Buying or Starting a Business:

Many people have those moments when they consider buying or starting their own business. There are many motivational factors that drive this desire, but the importance of planning, discussing and investigating the options is many times undervalued.

Below is a review of many aspects that you may want to consider if you are considering 'going it alone'. This is not an exhaustive list, however covers many factors that are often failed to be taken into consideration as people get swept up in the excitement of the new challenge and opportunity.

We always recommend a considered and frank evaluation of the reasons and the target with a professional before, during and after the establishment or purchase of a business to ensure that the outcome is what you desire.

1. ***Self-Assessment: ask yourself ….***

- *Why am I doing this?*
- *What do I want to get from this business?* A job, a challenge, a better return on my investment of time and money, a chance to control my own destiny?
- *What skills/knowledge do I bring to the business?*
- *What industries/products interest me?*
- *How much money do I have to invest in this business?*
- *What location would I like to work in?*

The answers to these will questions will provide you with a clearer picture of what it is that you want, and narrow your search to a target that will utilise your skills and investment and hopefully provide the outcomes that you seek.

2. **Where do I look?**
    - Trade Me
    - Various business websites
    - Business Brokers
    - Cold Calling target businesses
    - Other sources

This is not an exhaustive list, however provides you with a starting point. If you are serious about looking at your options then it would pay to look everywhere.

Whilst a broker may be charging commission, good brokers have extensive knowledge of industry trends, the market and a range of business and can advise you of businesses that sometimes don't even make it to a listing before being sold. Talk to them and utilise their skills.

Some businesses may not be openly on the market, however if you know the sort of business that you want, a quick chat to the owner may plant the seed for a sale and may reap benefits.

The secret though is to look at many businesses as often the more you look at, the more you refine your criteria and thus know when the ideal opportunity presents itself.

3. **Due Diligence – what is it and why should you do it?**
"An investigation completed with a certain standard of care, of a business prior to signing a contract"

Performing this type of investigation contributes significantly to making an informed decision by assessing the available information systematically to assess the risks, costs and benefits.

We work alongside you to investigate the business to assess potential areas of risk, some of which we encourage the potential purchaser to investigate – not only can this be more cost effective for you, but it also enables you to learn more about the business as you delve into it and add value to your investment if you proceed with the purchase.

How it works - together with you we review the business that you are interested in and from there prepare a plan based on the perceived areas of risk & opportunity.
Part of that process is a review of the Financial Statements (usually for at least the past 3 years) both the management and taxation accounts. What are they telling you? Have they been "normalised"? (meaning, adjusted for non-business items). What are the trends etc?
Other aspects that can form part of the due diligence process are legal, employment, IT, IP, rental, asset values and insurance issues.
Utilising the knowledge and skills of a professional in these areas is important if you are to gather the information to make an informed decision on the business.
What about 'cash'? Not only is this element of business illegal in regards to taxation and the IRD, it is unverifiable. There have been many instances of purchasers being misled with offers of unrecorded sales that in some businesses are not entirely correct. Make sure if you are a prospective purchaser that you are buying the business on what is verifiable not on unsupported verbalisations.

The bottom line is that consideration to a planned and professional due diligence is often overlooked and the investment in such a process can save you many times over either in a buying decision or in the negotiation process.

How much should you spend on due diligence?
Obviously your investment in this process should be tied to your investment. You need to evaluate it on a cost/benefit basis and decide how much is smart. Sadly too often purchasers see only the cost element in the price they pay rather than the cost of NOT considering and conducting a good due diligence on their potential investment.

You can spend valuable money on investigating and business that is right for you - but what is the cost of buying a business that you shouldn't have?

4. **Fair Price – what is it? How do I work it out?**
There are various methods of calculating the value of a business however at the end of the day, that price is what is agreed between a willing buyer and willing seller in an arm's length transaction.

Below we will touch on a few accepted methods so that you are aware of what they mean, however bear in mind that it is a negotiation process in which accurate information can play a key role – hence the need to evaluate the business carefully and thoroughly.
Issues that impact that negotiation process: information, motivation, the economy, the industry and emotion.

Multipliers:
Simply put – valuing a business on using a multiple of either sales or profit or some other figure.
Various industries have 'norms' for this, however at the end of the day these are just that – accepted norms.
Whilst the calculation can seem complex, the basis of these norms are sometimes not based on too much evidence to substantiate the price.
You may be able to substantiate the agreed sales or profit number from the financial statements, however the multiplier can be arrived at arbitrarily.
A price based on a multiplier should usually be taken as an estimate and you need to do your homework then negotiate.

Book Values:
This once again involves a multiplier – this time based on the book value of assets and liabilities of the business in the balance sheet.
However book values are not replacement value or always 'real value' – so there is an element of inconsistency in this method.
A valuation completed by an expert is the only way to arrive at a more accurate value.

Return on Investment:
Possibly the most common method used in valuing businesses. Basically translated is – the amount of money an investor can expect to realise from the business in profits.
In this process people use terms such as:
EBIT – earnings before interest and tax
EBITDA – earnings before interest, tax, depreciation and amortisation.
They are return numbers used in this method of calculating value and purchasers should be aware of these terms and what people are talking about when they mention these. You don't have to be an expert – but know what you are dealing with and what people are quoting.
Profit or earnings are what business performance is measured on and your potential return (profit) is what you obtain from your investment in that business. You earn money on the money that you invest in the business.
Whilst sounding simple enough, calculating the return based on the financial statements without adjustments (normalisation) is inherent with danger and a professional assessment of the return is recommended.
All business returns vary and can dependant on size, market and industry to name but a few variables.
You also need to consider the volatility and longevity of any potential returns. What could impact these numbers that you are basing your purchase price on?

Capitalised Earnings:
This method is similar to the Return on Investment method above where normalised returns are used to estimate projected earnings, which are then divided by a capitalisation rate.
What is the capitalisation rate?
This is determined by comparing the business return with other investments – for instance Government Bonds or stock in other companies.
If your return from the business is less than these other options is it really a good buy?
You need to analyse the business in terms of what you consider the projected earnings increases could be over the coming years based on the market, the product, competition and other factors and then apply the capitalisation rate that you consider fair.

Intangible Value:
A business that is operating with clients and generating turnover has some value – but what is it? It isn't shown in the Financial Statements, or if it is, it is often an arbitrary figure based on a past purchase.
So what is goodwill worth?
It can mean different things to different people.
Say Company A is trading, but it's bottom line net profit after paying wages to the owners is nil or even a loss? On the face of it – the business could be valued at nothing to most outsiders.
However, presume you run a business that utilises Company A's product or service.
If you were to purchase Company A and incorporate it's staff, supply chains and systems it may be that you can make savings due to economies of scale, improve your business outputs through the internal control of supply, quality or lead times and thus improve your bottom line? Would you then consider that Company A has a value?
So, although the Financial Statements of Company A show no profit and using other valuation methods has no perceived value, there could still be an intrinsic value.

Summary of values methods:
Valuation is more art than science.
All valuations are an opinion and are based on assumptions and judgement.
Obtaining independant and professional assistance in the buying or selling process and arriving at a valuation point or range eliminates bias, emotion and maintains objectivity that enables you to negotiate the best possible price.
Negotiating from an informed and educated position will enable you to achieve the best outcome.

5. **Pitfalls and Traps**:
    - What are you buying?
      It may seem like a silly question, yet are you buying the company (and with it all it's unknown liabilities) or the business?
      You can't assume that what you see is what you get. Some assets that you may view or assume are part of the business may be held by another owner or entity.
      Can licences and rights be transferred?

There have been many examples where purchasers have signed and agreed to buy a business only to find after agreeing terms, that valuable rights/assets/IP is not in the deal.
Do you know that with buying the company outright you are buying its ACC history and liability?
Is the lease transferrable if you just buy the assets and liabilities and not the existing company?

6. **Common Mistakes:**
   - Not doing your homework and rushing the decision. Your investment can be greater than just the purchase price. Are you tying yourself to a long term lease that you would need to pay even though you go out of business? Are you taking on warranties/guarantees of the previous business operator?
   - Underfunding – how much cash will you need to operate the business after the initial purchase? There is a huge difference between profit and cashflow. Do you know the difference? Have you prepared forecasts for the business you intend taking over?
   - Buying all the recievables. Are those that are over 90 days collectable?
   - Failure to verify all of the data you are being presented with
   - Committing to heavy repayment schedules that may restrict growth or expansion opportunities or place pressure on cashflow and your ability to survive if things get tight
   - Undervaluing the existing owners' input. We always look on what we can add to the business, but what will you not be able to do quite as well as the current owner?
   - Paying for what you can bring to the business. We all want to be positive and realise what we can add – but should you be paying the existing owner for that in the purchase price?

7. **Transition:**
   - Make sure that this is as smooth as possible
   - Talk with the current employees/suppliers/customers – you need continuity plus improvement
   - Time the hand over and support from the existing owner carefully - you don't want to have them dragging out their stay and not allowing you to take over , however you don't want to have all that experience and skill walk out the door immediately? Or do you ?
   - Job security – ensure that the key staff are on board with you and not feel vulnerable. Involve them in your planning and learn from them as they could be vital to your success and possibly have great ideas to share with you.