Buying a Business? How to Analyze All Components of the Deal

When a business, asset, or product line is put up for sale, there's always a reason. So when you're considering such a purchase, consider also that the seller may be out to chase in before the company or product hits hard times or goes under. The purchase of a business is a big commitment which can take a lot more of your time and money than you may be willing to spend.

What risks should you be on the lookout for in making an acquisition of a company, its products, or certain assets? This Special Reference Report gives you some of the questions that you should ask and to which you should get answers.

Some Hidden Risks

You and your advisers carefully examined the seller's balance sheet and financial statements. *The bottom line*: Projected earnings are good; the acquisition is consummated and, one year later, you are sued by:

- A customer who was injured by a product *delivered before* you acquired the company.
- The government for nonpayment of sales tax.
- A former executive for violation of his employment contract.
- A creditor of the former business who has a letter from the seller confirming his company's lien on the assets sold to you.

Even though these situations existed before you bought the company, you could be held responsible. What could you have done to lessen or eliminate these risks? As a matter of fact, would you have completed the deal if you had known about them?

Best advice: Before you make any acquisition decision, you should carefully evaluate the nonfinancial aspects of the purchase. They include: 1.the seller's motives, 2.hidden liabilities, 3.the pertinent facts on the company's owners, 4.the synergistic savings and growth opportunities, and 5.the due diligence work to assure an informed decision. All are discussed in this Report.

Seller's Motives

Again, a business or any asset is sold for a reason. And at the top of the list of areas to investigate are the seller's motives and needs, which can go far beyond the financial statements.

For example, the owner-seller may want to take his or her expertise elsewhere, retire, or he may just want to get away from the whole scene. But do you need him or her- short-term or long-term- for the acquisition to be successful?

If so, you had better contractually commit the owner to provide you with the following:

- A *noncompete clause* for a certain number of years.

- Term *life insurance* during the risk and transition period- sometimes up to five years.
- A *management clause* or *employment contract* whereby he or she is legally obligated to work for you for a number of years.

The risk that can result from the owner-seller not being present, particularly in businesses lacking management depth, can be devastating. In addition, identifying why the seller is selling forces you and your counsel to think of covenants necessary to protect your investment.

Legal note

Be sure the owner agrees *personally* with the noncompete restriction, management clause, life insurance, and employment contract. If just the company signs the Purchase and Sale Contract, the owner/seller may not be legally obligated to comply with its terms.

Also, analyze the management team. You may want to get other key people signed up to work for you before you close the deal.

There's more: If a noncompete clause is part of the purchase agreement, make sure it's reasonable in length of time and in geographical area. Don't unreasonably restrict any key employee. *Reason*: You may *not* be able to legally enforce the noncompete agreement if it's too restrictive.

More Hidden Liabilities

To add depth to your pre-acquisition investigation, you should not only examine the financial benefits that the company or product will bring (i.e., your return on the investment) – you also should *examine the potential damage the acquisition could do*. This damage could come from any of three sources: 1.the physical premises, i.e., the property and its operations, 2. potential product liability claims, and 3. labor relations.

First, the physical premises should be examined for safety. *Examples*: Are they structurally sound? Does the manufacturing process comply with OSHA standards? Is the workers' health or physical well-being endangered? Are any pollutants escaping into the environment?

Second, are there any defects in the product (or service malfunction) that could result in lawsuits? Are there any existing lawsuits that could be an omen of more to come? Look into products that have been discontinued- you might still be responsible if you prove defective.

Alert: The seller is usually required to represent that there are no current lawsuits, known or pending. This is okay; however, go one step further. Learn what suits were instigated *or* threatened over the last five years. History repeats itself. Moreover, you will get a good idea of how the seller runs his business.

Alert: If the seller has product liability insurance, check the insurance policy to make sure its benefits can be carried over to your company. Also determine whether or not the insurance covers future lawsuits resulting from actions taken *prior* to your acquisition of the product or business.

Third, are the relations between management and labor amicable? If there isn't a union, is one lurking in the background? Talk to the company's key people. Are they happy with their jobs? Do any plan to leave the company or retire in the near future? How critical are they to the continued success of the company?

What to do: If you uncover people risks, you might still decide to go ahead with the acquisition. But protect yourself. Confront and solve the problem now and determine the cost of any changes before making your acquisition decision.

Ownership Questions

You want to know who owns the company, how involved they 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).

1. List all current owners of the company's common and preferred stock, by class if applicable.
2. 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.
3. Break down the ownership by shares and percentage: both actual and pro forma (i.e., assume the warrants, convertible securities, and stock options are exercised).
4. How many shares does the principle stock holder own- personally and through his or her family? Have any shares been gifted or placed in a trust, e.g., a family limited partnership?
5. Does the common stock have preemptive rights? What about liquidation rights and dividend preference? Is there cumulative voting?
6. Do any shares of stock carry an investment agreement, e.g., are there restrictions on their sale, transferability or use as collateral?
7. Is there a buy-sell or other shareholder agreement? Is there any employee stock ownership plan or stock bonus plan?

Analyzing the Deal

As an owner yourself, you know the options one has in reporting income, inventory, sales, and the like. We're not talking about misrepresentations or fraud by the seller but about legitimate methods of moving around the company's reported financial position and results, particularly inventory and profits.

So, if you're buying another business or asset, *put yourself in the seller's shoes*. Do the following:

Determine niche and industry: Identify the seller's special niche in the marketplace and how the niche can help your company. What is the size of the market and the principal competitors? How do the company's products or services and their pricing differ from the competition?

Review all major contracts: Know the effects these contracts have on the business, or assets to be acquired, from both a business and a legal point of view. Examples are large purchase orders, lease agreements, supplier commitments, and loan agreements. Your accountant and lawyer can provide you with a list of additional items to review.

Analyze the customers: Get a handle on "why" they buy from the seller, and get a detailed customer breakdown by volume and product for the last three to five years. Look for good distribution (nonreliance on just a few customers); find out why some are no longer customers, and talk to them.

Review sales and marketing: How does the company sell its products: through its own sales force, distributors, or through manufactures' representatives? How are they paid and what are their responsibilities? Are the company's products distributed nationwide or in a select geographic area?

Check out the backlog: What is the amount by product and customer? How does it compare to prior years?

Understand the fixed and variable cost structure of the business: What are its gross and operating profit margins? 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.

Check out the seller: If the business is a smaller one, it's probably run and controlled by one or two individuals. Talk to the owner's banker, suppliers, customers, landlord. Look for integrity and substance. Basically, does the owner live up to his or her commitments? Don't rely completely on the legal contract; the people aspect is just as important as the purchase price.

More Big-Dollar Questions

- When was the last time the IRS or state audited the company's tax returns? Were there any assessments?
- Has the company ever missed paying federal, state, or local withholding taxes?
- Is the company conforming to the tax laws, e.g., the payment of sales taxes and the legitimate classification of workers as independent contracts?
- Is the company compliance with all discrimination laws, including hiring and fringe benefit programs?
- Have the seller's principal employees and executives signed confidentiality and noncompete agreements? Are there any employment contracts which represent a big-dollar liability going forward?

Four More Buying Cautions

Indemnification and encumbrances.

Have the seller (and owner) *indemnify you* that the representations in the contract are correct and that the assets are not encumbered by any liens, contingent liabilities, or other obligations. And talk to the seller's lenders and accountant to confirm the free and unencumbered position of the assets.

Deal structure

Buy assets, not stock. This will reduce the risk of your assuming unknown liabilities. It also will allow you to write up (capitalize) many of the assets to fair market value, which will generate future depreciation and amortization deductions. Those tax savings (deductions) result in a lower net purchase price.

Value the transaction

Value the company's assets and determine their reported net book, fair market, and replacement values. Compare these values with the total purchase price. Then adjust the seller's income statement to reflect its profitability *both* before and after the combination with your business. Determine the following *multiples* in relation to the purchase price:

- Price-Earning's (p/e)- Net income divided by the purchase price.
- Earnings Before Interest and Taxes (EBIT) - Operating profit before interest and taxes divided by the purchase price.

The range of multiples should be the following: p/e (10 to 20) and EBIT (4 to 8), principally dependent on the seller's growth rate. Be careful if the after-purchase multiples exceed those upper limits.

Asset verification

Don't rely on the seller's oral and written statements on his financial condition and the value of the assets- particularly if a lot of cash is involved. Get some credit reports, both business and personal, and have your accountant *audit* the assets being acquired.

Once you have made the decision to buy the business or asset, your work enters a new stage: The "due diligence" you need to do before finalizing the purchase. Be forewarned that some of the things you learn may kill the deal; others will help protect you and your business if the deal goes through.