

# The Nine Biggest Mistakes Business Buyers Make

## Buying Smart



Thinking of buying a business? Use this guide to avoid common mistakes. Buying a business is a complex process. Naturally, you want the process to go smoothly. An experienced professional at your side who has been through the process many times will achieve this goal for you.

### Introduction

From the start of the quest until the successful closing, you will have to resolve many issues, some of which you have never even contemplated before. Issues such as security, default, UCC1's, Bulk Sales laws, counsel's opinion, fraudulent conveyance, allocation of assets, potential bankruptcy, covenants not to compete, taxes, taxes, taxes and on and on. Many issues are technical and many are emotional to both you and the seller.

You will require the services of an attorney and a CPA to assure that you have structured the transaction effectively and properly from a tax and legal standpoint. Make sure you have money in your budget to cover these services. You may choose to engage an intermediary to help you in the quest and to advise you on values, issues and the techniques of the search.

### Not Focused

Most potential buyers are concerned about deal flow. They will leave no stone unturned to get to

look at a deal. This is the wrong approach.

The real issue is the quality of the deal - not quantity. The quality of the deal for you is directly related to narrowness of your criteria. A typical criteria we see from buyers is: a manufacturing or distribution business with sales from \$5 million to \$40 million, no retail, in the local metropolitan area. That's it. It is not unreasonable to assume that at least 1,000 buyers are actively looking for a business with the above criteria. If one assumes that 100 businesses will be sold, then success odds are 10 to 1 against. So how do you reduce the odds? You narrow your criteria. You go for the manufacturer of florescent lighting fixtures that sells only to schools. Not just lighting, or just lighting fixtures, but a specific type of lighting fixture to a specific market. With this narrow criterion, you can become an expert in the market, the manufacturing processes and the competition.

Think about this from the seller's standpoint. You will come across as a person who knows the business and knows where they are going. We have yet to see a seller who didn't want their business to continue and prosper. Your focus will telegraph the message to them that you are the ideal candidate to take over their business and make it grow and prosper.

So how does one focus? Target a narrow vertical market and manufacturing niche. Find out all of the players in that niche and contact them. Do this while studying the manufacturing processes,

the markets and the competition. Go to every trade show where the targets are exhibiting or attending. The ideal business will not drop in your lap. You have to target it, focus and go after it!

## **Buyer Not Motivated**

All buyers soon come to realize that the most important criterion for a selling situation is a motivated seller. The seller has to be passionately committed to selling. In order to successfully buy a business, you too have to be passionately committed. What is the measure of this passion? The buying of the business has to be your mission. You have to be willing to put up with the heartbreaks of the quest. The average successful buyer will look at 100 deals, 12 seriously, make offers on three and buy one. Are you willing to start the quest, knowing that on average it takes a year to consummate a deal? Visualize yourself after nine months, without a viable deal in hand and no good prospects. Will you continue the quest? Will you still have the passion?

## **Not Establishing the Seller's Motivation Early On**

In order for a deal to be done, the seller has to be motivated by some reason other than money. Maybe the seller wants to retire. Maybe the seller's spouse has moved to another state and the seller is commuting weekends or month-ends. Maybe the seller has a burning desire to be a missionary in Columbia. It is not easy to find out the seller's real motivation. You may have to ask several times in subtle ways. The seller may not have crystallized his/her thinking and may be just testing the water. Or

the seller may have a partner that wants to buy out the seller's interest and is using you for a stalking horse. Beware of the un-introduced partner and the seller who is anxious to get an offer in writing.

Some hints in detecting seriously motivated sellers include:

- Sellers who have a strong vision of what they are going to do after they sell.
- Sellers who have paid an intermediary an up-front fee.
- Sellers who are at retirement age, with no family members in the business.
- Sellers with strong family or health reasons to get out.

After establishing rapport, the first thing to find out in your initial meeting with a seller candidate is: "What made you decide to sell?" If the answer is, "Anything is for sale at the right price," you have a money motivated seller and you are wasting time. Go to the next deal.

## **Not Asking For Financials Early On**

We have observed some buyers who are reluctant to ask for the company's financials. You cannot evaluate a company without seeing the financials. The sooner you receive them, the better. Your objective should be to have a complete set of three to five years of financials plus the current interim statement by the end of the first meeting. It would be an even better use of your time if you could review them before your first meeting. However, most potential sellers will not give out their financials without some information on the potential buyer, plus a signing of a confidentiality agreement. Many times the seller doesn't feel comfortable giving out this confidential information before personally

meeting with the potential buyer.

If there is an intermediary involved, the intermediary can arrange to have financials forwarded to you prior to the first meeting, provided you have qualified yourself from a financial and technical standpoint. The intermediary will also arrange to let you review other important documents such as tax returns, business plans, product information, market information and a descriptive report on the business. The sooner you get the financials, the sooner you can preliminarily evaluate your price versus the seller's expectations. If the seller's expectations are unreasonable, gracefully terminate the discussions and move on to the next deal.

### **Failing To Assess Your True Financial Capability**

You can buy a business for "no money down," but you can't buy a business with no money down if you don't have any money.

It is the typical banker syndrome: A seller is not going to lend you money if you don't have collateral. Unless the seller and the business are in dire straits, the seller is not going to give you the assets of the business without any financial commitment on your part and then let you use the same assets for collateral. Before you start the process of looking at businesses, decide how much money, cash and collateral, you are willing to risk owning your own business. Are you comfortable with the feeling? Make sure you allow a reserve for future borrowing capacity or working capital infusion, in case of a dip in the cash flow of the business. Remem-

ber that cash flow can dip even if the business is growing well.

### **Expecting Good Deals to Come Over the Transom**

**Selling** There are all sorts of people who are aware of businesses for sale: Lawyers, bankers, accountants, brokers, friends, family, etc. To personally contact all of them in the area is quite a task.

How can you be effective in finding companies for sale? Who should you contact? Let your friends and professional associates know that you are looking, and let them know your criteria. It is possible (but not likely) your deal will be discovered through this route. Just don't spend an inordinate amount of time getting the word out to third parties. If there are intermediaries who specialize in companies with your criteria, then make sure that you are registered with them. Keep in mind that dealing with a seller's intermediary means that you are one of many who are looking at the deal. After all, that is the service the intermediary performs. The intermediary will attempt to get an auction going; it's their job. So the deal you see from an intermediary will be shopped heavily. The most important reason to deal with an intermediary is to evaluate their competence should you desire to hire them to help with your quest. Is there any channel that works effectively? Yes, focus your criteria and directly contact every candidate in your focused area. It's a jungle out there; you have to be efficient in your quest; you have to impress the seller with your financial and technical criteria and the chemistry has to be right.

You may want to consider hiring an intermediary to work for you. Most intermediaries have databases set up to do research efficiently. They have contact systems in place to do the mailings and record keeping. And you will get keen insights into the process and the candidates from the relationship.

## Working on Deals you Can't Do

For your quest to be efficient and effective, you must not work on deals that can't be done. There is no 100% accurate test - anyone in the business can quote exceptions, but the list below will give you situations that should raise a red flag.

- Seller under fifty years old with no strong motivation. Make sure that you are convinced of the sincere motivation of such a seller before spending significant time on the deal.
- Seller's price and terms unreasonable. Explore the seller's expectations early-on. If your offer would be insulting, you have two choices: moving on or educating. Can you reasonably expect to educate the seller?
- Seller with partner you never meet. Insist on meeting the partner, particularly if the partner is a working partner. Evaluate the partner's motivation also.
- Seller with a working younger family member in the business. Same situations as with the partner, except more so. The family member will get better terms than the partner.
- Sellers who don't have a clear vision of what they are going to do after they sell the business.
- Sellers who refuse or procrastinate in giving you critical financial documents. You can't buy the business without evaluating the financials. They can't sell the business if they don't share the financials. It's no deal.

The good signs:

- Sellers between 50 and 70 years old who sincerely are looking to retire with a retirement life planned.
- Sellers who have family or partner problems

and are at the point of exasperation.

- Sellers who are burned out to the point that the business is suffering severely from their inattention.

## Paying Too Much

We've seen buyers fall in love with a business and pledge all of the cash flow of the business for the first five years. That is too much and it is over-leveraged. It is a prescription for disaster.

Prudent buyers base the value of a business on return on investment (ROI), cash on cash. You must project the cash flow of the business, and based on the financing structure, predict the return on investment the cash flow defines. The ROI percentage you use should be based on the risk level of the business. For example, new ventures are more risky than established businesses. (Venture capitalist target a 50% return on investment.) Most privately held businesses sell for between 25% and 40% ROI, pretax. A manufacturing business in a growth market with proprietary products might sell at the 25% level, while a job shop or machine shop would go for 40%. (The after tax ROI will vary substantially with the leverage applied and the financial structure of the transaction. Needless to say, the key buyer number is the after tax cash flow.) For most businesses, future cash flow is most reliably predicted based on historical cash flow. Do not be misled by the glowing potential picture the seller predicts. For the most part the future is determined by the buyer and the benefits of that future should accrue to the buyer. There may be situations where the seller has set up the future and rightly should be paid for it, provided it happens (earn-out.). Over-leverage is equally as bad as over-priced and they frequently go together. The high fixed cost of interest means that a dip in cash flow could jeopardize the business. If you find yourself in a high leverage situation, do your homework to assure that you can stand the fluctuations in the business cycles of the business,