

Before You Buy a Business

...Or Any Major Asset

- **Why Do You Want to Buy It?**
- **Why Is the Owner Selling?**
- **What to Ask in Investigating the Seller**
- **What to Ask in Investigating the Company**
- **Critical Areas to Examine Closely**
- **What Is It Costing You?**
- **Mistakes to Avoid**
- **Closing the Deal**

Part Two — *Case Study: How a Bad Acquisition Almost Destroyed a Successful Business*

**Before You Take Another Step,
Ask Yourself...**

- Why are you buying this business? Have you carefully examined your motives, both business and personal?
- Why is the owner selling? He may say he's retiring but there's a possibility he's cashing out before an expected downturn.
- Do you know the business of the company being acquired?
- Does the acquisition fill a real business need?
- Is it cheaper to build the business from scratch?
- Do you have the cash or credit availability to purchase the business?
- If it's an exchange of stock, do you really want other stockholders?
- Do you and your staff have the *extra time* to devote to the acquisition to assure its success?
- Do you know what the acquisition is costing you, both in the purchase price and in the acquired company's *future* cash needs?

**Don't underestimate the amount of time you
and your staff will have to devote to the new
company during the transition period.**

Buying a Business: **Be Sure to Get the Whole Story**

Want to buy a business, division, product line, franchise, or other substantial asset? You're not alone. In fact, many business owners are discovering what large companies already know: one of the fastest ways to grow is to acquire another company. The right acquisition can result in economies of scale, more marketing clout, a competitive edge, and higher sales and profits.

But the wrong acquisition can drain your company's resources, lower overall profits, make you a weaker competitor, and even *destroy* your current business.

Investigate the Seller

Obviously, you're going to check out the new company thoroughly. But our first recommendation is to investigate the current owner and identify his real reasons for selling. Sometimes, the reason may seem obvious. The owner says he's ready to retire, or tired of the long hours and responsibility of running his own business, or anxious to spend more time with his family. That may only be part of the reason.

The bigger truth may be that the owner is trying to cash in before an expected slump in business or the imminent loss of a major customer. We don't mean to imply that all owners are less than totally honest when it comes to explaining their motivation to sell. And, in fact, many times it's not so much a deliberate deception on the part of the seller as an unwillingness to admit to problems in his own company.

But, face it, that's why "let the buyer beware" is such often-quoted advice. There are big dollars at stake in the sale of a business and it's natural for a seller to want to go after the biggest price he can. But you would be naive to trust everything he tells you without searching out corroborating evidence. Remember, the goal is to avoid liabilities that would otherwise surface after a deal closes.

Investigate the Company

This **Resource Report** will help you decide if you should buy an existent business and, if so, how to do it. It guides you in evaluating the health and potential of a business by analyzing all its components. It will help you formulate the questions to ask and interpret the answers you get. It will alert you to potential

pitfalls and warn you about common mistakes. It presents six acquisition guidelines, ten areas to review, and a comprehensive due diligence checklist to use *before* finalizing the purchase.

The overall task is to analyze the potential acquisition from three perspectives: where *the company is today*, where *it's been*, and where *it's headed*.

What Do You Want? **Six Acquisition Guidelines**

Following are the minimum criteria to establish before approaching any acquisition candidate.

#1 — Type of Company to Acquire

Preferably, the potential acquisition should be related to your company's business and its operations within the expertise of company management. The acquisition target should have growth potential as good as or better than that of your own company and/or features that would enable you to improve its overall sales, earnings capacity, profit margins, and rate of return. You could accomplish this in a number of ways:

- Broadening product lines and distribution channels.
- Acquiring instant research and manufacturing expertise.
- Expanding market area and share.
- Modifying the seasonal and cyclical aspects of your company's products.
- Diversifying a heavy reliance on just a few customers or products.

#2 — Cash Flow Implications

Question #1: Is it cheaper, in the long run, to *build the business from scratch* rather than buying an existing enterprise with all its unknown liabilities (e.g., product liability suits or other liabilities not recorded on the balance sheet or not known at the time of your purchase)?

Question #2: Does the acquisition *fill a real business need*? For example, if the

acquisition is merely a tax ploy or ego booster, reevaluate the move. The eventual cost may turn out to be far greater than anticipated, e.g., the tax benefits might be negated by future tax legislation. Buying an asset or business on an ego trip could cost you huge, unanticipated future cash outlays.

Question #3: What is the cost? Prepare projections of income, balance sheet, and cash flow for at least three years. Know what the acquisition is costing you in both the purchase price *and* in the acquired company's future cash needs. Then *prepare another set* of projections assuming a worst-case scenario.

After the projections are completed, factor in the purchase price and then compute your net after-tax cash outlay, which will obviously be *much less* than the total purchase price because of tax deductions. You want to know this absolute downside figure.

#3 — Rate of Return on Investment

The rate of return on the company being acquired should be near or higher than your company's historical rate of return and at a level that meets your overall goal for growth. The return should be analyzed in different ways. For example, as a start, compute the following basic return ratios:

- Net income as a percent of sales.
- Gross profit and operating profit as a percent of sales.
- Return on stockholders' equity, total assets, and total capitalization (long-term debt and stockholders' equity).

A comparative analysis should be completed for both the company being acquired and the acquiror, and the analysis should cover at least three years.

In addition, combined sales and operating profits should be projected to properly analyze the cost savings resulting from the acquisition. *Reason:* These potential savings can substantially reduce your actual net cash purchase price.

#4 — Management Expertise

Many an acquisition has turned sour because of management problems. In fact, if you don't have the capacity or capability to manage the acquisition, you should reconsider its purchase; lack of management expertise is one of the biggest

reasons acquisitions turn out to be losers. If the buyer doesn't intend to personally manage the acquisition, the key personnel of the acquisition should provide some formal assurance that they will continue to work at the company on a full-time basis. *Caution:* Seek these assurances only after you make sure that key personnel are compatible in personality and attitude with your own management team.

Recommendation: Buy only enterprises whose business you are thoroughly familiar with and only those that meet your acquisition goals in terms of dollar investment, return on investment, and payback. Don't over-commit yourself, and do identify all potential advantages to the acquisition.

#5 — Basis of Exchange

Should the purchase be for cash only, securities only, or a combination? If the transaction involves securities, what type should they be — straight debentures (long-term notes), convertible notes, preferred stock, convertible preferred stock, or straight common stock? Management should, as part of its overall acquisition plan, establish the payment form and schedule by which any acquisition will be effected, although such terms can be modified to reflect the needs of the seller.

Again, be sure you have more than sufficient resources to purchase the company and allow for unanticipated cash needs.

#6 — Setting the Price

You and the seller each should have a price range in mind — if the ranges overlap at the outset of negotiations, a transaction is possible. You should follow these steps before laying your offer on the table.

- Review where the company is *today* (its current balance sheet and income statement), where *it's been* (historical financial statements), and where *it's headed* (the projections).
- Then determine the value of the acquisition *exclusive* of the method of payment (the value can later be adjusted for the method of payment).
- Make the decision to acquire or not; if you decide to buy, review *why* that decision is being made.
- In answering the *why*, again search your motives and list all the pluses and minuses of the purchase.

Then there is the final step: The negotiation of the payment package, including the total price, method of payment (cash, notes, stock, or a combination), and the timing (e.g., cash today, deferred payout, or a combination of both).

What Is for Sale?
Ten Analytical Steps

In the fact-gathering process, the parties should become intimately familiar with each other's operations and the benefits to be derived from the acquisition. For you, the potential buyer, this means obtaining and reviewing financial statements, internal reports, and other records of the company covering a minimum of five years. This will, however, provide only an "armchair" view of the company. Much more is required for a proper evaluation of the business.

The process must include an inspection of company facilities and interviews with all key personnel. It is also desirable to interview outside parties, such as major customers and vendors, lenders/investors, advisers, and so forth.

Here is a listing of specific areas to cover in your analysis.

1. History and affiliations. How long has the company been in business? What has been its growth pattern? Has growth been achieved through internal means, through external acquisition, or both? To what extent has the company had to make investments or take significant writeoffs? Has the company changed its form of business organization since inception, e.g., from a partnership to an S corporation?

Affiliations: Is the seller affiliated with any other business(es), and if so, what is the relationship? What are the histories of such affiliations and their dealings with the company and/or its owners? Are the dealings on an arm's-length basis? Should you also consider buying those affiliated companies, particularly a real estate affiliate?

2. Nature of the business and niche. What are the company's products and its principal markets? Have these changed appreciably during the company's history? What is its niche and market share? Is its share static, increasing, or decreasing? Does the company's business depend on critical raw materials, and if so, are there adequate supplies and suppliers? Is the company's business seasonal

or cyclical? Is the company dependent on relatively few customers? Are there other significant factors that can affect the company's financial condition, operations, and results, e.g., its location or a soon-to-expire lease?

What about current customer and supplier contracts? You want to be sure that all important contracts will be passed on to you as the new owner. Find out why customers buy from the company, how much, for how long and whether there have been any changes in buying patterns. Try to interview *former* customers, too.

Also, look for changes in the viability of the company's major suppliers and customers. The bankruptcy of a long-time supplier or the move out of state of a big customer can dramatically affect the business' current value and potential profits.

Buying that special niche: You have to be especially thorough in identifying that characteristic of a business that makes it unique and special. Is it a proprietary product or service? A production process or patent? Method of distribution? The owner's drive or personality? The business' location (e.g., a retail store in a successful mall)? Analyze and understand this special property because it is what gives this business *added value*. Be sure this special property is transferrable to you.

3. Facilities. Personally visit the seller's facilities *several times*. Are they properly maintained and adequate for present and projected increases in sales? If not, what additional capital investment will be needed and how will it be financed? Have you included any future equipment or working capital needs in your projections of the total cost of buying the company?

If the facilities are leased, find out the lease terms and have your corporate lawyer review the lease agreement. Check if there's a renewal option and for how long. Check also for a purchase option; it may add to the value, particularly if the lease was negotiated many years ago.

If the facilities are owned directly by the company (or its owners), there is usually additional value to the properties over and above what is reflected on the balance sheet. Consider these excess values when valuing the business and determining the price to be paid; if you don't, the seller will.

4. Management continuity. Is present management willing to stay on and, equally important, *do they want to stay?* Are they the kind of people with whom you want to work (compatibility as to character, personality, way of doing business, etc.)? How would you have to compensate them, not only in money, but also in

responsibility and position? If the principals are also the managers, you will want to know how old they are, whether they are willing to devote part- or full-time to the business and for how long, and if they are in good health. If they have business life insurance policies, you may want to purchase them, particularly for the seller/owner if he is still very important to the business' operations and will continue working for you.

5. Other company personnel. What are the company's requirements for skilled, semi-skilled, and unskilled people? Is there an adequate pool of talent to draw on? To what extent are employees unionized, which unions are involved, and what are the terms and expiration dates of existing contracts? What are the history and current state of employer-employee relations? Have there been any strikes or work stoppages? What benefits are paid to the employees?

6. Compliance. Has the company ever been late with payment of payroll taxes? When was the last time the company's tax returns were audited, both federal and state returns? What was the outcome? What about recordkeeping: travel and entertainment expense, payroll forms (e.g., W-4 and 1099s), and pension regulations?

7. The products. Review the entire product line for defects and possibilities of liability claims. Be aware that you can't eliminate all such risks, but be sure your contract exempts you from any liability for events that occurred prior to the takeover. Insist on seeing all records pertaining to any liability claims made against products in the past — whether they were justified or not. If there are insurance reports, ask to see them. Products that were the subject of legal claims in the past could land you in court again in the future.

Look into *discontinued* products, too, to be sure there are no lurking liabilities there. Call the seller's insurance company for the details on any claims that might have been settled out of court. Confirm the availability and cost of insurance coverage for product defects and liability.

8. The books. Review independently all income and expenses by product line or division and the asset accounts. If there is any doubt on your part, ask for an audit that certifies those numbers. And be sure to have the seller, in the contract, represent that all the numbers and facts he gave you are correct and true. If the

seller refuses to personally indemnify you for misrepresentations, be wary. It may indicate that he is aware of problems that aren't being disclosed to you.

Confirm that the assets you're acquiring are free and unencumbered. Also have your accountant examine the seller's gross profit margin on each product — and be sure he works out and verifies the numbers independently.

9. External factors. What are the effects of changing economic and industry conditions on the seller's operations and results?

Note any trends and technological changes and how well the company is adapting to these changes in its development of new and improved products and services. Determine whether the company is subject to restrictive regulations (e.g., zoning requirements, OSHA, pricing, etc.) and/or actions by government agencies that could significantly affect the company's operating results and financial condition.

A buyer should be more interested in where the acquisition candidate is going than where it has been.

10. Financial position. Initially, examine the financial statements of the seller for the last five years. Prepare balance sheet and income statement Spread Sheets (see page 21 for a sample) to help you properly analyze where the company's been and how it has used its resources.

If the company's business is cyclical, study its performance over a full business cycle. *Reason:* The most recent results may not truly reflect the company's potential, e.g., it may be on the upside or downside of a product's life cycle.

What to Look For

Here is a checklist on critical areas in which company problems may be hidden. You want to investigate each of them closely.

□ *Cash flow:* Cash flow is an important item to consider because of differences in depreciation write-off methods and the effect they have on a company's cash position (today *and* future). Some companies have relatively low profits but

very good cash flow, which can offer substantial value, particularly if future capital equipment needs are low.

□ *Projections:* Obtain available budgets and estimates for as far into the future as reasonable. Note the date they were prepared, the number of years covered, and get the details on all the underlying assumptions. Are they realistic? This data should include the company's anticipated cash flow from depreciation. Don't forget to allow for equipment and working capital needs, such as higher inventory and receivable levels.

Important: In examining any forecast, find out how well the company has forecast in the past. In fact, as you move along the negotiating process to closing, you will be able to compare the monthly results with the budgeted figures given to you earlier. Be sure to do so because you will learn a great deal about the reliability of the other numbers the seller has given you.

□ *Comparisons:* In a review of the company's financial and related data, note the following: percentage trend of sales and earnings; volatility of sales and earnings, the latter in particular; rate of return on invested capital (and total assets); gross and operating profit margins; working capital condition (degree of liquidity); debt-to-equity ratio; borrowing capacity and credit lines; future capital requirements; extent of assets not required for operations (e.g., affiliated companies); and any other ratios you might discuss with your accountant. Again, use the Spread Sheets on page 21.

□ *Understand the fixed and variable cost structure of the business.* What is the seller's gross and operating profit margin? Is the business truly profitable? How much profit can be made after you take over? What is the contribution profit for each product line? This type of analysis is not detailed in a financial statement. Put your accountant or treasurer on it.

□ *Contracts with customers and suppliers:* Again, how dependent is the company on single contracts? For example, would it suffer badly if a contract with a major customer expired and that customer switched to another source? For how long does the contract run, is it renewable, and on what terms? Is it a good agreement, i.e., is the company making or losing money on the contract?

□ *Off-balance sheet items:* These include contingent liabilities, such as pending lawsuits, tax claims, and liabilities related to fringe benefits, such as employee stock ownership plans, employment contracts, and pension plans.

Examples: If a closely held company has an employee stock ownership plan, it may have an obligation to purchase company securities of plan participants, an obligation that requires capital. Be sure to ascertain the extent of any unfunded pension plan liability.

□ *Financial statements vs. tax returns:* Don't rely only on the financials. Request the tax returns for the last five years and have the seller's accountant provide you with a typed memo on the differences between them.

* * *

An acquisition may be the fastest way to grow, but it's not always the easiest or the safest. Do your homework on the company you want to acquire and you will minimize the risks.

And don't forget to search your heart — know **exactly** why you're buying the company. Don't risk everything you've already built by buying a losing or mediocre business which will drain your own company's resources. □

More Information —

Exhibit 1 — Ownership Questions, next page

Exhibit 2 — Mistakes to Avoid, page 15

Exhibit 3 — Due Diligence Work, page 17

Exhibit 4 — Spread Sheets for Financial Statement Analysis, page 21

Don't even consider an acquisition if you don't have experience in the business of the seller.

Ownership Questions

You want to know who owns the company, how involved the owners are, how old they are, and how free and clear their ownership is. Here are items to check out for a corporation; many apply to the ownership of any business (e.g., a partnership).

List all current owners of the company's common and preferred stock, by class if applicable.

Determine the number of shares exercisable under stock option and warrant/convertible agreements to purchase the company's common stock. Find out the option price and expiration dates.

Break down the ownership by shares and percentage: actual and pro forma (i.e., assume the warrants, convertible securities, and stock options are exercised).

How many shares does the principal stockholder own — personally and through his or her family? Have any shares been gifted or placed in a trust, e.g., a family limited partnership?

If all stock options, convertible securities, and warrants to buy the company's common stock were exercised, would the principal stockholder still control 51% of the company?

Does the common stock have preemptive rights? What about liquidation rights and dividend preference? Is there cumulative voting?

Do any shares of stock carry an investment agreement, e.g., are there restrictions on their sale, transferability, or use as collateral?

Is there a buy-sell or other shareholder agreement? Is there an employee stock ownership plan or stock bonus plan?

Are the shares fully paid for? Has any stock been sold below the par or stated value? Any shares been gifted or placed in a trust?

If the business is sold, what percentage of the total outstanding shares is needed to approve the sale?

Important: If you are going to buy another business, always consider buying assets, not stock. With the purchase of stock, you assume both *actual* and *unknown* liabilities (again, any liabilities not recorded on the balance sheet).

Mistakes to Avoid

Even if the company you're looking at is one you've dealt with for years, there still can be plenty of surprises when you look beyond and behind the financial records. Here are the most common mistakes. They also can be very expensive mistakes. Use them to guide you in the review of any company.

- A potential buyer doesn't check out the company by calling trade references and obtaining independent personal and business credit reports, e.g., TRW and Dun & Bradstreet.
- The buyer doesn't spend time getting to know the seller: his reasons for selling, his importance to the company, his reputation, his character.
- The buyer doesn't request a full audit of the company's financial statements and instead accepts an accountant's Compilation or Review Statement as sufficient.
- The buyer doesn't thoroughly analyze sales by customer for the last three years. *The question:* Which customers no longer do business with the company and why not? *Note:* Past customers and those whose purchases are in downtrend should be contacted.
- The buyer doesn't require that the seller represent *personally* to the accuracy of the company's financial statements, customer list, backlog, etc. *Result:* The buyer has no recourse against the seller individually for misrepresentations or inadequate disclosure.
- The buyer doesn't verify the assignment and transfer rights of important contracts, e.g., lease and rental agreements, customer and supplier contracts, and loan agreements which can restrict the company's future operations.
- The buyer doesn't prepare pro forma (combined) financial statements to determine post-acquisition profitability and what the acquisition is costing in both pre-tax and after-tax dollars.
- The buyer doesn't request the company's tax returns or analyze the

differences between the returns and the company's financial statements as reported by its accountant.

- The buyer doesn't analyze dramatic changes in inventory levels from year to year. *Reason:* Inventory increases can make operating profits look much better than the company's reported results.
- The buyer doesn't analyze affiliated companies and their relationship with the company, owners, and their families. *The questions:* Are the transactions fair and reasonable? If not, can they be questioned by the IRS? Will the benefits of the relationship(s) carry forward to the buyer and for how long?
- The buyer doesn't properly value the company's assets, e.g., equipment, by determining their reported net book, fair market, and replacement values.
- The buyer doesn't review consolidating financial statements of profit and loss to determine the profitability of each subsidiary, division, or product line.
- The buyer doesn't properly analyze the company's cash flow projections and its future need for more employees, facilities, equipment, and working capital for higher accounts receivable and inventory levels.
- The buyer doesn't concentrate on the people aspect of the deal. People make the deal happen; people make the transition orderly and successful.
- The buyer doesn't use a corporate lawyer who is experienced with asset and business purchases. As a result, buyers end up buying *liabilities* and *problems* they didn't know existed.

* * *

A company that appears healthy on the surface can be drowning in problems and red ink below the surface. You owe it to yourself to ask all the right questions before buying, selling, investing in, or valuing any business.

Part Two of this **Resource Report** starting on page 22 illustrates the devastating consequences to a buyer when a deal goes through without the mistakes above being addressed. □

Due Diligence Work

There's a great deal of time and energy expended in buying a business *both* before and after the closing. The period from your initial meeting to actual closing usually covers 90 to 180 days and the post-closing transition period can extend over six months to one year. Be aware of the time required; you and your executives *must* set aside that time to meet your commitments in negotiating and closing a deal.

There is basic information you will need to properly analyze and value the to-be-acquired company. *We have divided it into three parts:* (a) the information to determine your preliminary interest before proceeding with the negotiations; (b) a financial justification for purchasing the company; and (c) the pre-closing documentation when you're getting ready to finalize the price, payment terms, transition, and payment schedules.

#1. Initial Information

Request the following preliminary information to start your review and analysis of the potential acquisition.

- *About the business:* Company literature, product brochures, catalogs, sales aids, etc.
- *History and ownership:* Typed description of the company's history, prior and current ownership, and form of business.
- *Financial statements:* For the last three to five years along with comparative interim statements. Include statements for any affiliated companies.
- *Customers:* Breakdown of sales by customer for the last two years, by both dollar amount and percentage of total sales. At this stage, the top 10 to 20 customers are sufficient. You're looking for a heavy reliance on only a few customers.
- *Projections:* For three years going forward — income statement, cash flow, and balance sheet.

- *Major contracts:* Leases, employment and shareholder agreements, purchase orders, etc.
- *Other information:* Business Plan if available, details on officers and employees, salaries, benefits, suppliers, industry, competition.

#2. Acquisition Justification

As a buyer, you want to know what the acquisition is costing you, what effect the seller's company has on your company and its financial statements, and what the synergy savings and tax writeoffs are. Here's how to do it.

- *Combine your company's financials with the seller's:* Prepare a pro forma (combined) balance sheet, income statement, and cash flow as of today and projected for a year or two. This combination of your company's numbers with the seller's also will show you the "synergy" savings from the acquisition.

That's important since the combination of two companies should increase the combined profits through reduced costs, e.g., duplicate overhead expenses, personnel, facilities and equipment, product catalogs, etc. Furthermore, when the buyer and seller are in the same or related industries, the following should result: (a) sales and profits should automatically increase since one sales staff can sell both lines, (b) two customer lists have been merged, (c) the product line has been expanded, (d) greater geographic areas are being covered, and (e) corporate support is consolidated, e.g., one marketing director focuses on selling the products of the combined companies.

- *Compute after-tax cost:* Determine what the acquisition is costing you in both pre-tax and after-tax dollars. For the after-tax cost, don't forget to include all tax deductible items, such as depreciation from the write-up of equipment and other assets to fair market value, interest paid on installment notes, amortization of goodwill and the noncompete agreement over 15 years, and payments (salary and benefits) to the seller under an employment contract, which are tax deductible as paid.
- *Justify the price:* Now, redo your pro forma (combined) balance sheet, income statement, and cash flow to reflect the full purchase price. This will show you your combined and projected earnings and net cash flow after the acquisition is completed, including the synergy and tax considerations discussed above.
- *Compute return on investment:* Look at the seller's financial statements

after allowing for the synergy savings and terms of the purchase. Then compute the operating profits, say \$175,000. Divide that amount by the purchase price, say \$750,000, which gives you a return of 23%. Is that initial annual return acceptable to you?

#3. Pre-Closing Documentation

After you have decided to move forward with the negotiations, there is more information you will need to review before closing the transaction.

- Financial statements for the last 10 years; you want the seller to represent to as many financial statements as possible. Also, read *all* of the footnotes; they will tell you a great deal about the company, its history, and owner-related transactions.
- Loan and mortgage agreements, particularly any restrictions on the business' future operations.
- Expert appraisal of the assets and review of any UCC filings on the company's assets.
- Patents and licenses issued and under consideration, as well as trademarks, registrations, copyrights, and trade secrets. Do any expire soon?
- Tax returns for the last five years. Ask the seller's accountant to provide you with a memo on the major differences between the financial statements and the actual tax returns.
- Lease agreements: Autos, equipment, and facilities.
- Contracts with suppliers and customers.
- All other legal contracts and agreements, as well as pension and profit-sharing documents and other contractual commitments.
- Corporate charter, by-laws, corporate minutes, and stock certificate book.

Legal caution: When making any verbal or written offers, hedge the offer by including the following: "...*subject to final approval by our company's Board of Directors, stockholders, and legal counsel.*"

Last, consult with your lawyer and other advisers *before* the start of negotiations, if only to discuss the structuring of the transaction, tax considerations,

and overall strategy. You want to avoid having to change the deal drastically to provide for an overlooked major item. You also want to make your requests at the early meetings rather than after the deal has been negotiated and structured.

Part Two: Please see page 22, *Case Study:* How a Bad Acquisition Almost Destroyed a Successful Business. □

Spread Sheets for Financial Statement Analysis

Historical Income Statement Data

(Dollars in thousands)	2004		2005		2006	
	\$	%	\$	%	\$	%
Net sales	—	—	—	—	—	—
Cost of goods sold	—	—	—	—	—	—
General, selling and administrative expense	—	—	—	—	—	—
Operating income	—	—	—	—	—	—
Other income (expense)	—	—	—	—	—	—
Pretax income	—	—	—	—	—	—
Taxes payable	—	—	—	—	—	—
Net income	—	—	—	—	—	—
Return Analysis						
Net income % sales	—	—	—	—	—	—
Net income % net worth	—	—	—	—	—	—
Net income % assets	—	—	—	—	—	—
Gross profit margin	—	—	—	—	—	—
Operating profit margin	—	—	—	—	—	—
Turnover Ratios (in days)						
Average collection period	—	—	—	—	—	—
Inventory turnover	—	—	—	—	—	—
Accounts payable turnover	—	—	—	—	—	—

Historical Balance Sheet Data

(Dollars in thousands)	2004	2005	2006
Cash and marketable securities	—	—	—
Accounts receivable	—	—	—
Inventories	—	—	—
Prepaid expenses	—	—	—
Current assets	—	—	—
Gross plant and property	—	—	—
Less: Depreciation	—	—	—
Net plant and property	—	—	—
Investments, loans, and advances	—	—	—
Other assets	—	—	—
Total assets	—	—	—
Notes payable	—	—	—
Accounts payable/Accruals	—	—	—
Current portion of long-term debt	—	—	—
Current liabilities	—	—	—
Long-term debt	—	—	—
Preferred stock	—	—	—
Common stock	—	—	—
Capital surplus	—	—	—
Retained earnings	—	—	—
Less: Treasury stock	—	—	—
Stockholders' equity	—	—	—
Total liabilities and equity	—	—	—
Liquidity Ratios			
Net working capital	—	—	—
Current ratio	—	—	—
Net quick assets	—	—	—
Net quick ratio	—	—	—
Cash ratio	—	—	—
Leverage Ratios			
Long-term debt as a % of stockholders' equity	—	—	—
Total debt as a % of stockholders' equity	—	—	—

Important Definitions

#1. *Net working capital* is current assets *less* current liabilities. *Current ratio* is current assets *divided* by current liabilities.

#2. *Net quick assets* are cash items and accounts receivable *less* current liabilities. *Net quick ratio* is cash items and accounts receivable *divided* by current liabilities.

#3. *Average collection period* is accounts receivable *divided* by daily credit sales.

#4. *Inventory turnover* is average inventory (beginning and end-of-year position) *divided* into cost of sales (or into sales).

#5. *Accounts payable aging (days)* is accounts payable *divided* by daily purchases of goods and supplies.

Part Two: Case Study

How a Bad Acquisition Almost Destroyed a Successful Business

- ***Balance Sheet Disaster: Financial Statements Before and After the Acquisition***
- ***What Went Wrong: Review of Problems and Mistakes***
- ***Trying to Survive: Restructuring the Debt***
- ***Lessons to Learn: How to Avoid Similar Problems***

The company had to take an inventory writeoff of \$160,000 within one year after closing the deal. *The problem:* That inventory represented 44% of the total purchase price.

Buying, Selling, and Valuing a Business

As a seller, thoroughly analyze your own company, its value to the buyer, and his or her motives for wanting to buy it.

As a buyer, fully investigate the seller personally, as well as his or her business. Justify the purchase price by preparing conservative projections of income and cash flow for at least three years. Include in your analysis any new capital the acquired business will need to reach its projections.

The bottom line: If you don't ask and get answers to all the critical questions, the seller, buyer, or both will wish the deal never happened. □

Smith's Company:
Before and After the Disaster

Here is select financial information *before* Smith's acquisition of ABC Company and one year *after* the closing date (in thousands):

	<u>Before</u>	<u>After One Year</u>
Current Assets	\$385	\$488
Equipment and Leaseholds	47	89
Other Assets	<u>25</u>	<u>50</u>
Total Assets	<u>\$457</u>	<u>\$627</u>
Current Liabilities	\$127	\$205
Note due Seller	0	192
Note due Bank	<u>0</u>	<u>120</u>
Total Debt	127	517
Stockholder's Equity	<u>330</u>	<u>110</u>
Debt + Equity	<u>\$457</u>	<u>\$627</u>
Debt as a % of Equity	<u>38%</u>	<u>470%</u>

<p>A company twice as big doesn't always deliver profits twice as great.</p>

How a Bad Acquisition Almost Destroyed a Successful Business

One of the biggest problems for business owners is restraining that instinctive desire to expand when any opportunity presents itself. It's natural to associate expansion with growth and a bigger company with greater profits.

That's what this business owner did. He had an established company that was doing well. It was on a solid financial footing with a stable customer base and little debt. And it was providing the owner with good income to support himself and his young family; he was only 46.

Then an opportunity to expand presented itself. That's when the trouble started. Maybe you can learn from this owner's mistakes, particularly the many questions he never asked.

This is the second part of our report on acquisitions. Part One provided a detailed overview of the many initial steps involved in analyzing a potential acquisition and assessing its value. This Part Two uses a real-life case study to illustrate all the ways an acquisition can go wrong if you don't do that detailed analysis.

Thomas J. Martin, *Author*

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The Company: A distributor of a wide range of electronic components to the utility industry. Sales: \$1.8 million • Net Income: \$55,000 • Stockholder's Equity: \$330,000.

The Opportunity: The owner of this company (we'll call him Smith) decided to purchase a second business (we'll call it ABC Company). ABC had sales of \$1,125,000 and net income of \$42,000. Its products also were sold to the utility industry. The purchase price of ABC was \$365,000, payable as follows:

Cash at Closing	\$125,000
Five-Year Note	<u>240,000</u>
Cash and Note	<u>\$365,000</u>

The \$240,000 Note was repayable monthly over 60 months, \$4,000 per month (\$48,000 annually). The interest rate was 8%, also payable monthly.

On the surface, it was a good deal. The product lines complemented each other; Smith could include both company's products in one, expanded catalog; and he knew the industry. Even the price looked good. Smith was buying ABC's assets dollar-for-dollar at their fair market value and at a price-earning's (p/e) multiple of only 8.7 (the purchase price of \$365,000 divided by the seller's net income of \$42,000).

Furthermore, the deal was a straight asset purchase, the best approach when purchasing a business. *Reason:* Buying stock in a business means you assume all the unknown and contingent liabilities of the business.

So what went wrong?

Basics of the Deal

The owner of ABC Company (we'll call him Jones) was 68 years old. As part of the closing documents, Jones signed both a noncompete agreement and a management clause that required him to continue to work at ABC part-time. Jones committed to work two days a week for three years; he was to be paid \$250 a day and the company would maintain his health and life insurance for the three-year period of his employment. Jones, incidentally, had no successor or second-in-command trained at ABC and he personally managed and controlled all the details of the business. Only he knew those details, none of which he had ever written down or shared with others at ABC. For this reason, he was vital to the orderly transition of ABC and its customer base to the new owner.

In structuring the deal, there was no allowance for goodwill; the assets were purchased at their fair market value, which totalled \$365,000 and consisted of the following:

Inventory	\$235,000	
Accounts Receivable	63,000	
Leasehold Improvement	42,000	
Noncompete Agreement	<u>25,000</u>	*
Purchase Price	<u>\$365,000</u>	

* Because of the seller's age (68), a low value was assigned to the Noncompete Agreement.

Jones, the seller, received the following at closing: \$125,000 cash and an 8%, \$240,000 Note payable monthly over five years.

To finance the cash downpayment, Smith borrowed \$150,000 from his bank. The term was five years; monthly payments of \$2,500 plus interest at two points above the prime rate. The bank loan was secured by his *own* company's accounts receivable and inventory since the seller had a first lien on the assets sold to Smith.

The Problems

First, Jones, the seller, died within six months after closing. He had pre-existing medical problems, complicated by alcoholism, which were never disclosed to Smith at the time of the sale.

Second, the \$235,000 inventory part of the purchase price turned out to be worth only \$75,000. The inventory was so old it was neither saleable nor worth the effort to catalog it. Smith took a *one-time inventory writeoff of \$160,000* within one year after closing the transaction; that amount represented almost half the acquired company's reported net book value of \$330,000.

Third, the newly acquired company, ABC, was now losing money at the rate of about \$5,000 a month, and Smith was having great difficulty in meeting the \$240,000, 8% Note due Jones' estate. Smith missed four payments before Jones' disgruntled widow retained a lawyer to foreclose on the company's assets. (The Purchase/Sale Agreement had given the seller a lien on the acquired assets until the \$240,000 note was fully paid off.)

Fourth, the income statement showed a \$220,000 loss in the first year — the \$160,000 inventory writeoff plus a \$60,000 operating loss. In addition, because of the transition problems in year one, and without Jones to guide the company, ABC's *sales declined 32%* from \$1,125,000 to \$750,000.

Fifth, the bank called its loan after reviewing the financial condition of ABC and because of the violation of certain negative covenants. The inventory writeoff of \$160,000 and operating losses of \$60,000 reduced the company's net book value to \$110,000 (\$330,000 before the acquisition less the \$220,000 losses). Smith had agreed to negative covenants in the bank loan agreement which required him to be in continuous compliance with certain ratios and tests. When he wrote off the inventory, his company violated both the current ratio test (current assets divided by current liabilities) and the debt-to-net worth maintenance test. The bank was within its rights to call the loan.

Result: The notes due both to the bank and the seller's widow had to be restructured. In addition, since Smith had *personally* guaranteed both notes, he couldn't walk away from the acquisition.

The Buyer's Mistakes

Mistake #1. Smith never established or analyzed his *personal* reasons for wanting to buy ABC. He assumed the combination of complementary product lines would increase the revenues of both companies and substantially increase profits. He had even documented this optimistic assumption with income and cash flow projections that supported the repayment of the loans to both the selling stockholder and the bank. However, he did *not* seek outside help, e.g., from his accountant, to confirm the projections and the assumptions.

Mistake #2. Smith's second mistake was his failure to conduct an *independent* audit of the assets being acquired. This was particularly important for the inventory position of \$235,000 since it represented 64% of the \$365,000 total purchase price. Smith planned to send in his own people to count and inspect the inventory a few days before closing but it was never done. Instead, he relied on the representations of Jones and financial statements prepared in-house by the seller.

Mistake #3. As a buyer, Smith should have investigated the seller personally. Not one trade or reference check was made. He assumed he had some leverage over Jones since a good part of the purchase price was structured on a deferred payout basis: \$125,000 cash and \$240,000 note, which represented 66% of the total price of \$365,000.

Mistake #4. Smith didn't request the company's tax returns to reconcile them with the company's financial statements. If he had, he would have found \$55,000 less inventory that the seller had written off two years before the sale.

Mistake #5. Smith assumed the seller would be available for a few years; he wasn't. Smith spent 75% of his time for 18 months after closing trying to solve the acquired company's problems. That time included negotiating and restructuring the debt due to the bank and the seller's widow.

Mistake #6. Smith didn't require the seller to *personally* represent to his company's financial statements, particularly the assets being acquired on the day of closing.

Mistake #7. Smith used *all* debt to acquire the business, which not only committed his company to future fixed charges of loan repayments and interest but also tightened his cash flow and reduced his borrowing power. To show the impact, let's look at his company's debt-to-equity ratio *both* before and one year after he acquired Jones' company:

Before the Acquisition — Debt was 38% of stockholder's equity

After the Acquisition — Debt was 470% of stockholder's equity

Those ratios tell you the whole story and illustrate how borrowing money to buy a second company is potentially destructive to the health of the original company.

Trying to Survive: Restructuring the Debt

- To satisfy the bank's loan, Smith and his spouse took out a \$140,000 second mortgage on their home.

- To satisfy Jones' widow, Smith *personally* paid her \$100,000 in cash and restructured the remaining loan balance over ten years. In exchange, she forgave 30% of the debt, about \$72,000 of the \$240,000 note.
- Smith restructured the combined company and eliminated 60% of the acquired company's product lines. He kept only the 40% higher-gross-profit business.
- Smith hired a new salesperson/executive to help get everything in order. He gave him an option to buy 20% of the combined company over a five-year period. The option price was based on a 10 multiple (p/e) of each year's net income. Under the agreement, the new executive could buy 4% of the company each year.

Currently, the company is operating, but it still is very vulnerable; profits are nominal and cash is extremely tight. However, filing for bankruptcy, an option seriously considered by Smith in the months immediately following Jones' death, is no longer being considered.

Lessons to Learn: **How to Avoid Similar Problems**

■ Search your heart and your mind *for the real reason* you want to make any major expansion move or acquisition. Be objective, practical, and honest with yourself. An expansion decision is too important — and too potentially expensive — a decision to be based on emotional or instinctive reasons. Ego is not a legitimate reason for expanding or buying another business. *Bigger is not always better.*

■ Be sure your decision to buy is fully documented mathematically. Realistically assess the probabilities of meeting the projections and the time required to meet them. After you do that, allow a downside cushion of 20% and see what it does to your income and cash flow projections. Then have your financial adviser or accountant play devil's advocate on the numbers.

Confirm through an audit all income, expense, and asset accounts. Obtain relevant UCC (Uniform Commercial Code) data, i.e., liens on any assets to be acquired.

- Insist that the company and seller/owner *personally* indemnify you for the

representations in the closing documents. The lack of the seller's personal indemnification negated many of Smith's rights in negotiating a settlement with Jones' widow.

■ Even when you get an indemnification, never rely solely on the seller's representations, particularly when a single representation involves a substantial part of the transaction. Audit and verify any significant asset being acquired; in this case, it was the \$235,000 inventory position, 64% of the total purchase price. And don't perform the audit yourself as this owner did. Use your accounting firm or, even better, an appraisal firm familiar with and experienced in the industry of the seller.

■ Consider obtaining a retail credit report on the owner, possibly even hiring an investigator to check out the seller personally, particularly if it's a big transaction which could seriously affect your own business.

■ Call the company's customers and suppliers to ascertain the owner's *personal* reputation and integrity. Include a discussion of the extent and length of their involvement with the company and the industry. Ask their assessment of the company's potential, problems, management, etc. Also call the seller's banker and accountant.

■ Be very conservative in making cash flow projections. Prepare *minimum* projections with the assumption that all will not go well. These downside projections also will give you a worst-case scenario on whether the acquisition is worth the investment *and* the time to make it successful. Be sure to include debt repayments and interest in those projections.

■ If the purchase price is substantial and there are performance requirements for the seller, place some cash in escrow.

■ If the seller is vital to the success of the combined company, take out some term life insurance on him or her for a few years. Just the process of applying for the life insurance will alert you to serious health problems.

■ Review all major contracts that will affect the transaction. Be sure the

benefits of those contracts will carry over to you after the purchase.

■ Try to get to know the seller personally. Take him out for a dinner with his spouse. You may learn a lot about him, his motives for selling, his character and integrity, his family's financial situation, and any health problems he may have. It is absolutely imperative that you identify and analyze the seller's real motives for selling.

■ If you're going to borrow money to finance the acquisition, *double* the number of questions you ask and rework your cash flow projections two or three times during the negotiations and then again one week before closing.

■ Review the tax and accounting effects of the transaction *before* negotiating and structuring the transaction. Prepare projections of income, balance sheet, cash flow for at least three years. Know what the acquired company is costing you — the total purchase price *and* its future cash needs — in both pretax and aftertax dollars.

* * *

The Financial Position data on page 36 shows the balance sheet, both before (actual column) and after (pro forma) the acquisition. It also reflects the operating losses of \$60,000 and the inventory writeoff of \$160,000.

To further help you understand this important Case Study, please see the following:

- Compute Return on Purchase Price, next page
- Are You Prepared to Expand?, page 35

We hope you enjoyed reading this Case Study and, more important, learned something from the many mistakes this owner made. □

Compute Return on Purchase Price

The purchase price for ABC Company was \$365,000; its net income was \$42,000. Look at the \$365,000 investment from a simple return-on-investment point of view: *net income divided by the purchase price*. Here's the calculation:

$$\frac{\text{Net Income}}{\text{Purchase Price}} = \frac{\$ 42,000}{\$365,000} = 11.5\%$$

The question: Assuming the \$42,000 net income will actually occur and be constant, will an 11.5% annual return compensate you for the risks associated with buying this company? What about projected net income? Let's calculate that return also. Keep in mind that you, the buyer, have to prepare the projected net income figure (it's what *you* expect net income to be *after* you take control). Let's assume it's \$75,000 (79% higher than the \$42,000 actual). Here's your adjusted return.

$$\frac{\text{Net Income}}{\text{Purchase Price}} = \frac{\$ 75,000}{\$365,000} = 20.5\%$$

Again, you have to evaluate the 20.5% annual return vis-a-vis the risks of buying this company. But wait, there's more to consider. For example, you may wish to add depreciation to your projected net income, but only if there is no need for future capital expenditures which will use up the added cash flow from depreciation. You also can adjust net income upward to reflect any savings resulting from the *combined* companies, e.g., one catalog, one accountant, one office facility, etc.

Bottom line — you must perform these basic financial calculations. They will tell you a great deal about whether or not a potential acquisition or even a planned expansion in your own company makes sense from an investment point of view. Even if an acquisition is profitable, it can be too costly in other ways — stress, time away from your family, additional debt to repay, financial illiquidity.

Too many rash and costly business decisions are made because we forget to ask

ourselves these simple but very critical questions:

- *What am I getting for my investment?* In this case, what am I getting in return for my \$365,000 investment in cash and notes?

- *Could I do better elsewhere?* In this case, compare the \$365,000 investment in ABC with the comfort and profit potential of investing \$365,000 in your existing business or another investment vehicle.

- *Is it worth it?* The purchase of a business requires a greater commitment in personal time and energy than an investment in your own company or a mutual fund. You should ask yourself: first, whether you have the time, money, and energy to commit, and second, whether the return you stand to gain more than compensates you for that time, money, and energy. □

Are You Prepared to Expand?

Before taking on an acquisition, examine your motives very carefully — both personal and business.

- Be sure the acquisition *fills a real business need*. For example, if the acquisition is merely a tax ploy or ego booster, reevaluate the move. The eventual cost may turn out to be far greater than anticipated, e.g., the tax benefits might be negated by future tax legislation.

- Examine whether it would be cheaper, in the long run, to *build the business from scratch* rather than buy an existing enterprise with all its unknown liabilities (e.g., product liability suits or other liabilities not recorded on the balance sheet).

- *Know the business* of the company being acquired. When acquisitions go sour, the typical reason is that the buyer knows little about the seller's business and finds himself relying on the judgments of the acquired company's management team. In this case study, Smith knew the industry of the acquired company but not the company itself. Unfortunately, only Jones had that knowledge.

- Be prepared to *commit the time* needed to manage the acquired company. It usually takes a multiple of what you think it will take. This is especially true in the first year after the acquisition occurs.

Bigger but less profitable: Be very careful of falling into the trap of "more sales and less return" — both profit- and time-wise. Many business owners make acquisitions simply because they want to increase the size of their companies. But a company twice as big does not always deliver profits twice as great. □

Financial Position: Before and After the Acquisition

	<u>Actual</u> <u>Pre-Acquisition</u>	<u>Cost of</u> <u>Acquisition</u>	<u>Combined</u> <u>(Pro Forma)</u>	<u>After</u> <u>One Year</u>
Cash	\$ 15,000		\$ 40,000	\$-20,000
Cash: To Seller	0	-125,000		
Cash: Bank Financing	0	+150,000		
Accounts Receivable	145,000	+63,000	208,000	208,000
Inventory	<u>225,000</u>	+235,000	<u>460,000</u>	<u>300,000</u> ⁽²⁾
Current Assets	385,000		708,000	488,000
Net Equipment	47,000	+42,000	89,000	89,000
Other Assets	<u>25,000</u>	<u>+25,000</u>	<u>50,000</u>	<u>50,000</u>
Total Assets	<u>\$457,000</u>	<u>+390,000</u>	<u>\$847,000</u>	<u>\$627,000</u>
Accounts Payable	\$ 82,000		\$ 82,000	\$ 82,000
Accruals and Taxes	45,000		45,000	45,000
Current Portion: Notes	<u>0</u>	+78,000 ⁽¹⁾	<u>78,000</u>	<u>78,000</u>
Current Liabilities	127,000		205,000	205,000
Five-Year Notes (Seller)	0	+192,000	192,000	192,000
Five-Year Notes (Bank)	0	+120,000	120,000	120,000
Stockholder's Equity	<u>330,000</u>		<u>330,000</u>	<u>110,000</u> ⁽³⁾
Liabilities + Equity	<u>\$457,000</u>	<u>+390,000</u>	<u>\$847,000</u>	<u>\$627,000</u>
Sales	\$1,775,000	\$1,125,000	\$2,900,000	\$2,112,500
Net Income	\$ 55,000	\$ 42,000	\$ 97,000	\$ -123,000
Acid Test ⁽⁴⁾	1.3 to 1.0		1.2 to 1.0	0.9 to 1.0
Debt as a % of Equity	38%		157%	470%

(1) Reflects current position of long-term debt: \$48,000 due seller and \$30,000 due bank.

(2) Writeoff of \$160,000 inventory.

(3) \$330,000 less writeoff of \$160,000 inventory and operating losses of \$60,000 for the first year.

(4) *Acid Test*: Cash and receivables divided by current liabilities.

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The company was formed in 1974 by Thomas J. Martin. Martin has written more than 900 articles and advisories and presented *hundreds* of workshops and seminars to *thousands* of business owners and executives on many of the subjects covered in *The Business Library*. He is an Investment Banker and an expert witness in Valuation and Succession Court Cases. He has helped *hundreds* of business owners and executives raise capital, refinance debt, prepare for succession, and value and sell their businesses.

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