FIVE A buyer's guide – The good, the bad and the ugly

"You only have to do a very few things right in your life so long as you don't do too many things wrong."
Warren Buffett

"Flaming enthusiasm, backed by horse sense and persistence, is the quality that most frequently makes for success."
Dale Carnegie

Chapter focus

What to look for when considering a business purchase, and also what to be wary of.

- **Introduction**
- **Getting started**
- **Timing the purchase**
- **Researching and setting your strategy**
- **Sources of businesses**
- **Handling the seller**
- **Look for potential**
- **Staff meeting**
- **Due diligence checklist**
- **Potential purchase timetable**

Introduction

If you already own a business and are thinking of selling you may wish to skip this chapter, although it is useful when selling to get insights into the buyer's strategy and requirements. Buying a business successfully requires effective planning, knowledge and a clear strategy. In this chapter we focus on the practical aspects of the process. We have assumed that you have some strategy over what to buy, and why you are focusing on a particular sector, so we only briefly touch on this subject. If you don't have a strategy of what to buy, setting one is a vital first step.

In this chapter our aim is to save you time by getting you started. Buying is a complex process and this chapter is not definitive. Professional advice should be taken. Negotiation is a specialist subject, whether buying or selling, and has it's own chapter later. Understanding the financing process prior to starting your search for a purchase is essential to appreciate how much you can afford and how potentially to structure the deal. We cover this in the next chapter, as fund raising can form an important component of business planning. It is of course not possible to exactly identify how to finance a deal until a purchase is found as there are many variables including how much funds can be raised against the assets of the business.

Getting started

Buying and searching can take up a lot of time if you let it. One way to shorten the process is through preparation. We suggest the following steps before you undertake the project.

- Line up good professional advisors from the start (see Chapter 10 for ideas on choosing an intermediary).
- Understand and research the purchase process continuously
- Be aware of your funding options
- Analyze and be clear on why and what you are going to buy
- Be clear on your objectives and strategy
- Set out realistic criteria and stick to it
- Research target sector in depth (market trends, competitors, legalization, threats, opportunities, demographics)

- Dedicate time to the process
- Draw up a timetable and action plan.

Timing the purchase

When to buy? Buy when the market is low, and sell when the market is high. It's obvious but difficult to forecast. In reality the only way to predict is via analysis of information, research and instinct. Look at economic data, past trends and use common sense. Many people will buy a company's shares during a boom when the industry they are looking at is doing well. Consequently the price can be high. The trick is to predict the boom, or buy mid-cycle, not at the top. When there are boom conditions many average companies can ride on the crest of the wave, have good profits and growth.

The IT recruitment industry during the late 90s and early 2000s was textbook boom and bust, with many investors coming in late on the boom. At one time even graduates with inexperience were achieving average salaries of over £80,000 per year in this high margin industry. Could that last? One year later, with the turndown in the requirement for highly paid IT staff, this value did not just drop it disappeared. Six vacancies chasing every IT contractor turned to six contractors chasing every vacancy. Many companies went into liquidation, profits turned to loss, and companies became half the size that they previously were. All in the space of a few months. Valuations based on profit multiples went from £multi-millions to zero over the period of one quarter.

The point we are making is that when you buy a company you are buying the future profits, not the current ones. Past profits are only an indicator of the future profits trend. The true figure you need to calculate is what you expect the profits to be. This means you make your mind up on future performance, and don't just follow the crowd.

Markets are notoriously difficult to predict and even the experts get it wrong. It is sometimes better and simpler to buy when it is right for you, and rely on a good purchase strategy and strong business plan for your purchase. This will always enable you to buy at the right time (cheap), because you will be able to build on the base that the purchase has provided. Valuations based on a multiple of profits, reflecting how the company was historically run, is the market norm, and this can produce companies on offer at below their real value and potential. If well run (by you), it is the people, product and idea that really dictate a business's future value. Finding and targeting an acquisition of a company that is doing well, regardless of market conditions, and that has potential can be the most effective route to buying at the right time.

Researching and setting your strategy

A good purchase strategy is subjective, and it is only with hindsight that you will tell if the plan worked. Many of the reasons businesses are valued higher (see Chapter 4) is because the business offers strong reasons for purchase; however, how can you look at your position and set your strategy? We suggest the following be considered as a start:

- Assess your targets for cultural alignment with your personal values, or existing organization's approach.
- Look for potential, market growth and expansion prospects.
- Identify strong future economic demographics in your chosen sector.
- Decide if you are an existing company seeking economies of scale and cross-synergies.
- Be realistic about your ability to change the target.
- Avoid arrogance.
- Listen to others but determine your own mind. A bad purchase decision implemented with conviction is often better than a good decision implemented tentatively.

Research is also essential. Do your own quick competitor analysis by ringing companies as a customer and record their responses. Here are ten suggested questions to assess each. You may like to change these reflecting the particular type of industry.

- How many rings to answer the phone?
- Was the voice on answering the phone polite, helpful and positive-sounding?
- Was I put through efficiently to the right person?
- Did they have any special offers or promotions?

- Can you (in the proposed business purchase) offer something better than them?
- Do they have something to offer that you cannot?
- Did they ask for your name and number?
- What are their prices like?
- Do they have a clear market niche?
- How many marks out of ten would you give their response to you?

One of us recently bumped into a friend loitering in a local town on a Saturday morning. It turned out he and his wife were researching. They were looking at retail establishments with a view to setting up a niche estate agency for overseas properties. Walk down the high street at different times, notice the traffic. Go in to the businesses as a customer. Talk to other people that are shopping. Send friends out to meet the sales representatives under false pretences. Research, research and more research.

The friends found out that demand for services was very high but customers were very dissatisfied and untrusting of the people they were dealing with; hard, pushy sales people seriously put people off making an enquiry in the first place. The opportunity was clearly in offering a service in a radically different way providing a consultative selling approach.

Industry associations and trade bodies will all provide you with information on their sectors, usually for free on their website. They will also probably have a magazine you can subscribe to. Read up on the industry, find out the trends. Is the industry likely to grow? Or is the industry running outdated practices that are waiting to be updated? There will also be businesses for sale in such publications. You can also attend trade shows and exhibitions, most are free. A day so invested can give you a tremendous amount of knowledge and contacts.

The Internet is a great research tool. You can even obtain target companies or competitors' accounts via the Internet so long as they are companies (not sole traders-partnerships).

Sources of businesses

There are many ways to find a business for acquisition. There is an old saying that everything is for sale at the right price, so identifying and targeting possible acquisitions by direct approaches to non-active vendors is one way. The other and probably easier way is via sources of vendors who are actively seeking a sale. The active vendors are probably easier as generally they have a thought-through motive for sale and are likely therefore to be both more realistic and prepared, particularly if they have employed a good broker. The advantage of the direct approach is it can avoid competition with other buyers and can be a good second phase if there are no active vendor targets that suit your criteria, however be wary of greedy and unprepared sellers. There are many. We have listed below many sources along with some of the pros and cons of each. When you contact your advisors be positive and take time to explain your requirements preferably via a pre-prepared brief.

Source of Businesses	Pros	Cons
Sale Brokers	Professionally valued Prepared and realistic vendor (usually) Professional advice Middleman in negotiations No fee to you If you tell them what you are looking for they will keep you in mind Prepared sale information Saves time	Broker represents seller Good brokers create competitive process and find more than one buyer to push price up
Acquisition Brokers	Saves your time Offers a buffer to direct targeted approach for vendors increasing their likelihood of opening discussions increasing audience of vendors Cost usually offset by broadening audience of potential businesses	Upfront expense (usually)
Personal Contacts	Might know the business itself and have a trusting relationship with the seller	

Source of Businesses	Pros	Cons
Speculative Enquiries	Might dig up good opportunity that no one else knows about	Time consuming Unrealistic perception of value in vendor's eyes Unprepared vendors without prepared information
Auctions	Prices can be attractive	Must do all due diligence and valuation before attending auction
For Sale By Owner	Unlikely to find as many interested buyers Inexperienced vendors offer potential to chip away at price Naïve vendors can under-value	Needs research to track down willing sellers Unrealistic perception of value in vendor's eyes Uncertain seller lacking in appropriate professional advice

Sources of Direct sellers/Brokers	
National Press & web	Daltons, Financial Times, Sunday Times, Financial Mail, Evening Standard
Internet:	www.Businessesforsale.com www.Buybiz.com www.business-sale.com www.Daltonbusiness.com www.avondale.co.uk www.loot.com www.bizsale.co.uk www.nationwidebusiness.co.uk www.startupinbusiness.co.uk www. startups.co.uk
Research	Databases such as FAME, Dunn and Bradstreet
Recommendations	Recommendations: Banks, Accountants, Lawyers, Business Links
Trade press	Per sector. See **http://www.intellagencia.com** for trade publication lists
Advice	Advice: www.businesslink.gov.uk

Handling the seller

Many buyers see their approach to the seller as adversarial. That is, they see the buying process as one where they have to win. This is very dangerous particularly with the purchase of historically owner-managed businesses. The goodwill may rely on the outgoing party more heavily than you realize and the buyer more often or not will need to rely on the seller's goodwill after purchase.

Find out quickly what is driving the seller. The ideal seller is a motivated one. Make sure they are driven by personal circumstances, not something bad about to happen to their business. Why do they really want to sell? Are they telling you the truth, the whole truth and nothing but the truth? What will they really sell for? How influential is their partner on them? How key is their role really? Is there anything that they don't want you to find out? Are they serious about selling or are they just testing the market? What does their body language tell you? What are their expectations after sale?

This is a two way process. You will need to get the most out of the seller to reveal your motivations and situation. Often, particularly if being handled by a broker, you may need to provide evidence of your financial ability and to provide an undertaking to ensure that the information given to you on the target is confidential.

If it is an owner/manager selling it is highly likely that they will have an emotional connection to the enterprise. Be aware and respect this, it may well work in your favour, particularly if you play on sentiment to get the price down. Reassuring the seller that you care about the future of the seller's business as much as they do will give comfort to uncertain sellers. Try yourself to avoid emotion, maintaining an objective overview of your discussions, yet at the same time present enthusiasm to the seller about what you offer.

What a seller wants for a business should not really influence you that much. Do your own calculation of its value to you, irrespective, and then close a deal at this figure or below, or walk. If you find a business you like, but not at a price you like, make a firm offer anyway. Every month send the seller a reminder that your offer still stands. There is nothing like time with nothing new coming up to reduce the price in the seller's mind. Patience is a virtue few entrepreneurs have because they have learnt to deal with things urgently to survive and beat the competition.

If the seller is not getting exactly what they've asked for, they want to sit around for a while and find out what other offers are going to be made. When the offers stop, their mood changes. If they are sitting around and feeling disheartened because nobody has given them a realistic offer, and you've been consistently interested, they might just call you. Keep looking until the ideal conditions are met.

Prepare the questions you want to ask and the answers you can expect to be asked by the seller. In summary these should include preparation for the following in addition to any relating to the specific enterprise in question.

Look for potential

In 2000 Philip Green brought the UK based High Street retailer BHS with over 160 stores for £220 million. After just two years BHS reported a 202% profit increase. Analysts valued the business at over 6 times its purchase price; some improvement. Green brought a poorly perceived business, which was considered by many to have had its day, then with tight financial controls changed the way the business thought about itself, in particular in the buying area. They were very tough on suppliers driving purchase down. Just think: 1- 2% extra margin on sales of Y = an increase in profits on the bottom line of X, less any cost involved in negotiating.

When you look at a business and assess its value, you are assessing your own or your organization's ability to take it forward. You are after all buying its future profits, not its historic profits. So you need to know what resources you have that can add value to a business. These can include financial muscle, knowledge and contacts within an industry, sales or marketing expertise, or just a very creative commercial mind that can see opportunities that others miss.

You do not want to buy an average business with limited potential at a bargain price. You do not even want to buy an excellent business with limited potential at a bargain price. The potential is the key. If the current business owns a corner shop and is keeping it open virtually all hours, then there is probably little scope for development.

The potential can sometimes be found by looking at it a different way, and it works just as well on a smaller scale than BHS. A friend, Homayoon Fassihi, bought a small laundrette some time ago in Norwich with a flat above. The laundrette was really at potential in terms of local residents. However, the 12 machines were inoperative for about 15 of the 24 hour day. The marginal cost of running a machine was next to nothing. So Homayoon walked into hairdressers in Norwich and said to the owners, "You obviously need to wash a lot of towels every day, how much does it cost you?" The answer was that they sent one of the staff to a local laundrette and paid the slot price. Homayoon said, "I will pick them up and deliver them back to you at any time you like for less price than you are paying now, plus you have your staff back instead of sitting in a laundrette. Can I have the business please?" He expanded to other hairdressers, theatres, government instructions and even airlines. Soon his machines were working 23 out of 24 hours. Clearly at this point growth was limited and he moved on. Talk about a money making machine!

Business owners can get so focused on day-to-day management issues that by definition they rarely get the chance to stand back and look at the bigger picture objectively. Thinking big and objectively can mean that you can see different routes to exploit for profit that have been missed. A company for example, might be selling most of its wares via its web pages. Yet have they explored the idea of selling via other people's web pages on a sales commission basis? This is an example of an idea asset. No financial resource is required here and yet the idea alone, when put into action, can make a big difference. Whatever a company sells, there will always be alternative routes to market. Uncover one and you can buy yourself a bargain and be in for a capital gain in a relatively short period of time.

As well as growth opportunities, most businesses offer cost savings. We all understand the difference between a profit and a loss. What fewer understand is the concept of a hidden loss. A hidden loss is the difference between the profits made and the profits that could or even should have been made. Buying a business is not just about analyzing the profits and losses but looking for the hidden losses. Are there too many staff, could better systems speed up production, etc.

The following is a list of some of the things we look for in an acquisition. Clearly each purchaser will have his or her own requirements. We use a very basic grading system to score each target. It does not matter what the technique is so long as the scores are kept objective, impartial and consistent across each potential target. We use 10 as good.

<table>
<tr><th colspan="3">A. Basic grading model</th></tr>
<tr><th>B. The good</th><th>C. Grade 1-10</th><th>D. The bad and the ugly</th></tr>
<tr><td>Motivated seller</td><td></td><td rowspan="16">The opposite is usually in the bad and ugly, but be wary of grading bad as a downside. Some bad elements in a business present opportunity. Look for negatives that can be turned around but also used as a bargaining chip.</td></tr>
<tr><td>Strong retainable management workforces</td><td></td></tr>
<tr><td>Strong matching culture</td><td></td></tr>
<tr><td>Strategic match with ideas</td><td></td></tr>
<tr><td>Sustainable profit record</td><td></td></tr>
<tr><td>Economies of scale obtainable</td><td></td></tr>
<tr><td>Clear and unique brand</td><td></td></tr>
<tr><td>Location or market limits potential</td><td></td></tr>
<tr><td>Quality personnel</td><td></td></tr>
<tr><td>Cost savings</td><td></td></tr>
<tr><td>Strong track record</td><td></td></tr>
<tr><td>Low cost of expansion</td><td></td></tr>
<tr><td>Expandability</td><td></td></tr>
<tr><td>Strong on-going customer relationships/contracts</td><td></td></tr>
<tr><td>Affordability</td><td></td></tr>
<tr><td>What barriers to entry are there</td><td></td></tr>
<tr><td>Strong systems</td><td></td><td></td></tr>
</table>

Build your business plan before completing the acquisition. There are arguments to say don't implement it until you have had the opportunity to listen and really get a feel for the business. However, much of what you are buying is, we hope, the potential for growth, so having some ideas on how these can be achieved is a pre-requisite prior to every acquisition. Ask:

Staff:

- What motivates you?
- What ideas for improvement do you have?
- What training would be appropriate to improve productivity?
- What decision could be made right now, to make your job easier?

Customers:

- Who shall I meet with first?
- Can we offer anything extra to them?
- Why do our current customers use us?
- Can/should our prices be raised?

Operations:

- What is the least efficient process in the company?
- How effective are the IT systems?

Marketing:

- Have they got an effective web presence?
- What advantage do they have over our competitors?
- What opportunity are they under-exploiting?
- Have they a clear market niche?
- Are they focused?
- Should they move away from certain types of customer?
- What free advertising resources can we take advantage of?
- Are there any synergistic partnerships we could make?

Finance:

- How can cash flow be improved?
- Should I consider factoring?
- Where are they wasting money?

Staff meeting

Depending on the business, the staff can be a significant part of what you are buying. The problem being that staff, however valuable they may be to the enterprise, are free to resign at any time. They cannot be made to stay by law or contract, but they can be motivated to stay. The question therefore that you really want to ask is: 'If I was to be the new boss of this business would you stay, leave, or wait to see what the new change brings?' If your coming in brings new investment with it then they are likely to benefit significantly from the transition. For staff expansion brings opportunities for career progression.

As you don't own the business yet and it is a going concern, you have to be very diplomatic in meeting staff. Often vendors will quite reasonably not let you meet the staff to protect confidentiality until terms and legal matters have progressed significantly.

You have to be able to make a judgement; are they the sort of people you feel you could lead? What are their hopes, frustrations and ambitions? Sometimes you will have to judge this from an overall impression of how they respond, their body language, work atmosphere, how they react to each other.

If there are really key staff, it is possible to bring them into a deal by agreeing with the vendor that he/she will pay a loyalty bonus after the staff stay with you for say six months after completion. Other ways might be improving packages or offering a share incentive scheme.

On a technical note, if you are buying just the business assets and goodwill, not the shares of a company, then in the UK the transfer of undertakings of employment legislation (TUPE) will apply. This means that all staff contracts are assigned to you as they stand automatically on purchase. Please refer to your legal advisors for more detail. In particular there may be an obligation to consult with the staff about the transaction, which clearly has implications for both buyer and seller. There is a particular obligation to consult if you intend to change terms on purchase.

Due diligence checklist

The due diligence process is a fact-find mission or survey designed to ensure that the representations being made by the sellers are true, and that the business is sustainable without hidden liabilities. Buyers should be wary however. The past is not a guide to the future and as many questions should be asked in the due diligence process about 'what next' as they are about the past. Indeed, the most positive way to undertake the due diligence process is not just to check the business, but also to use it as a very real part of the future of the business, forming a base for business planning. This double whammy approach also gains the most value out of it. Instead of a survey to cross the T's that ends up in a drawer, the process can identify weaknesses and threats, all of which present opportunity and challenge.

The idea of due diligence is, as the name implies, to diligently check all aspects of the business. In particular, if shares are being bought the new shareholders will inherit all previous liability whether known or otherwise. Indeed, this is why most buyers would prefer to just buy the assets from the company rather than shares, however usually this makes the tax position untenable for the seller. Liabilities for previous activities such as environmental issues or revenue claims are typical, and although these can be warranted and indemnified (financially guaranteed by the seller) in the legal contract it is still much better to be aware of what you are getting into. The due diligence process also helps as issues identified can form the basis of extra covenants to include in the legal contracts to manage the risks associated with a deal.

The due diligence formally starts when you have reached an agreement on principle on the purchase and you will now be inspecting all of the records. Eventually you will find out all its secrets, but you want that to be before you buy. Make sure you are not put under pressure during this period. Do all the checking you need to do before progressing. Your due diligence checking should cover every aspect of the business. The vendor should allow you and your advisors access to do so. Anything they don't want to give you access to, be wary over, although respect that there is certain key information they may need to keep to the last point to protect the goodwill until contracts are nearly agreed.

It is entirely possible for a buyer to do much of the initial due diligence work themselves, however it is a very in depth job and the benefit of employing a skilled professional to produce a report is they should have significant experience of what to look for. All corporate lawyers and most accountants can help in some way and they should be insured for the job. Most corporations will have someone internally who can help them manage the process. Don't assume the professional will find out everything 100%, its your money you are spending after all. Double-check and double-check again and use your common sense. Also make sure if using a professional you manage your costs.

If the due diligence process shows the business in a bad light either drop the price or, failing that, walk away. We recommend breaking the process into 5 areas. The following is a basic initial list and not intended to be exhaustive. The cultural one is an unusual fifth, however, as in a recent survey over 70% of Chief Executives felt that their acquisitions underperformed and they identified cultural reasons as the biggest contributor. Their two organizations just did not on reflection understand each other.

Legal	**Financial**	**Commercial**	**Property**	**Cultural**
Employee contracts, personnel files	Files on pensions, profit shares or bonus payments	Registered brand names, patents or copyrights	Health and safety	Management style
Any commitment/ promises to any supplier or customer or staff	Any seasonality in sales or customers over 10% of business	Complaints	Environment assessment	Age and length of service
Any potential claims – environmental, employees	Asset valuations and resale values – fixed asset register	Pricing policy and terms and conditions to customers	Copies of leases	Past track record
Memorandum and Articles of Incorporation	Stock ordering and levels	Marketing files, including brochures and web page	Schedule of any dilapidations	Staff ambitions and aims
Minutes of Board of Directors, Committee and Shareholder meetings	Tax and VAT policies	Brand and press profile	Property surveys	Staff policies, holidays, cars expenses culture

Legal	Financial	Commercial	Property	Cultural
Details of current shareholders and other interests in the company	Insurance		Site plans	
Overviews of any pending legal cases	Bank guarantees and charges			
All contracts, customer staff	Aged debtor creditor list			
	3 years accounts			
	Accounts projections/ cashflow forecasts			
	Management accounts			

In summary the aims of the due diligence process can be to:

- Ascertain the true value of the business and that the right price is to be paid.
- Identify hidden or potential liabilities to be managed in the legal contract.
- Find hidden profit and opportunities.
- Ensure there are no cultural clashes with your plans or organization.
- Make sure that all facts are being disclosed and the vendor and their advisor are telling it how it is.

Potential purchase timetable

	Responsibility	Item	Month					
			1	2	3	4	5	6
1	Board/Me	Identify your strategy	•					
2	Board	Choose professional advisors (see note below)	•					
3		Research	•					
4	Appointed head of project	Contact Brokers	•					
5		Potentially employ acquisition advisor to help with research, valuation and negotiation	•					
6		Look at direct approaches	•					
7		Shortlist prospects	•					
8		Agree confidentially	•					
9		Provide within reason initial information on your financial position/reason for interest	•					
10		Obtain key financial, business information	•					
11		Analyze business information	•					
12		Visit vendor		•				
13		Assess vendor		•				
14		Checklist against your buying criteria		•				
15		Does it match now, or can it with potential		•				
16		Identify objectively its value to you		•				
17		Research funding options if serious to assess your ability to finance		•				
18		Negotiate hard but non adversarial		•				
19		Listen to vendor			•			
20		Wait if they don't accept	As required					
21		Agree heads of terms (exchange of letters outlining key points of your agreement subject to contract, to create clarity and avoid moving goal posts)				•		
22		Apply for funding				•		
23		Instruct lawyers				•		
24		Seek regulatory approval if required				•		
25		Set target for completion				•		
26		Carry out due diligence and instruct advisors to help				•	•	
27		Negotiate with legal advisors definitive sale contract					•	
28		Manage lawyers/advisors to completion						•

Note: Good professional advisors will help you free with initial research if you go and see them, and undertake to use them as you progress matters. Most offer 30 minutes free advice if you approach them in the right way. Be careful not to employ them unless you have specific need.