller to get to a fair price only with an earnout. This effectively puts the risk of "is the buyer capable of growing the business?" on the seller. An earnout, when used correctly, gives the seller potential benefit for something in place that they have not had the chance to maximize benefit on yet. For example, let's assume a widget company sells five types of widgets, adds a sixth widget to the line, thinks it will do well without hurting sales of the other five and then the owner is forced to sell. An earnout will give the seller a percentage of the profits on that sixth line, if he or she is right about the new line's potential and it is successful. If it was just exuberance over potential the buyer is not overpaying.

In one deal, I had the buyer offer a fair price and very low down payment. During times of tight credit, economic slowdowns or with specific industries banks get very cautious and one of the first areas many get cautious on is acquisition loans. The buyer explained to the seller that he could get more money for the down payment if he went to a bank. However, the bank would put on covenants that would prevent the buyer to pay off the seller early. The seller took the deal of less cash for a much quicker payoff (because the banks wanted full subordination, meaning no payments to the seller until the bank was completely paid back).

As we see there can be a lot going into a deal besides the price and note payoff schedule. The above examples are just some of the ideas and techniques available. As each deal is different you can't assume you can universally apply any technique until you've analyzed the situation.

Working out the details

Once you've worked out a tentative deal structure, discussed ranges with the seller, so what you offer is not a complete surprise, it's time to present the deal, negotiate the finer points and start your due diligence.

It is usually advisable to make the first offer face-to-face and do it verbally or with a term sheet. I've seen too many situations where a formal offer or Letter of Intent (LOI) is presented cold and taken as an affront by the seller. Remember, this is a relationship game. After you've worked with someone for months to get to this point I believe you owe the seller the courtesy of an in-person meeting to walk through the offer, explain anything that is unclear and give your justification for why your offer is what it is.

I have been involved in over 100 transactions, the majority of them representing the buyer, and many clients who made multiple offers, so believe me when I say that it is rare that negotiations are anything like what we see in movies or hear about regarding multi-nation treaties, sports star contracts, union contracts or anything similar. Negotiations are, for the most part, friendly with a lot of dialogue that explains positions, clarifies "errors" in the assumptions made (by both parties) and have an intent, a serious intent, of getting a deal done.

One of the most memorable took place in a coffee shop. I was representing the buyer and when the meeting was over he turned to me and said, "You earned your whole fee in this meeting." What did I do? I convinced the seller that good buyers, with money, skill, an interest in your business and who you like don't come across often. I convinced the buyer that good businesses that you can afford and, feel comfortable running don't come across often. So, to both parties, I made the point that it could be a long time before either of you meet another great match so do everything you can to get the deal done. It closed the next month.

If the negotiations get contentious and/or the attorneys get involved in negotiating deal points (not legal points) it can be tough to get the deal back on track. That's why it is often beneficial for both sides to have an intermediary on their team. Not only can the intermediary wear the “black hat” and be the bad guy or gal but they have experience and can mitigate potential problems and disarm minor issues that the inexperienced person will magnify out of proportion. During a recent panel discussion an attorney and a CPA both commented that one of the biggest disruptions to a deal is the know-it-all buyer or seller who hasn’t bought or sold a business before and doesn’t want to take advice. This is where the acquisition advisor can add real value by keeping the buyer and seller from going at each other over little things, when they are basically still on-track and have a good relationship.

Once a deal structure is agreed on, an LOI signed and the Purchase and Sale Agreement is being drafted by the attorneys it is time for due diligence. As mentioned above, due diligence is the process of proving what you’ve been told—that is—the facts upon which you based the offer. During the process you may also uncover some risks that may cause you to change or kill the deal or you may uncover opportunities you didn’t know about.

If you’re thinking, “Shouldn’t I be performing due diligence before I make an offer?” consider it from the seller’s perspective. If you were the seller would you let a buyer talk to your employees, customers, vendor or landlord before you had a deal in place? Would you want a buyer “auditing” your books, seeing your business plan and getting other secrets and strategies from you? That’s why you ask for an overview, but then engage in comprehensive questions during analysis; to uncover red flags that will influence your valuation. It’s why you tell the seller “I will base my offer on this early information and will prove it during due diligence. So please tell me about the things that might concern me now as I don’t want to be surprised later (and have to renegotiate the deal).”

So what exactly is due diligence? I could write, and others have written, a book on the subject. In simple terms it is investigating all the details and intricacies of a business to verify it’s what you thought it is or better than you thought. You will break down the financial statements, prepare a budget and do a month-by-month cash flow projection. On the non-financial side you will discreetly interview customers (not telling them you are buying the company), talk to the management team and key employees, work with the landlord on your lease, interview vendors and if there are any contracts get approval to transfer them to you. In addition you will update or prepare a business plan for yourself and the bank.

If you are purchasing the stock of a company you will have your lawyer review the incorporation papers, board minutes and other legal documents. Here is a list of categories that should be on every list followed by some of the items you will need to thoroughly review the company.

Due Diligence Categories

- Establish responsibilities and time line
- Legal documents and contracts including leases
- Company's business
- Industry outlook
- Marketing strategy
- Marketing plan
- Product pricing
- Customer analysis
- Facilities required
- Employees

Due Diligence List

List of shareholders and percentage ownership

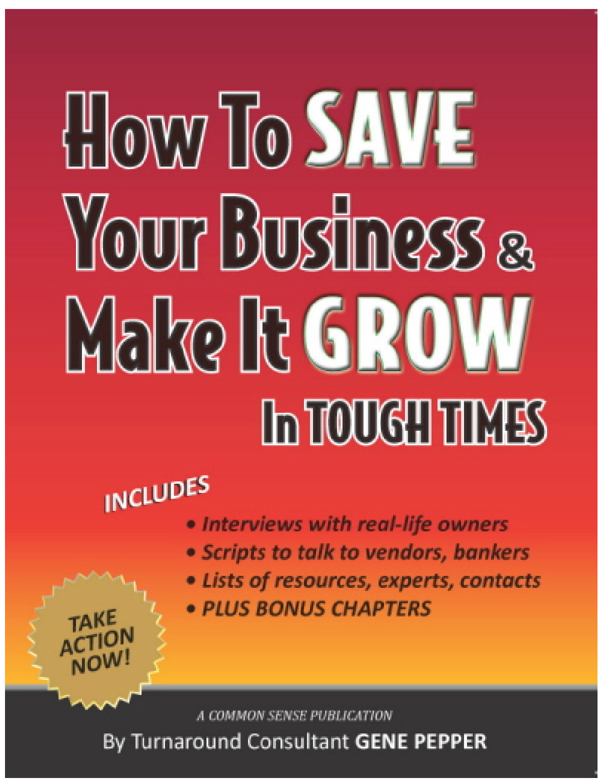
- Company's attorney, CPA, insurance broker, health insurance broker, etc.
- Company's bank
- Environmental reports
- Employee manuals
- Copies of company leases
- List of all major assets—current, at fair market value
- Brochures and other marketing materials
- Financial statements last five years
- Financial statements, monthly for one to two years

- Accounts receivable aging report
- List of all debts and liabilities
- Copies of the last five-years federal income tax returns (4506 with IRS if needed)
- Copies of 3-5 years state sales and use tax returns
- Copies of all agreements, loan agreements, notes, pledge agreements and security
- Copies of all profit sharing or deferred compensation plans
- Business Plan
- Litigation history and anticipated (both ways), court search
- Insurance coverage, any changes, etc.
- Liens (equipment, tax, etc.)
- Off balance sheet items, vacation, sick pay, etc. and proprietary information such as drawings, reverse engineered and manufactured parts, etc.

An important word of caution is not to fall into the trap of analysis-paralysis. There are no perfect businesses and no perfect deals. The desired rate of return on small business acquisitions is so much higher than savings accounts and the stock market because there are more risks. If you cover the big topics, feel comfortable with the answers and feel your skills match up with the risks of the business (the red flags you find) it's time to move ahead. Looking for the perfect business and perfect deal means you won't buy any company.

How To SAVE Your Business & Make It GROW In Tough Times

By Gene Pepper
eBook Version



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