How to buy a small business

Should you buy that business? While there are many advantages to taking over an established operation with documented procedures, trained staff, and established suppliers and loyal customers – there are also plenty of pitfalls. Buying a small business can have some challenging hurdles to negotiate but there are some steps you can take to ensure you’re making a sound investment.

What you need to know when buying a small business

Buying an existing small business can be easier than setting up a new business from scratch. But the process can be daunting, especially if you’ve never been in business before. The main reason most people buy a small business rather than starting one is for the established infrastructure and ongoing cash flow. People buy franchises for similar reasons - they usually come with supplier agreements and a proven system of what works and what doesn’t.

The approach

Once you’ve found a suitable business, you’ll need to verify the state of the business before making an offer. This includes ensuring that sales are as good as the owner says they are, that employees will be happy with a new owner, and that customers will remain loyal once you take over.

Make sure you investigate all aspects thoroughly. Are the business systems sound and documented, and is the cash flow sustainable? A business owner will want to sell their business for as much money as possible and as the buyer, you’ll want to pay as little as possible. Your aim is to make the seller want to sell the business to you – on your terms and at your price.

Establish your credibility

Formally register your interest in buying the business. The owner will usually have instructed a business adviser, such as a business broker, lawyer or accountant, to sell the business. Approach the advisers, rather than the owner to register your interested. Your integrity and your future plans for the business are usually extremely important to the seller.

Analyse the seller’s objectives

Working out the seller’s motivation will assist you later in the process, for example:

- Does the owner have to sell? If yes, is the owner under time pressure?
- Does the owner wish to sell just the trading part of the business, or a company that holds both assets (such as a building) and the trading part?
- Is money the prime motivation for selling or is there some unrevealed reason, such as a competitor planning to open nearby?

If you can uncover the seller’s motivations, you’ll gain an advantage in the negotiation process. For example, if the owner has to sell within a certain time period then you may be able to negotiate a lower price.

Go deeper

Before you make any offer, complete a preliminary ‘due diligence’ to ensure the business has no major problems. Always ask yourself this question – “If the business is as wonderful as they make out, why they are selling?”

Sellers often gloss over the weak areas of the business or create short-term gains to give a favourable impression of the business. For example, lowering stock levels to artificially inflate profit (before stock needs to be re-ordered) can make a business seem more profitable. Ensure you investigate thoroughly before you show your interest in buying the business.
Get a feel for the business
Immerse yourself in the business:
• Research its market and main competitors.
• Assess the risks associated with the business’s future trading and with the industry as a whole.
• Talk to customers and others involved such as suppliers.
• Try to gain as much access to a business as you can before you indicate any interest.
• If the location is important, stand out of view outside and estimate the sales activity.
• Visit the business at different times, both announced and unannounced. A buyer of a restaurant was fooled into believing the business was doing well because the seller invited friends around for a free meal every time he knew the buyer was appraising the business.

Ask industry experts
Tap into the knowledge of those in the know:
• What’s the current and future demand for the business’s products or services?
• Are prices (and margins) rising or falling?
• How is the competition in that market changing? For example, which new competitors are entering or who else is looking to exit?
• Contact the relevant industry association if there is one. For example, if you’re interested in a retail business, talk to your state retailing association.

If the business is not making a profit, try to uncover why. For instance, it’s not a good investment to buy a café in a location where three other food and beverage businesses have gone bust.

Conduct detailed due diligence
Once you’ve indicated that you’re interested in buying the business and you’ve signed a Heads of Agreement or confidentiality statement, you can usually get access to more detailed information. Detailed due diligence should include the following:

Speak to customers
Establish existing customer perceptions:
• Who is their main contact at the business? If this is the owner, then the owner’s continued involvement during the transition will be more valuable.
• What are the strengths and weaknesses of the business’s products or services?
• Do the customers use competitors? If so, what are competitors’ advantages?
• To what extent will they continue to support the business after a changeover?

Ask suppliers
Get a feel for the business’s credit history:
• Does the business pay on time?
• How does it compare with competitors?

Analyse results and trends
Analyse historical information and trends:
• Look at sales growth, profit margins, overheads and working capital (review debtors, creditors, stock and work-in-progress).
• Is there scope for improvement? What specific value can you add to this business based on your skills and experience?

Look for changes
Take care to look for changes or inconsistencies:
• Has the business recently changed its accounting policy to show better profits?
• Compare the business’s financial projections with other evidence you have. Do the forecasts tally with the historical trends?
• Is the sales forecast achievable given the current order book and what you’ve learned from customers?
• Does the forecast reflect the outlook for the industry and the whole economy?

You may need to revise any projections that are out of step with these indicators.

Check the finances
Does the business have an efficient accounting system in place and does the owner monitor key performance indicators regularly?

Check the major balance sheet items:
• When was the last full audit? If it was over six months ago, ask for another one.
• What are stock levels? Rising stock levels may be a dangerous sign, especially in manufacturing, seasonal or fashion industries.
• How large are the bad debts and why did they happen?

Conduct an employee audit
If you’re allowed access to the business, consider an employee audit:
• Identify the key employees so you can plan how to run the business.
• Compare the general skill levels, employee turnover and pay with industry averages.
• Ask employees how they feel about a change of ownership.
• Would you expect any to leave? If so, would the key people stay?
Uncover any legal issues?
Complete a legal due diligence as well:
- Confirm legal ownership of all key assets. This might include property, equipment, vehicles and intellectual property (such as registered patents, designs and trade marks). Is the ownership clearly defined in all cases?
- Check for any past, current or pending lawsuits.
- Examine all contractual obligations. This includes employment issues and contracts with third parties such as customers and suppliers. Look for any contingent liabilities.
- Consider what effect a change of ownership will have. Are you likely to lose any contracts?

Making the first offer
Before you make an initial offer, get professional advice to help you value the business, especially if there are any tax implications. Make your own sales and profit projections rather than relying on supplied figures.

If you have ideas on how to increase profits, this is your good fortune, so don't inflate your offer price because of opportunities you've identified. If you can't identify where savings can be made and where there is scope to increase profits, then you shouldn't be buying the business.

What is the risk?
Consider your level of risk. The risk is higher if the target business:
- Has assets (stock and equipment) worth less than your offer price.
- Relies on one or two major customers – or suppliers or key employees.
- Is currently unprofitable or has a history of losses. In this case, you may have to fund losses for some time to come.

Though it sounds obvious, making a lower offer and increasing it if required is always a better strategy than going in high at the start. Ultimately, the business is only worth what someone will pay for it. The seller might have to lower their expectations.

Negotiating goodwill
Goodwill is an amount the seller might expect from you for the value of the business's intangible assets such as an established brand, loyal customers, high profit, quality staff, good location, long lease or supportive suppliers.

Get advice from your accountant on the most favourable way to deal with goodwill. Try to negotiate it down if you can. For example, it may be more favourable to pay more for assets than to pay goodwill because assets can be depreciated over time.

Buy now, pay later
Sellers usually prefer a lump sum for the business, but in reality the seller often has to leave some money in the business to help finance the deal.

Try asking the seller if you can pay off the business over a period of time rather than in a lump sum. This allows you to pay using cash generated from the business itself and hints that the seller is confident the business will be able to fund repayments from cash flow.

For more information, visit nab.com.au/smallbusiness