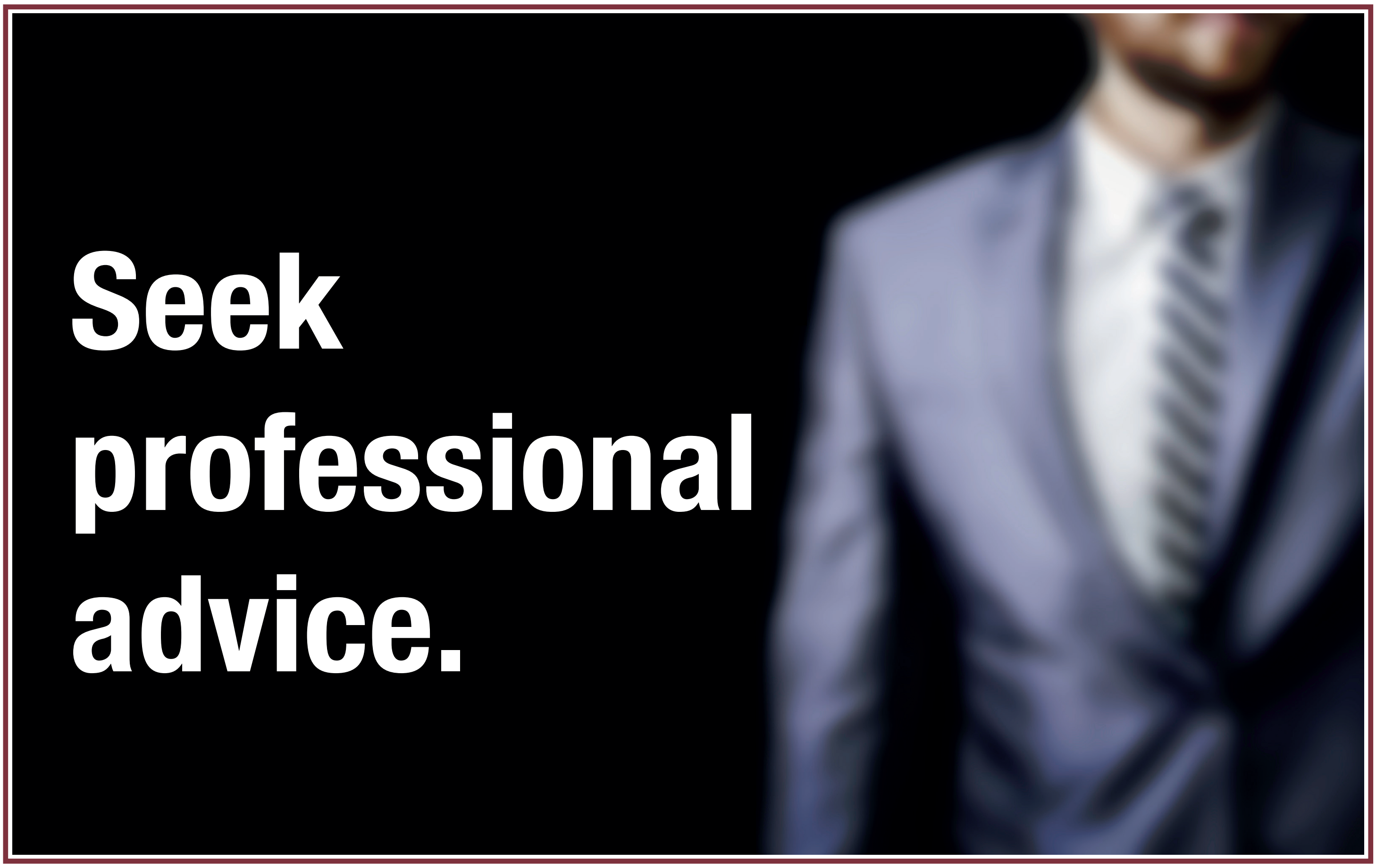
BUYING OR TAKING OVER ANOTHER BUSINESS?

Don't ever forget ***Caveat Emptor - buyer beware*** - always applies when buying or taking over an another business.

By Kim Radok - July 2020



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DISCLAIMER:

As a risk management professional with 50 years of experience in the world of business, I have been involved with a number of business take-overs, and started 4 businesses on my own or in partnerships.

This feature is a product of my experiences and observations.

In all business purchases and take overs, it is highly recommended that you seek specialised professional assistance. This feature is for informational purposes only and is not to be relied upon as professional advice.

INTRODUCTION

The three greatest benefits of starting a new business are:

1. the blank canvas you start with;
2. your vision and positive enthusiasm; and
3. all the exciting possibilities that might exist for your future.

In addition, when starting a new business, there are fewer hidden traps within the business or liabilities such as undeclared debts, disenfranchised employees, poor supplier relationships, overvalued stock and/or customer lists, and other factors which are the product of "creative accounting" etc.,

The main drawbacks however, may be your blind enthusiasm of the concept, a lack of sales history, proof of market acceptance, and where actual profit potential is not known or proven. Another negative factor may be your lack of experience in operating a business. Just because you're proven as a successful, salesperson, technician, tradesperson etc, doesn't mean you'll adapt quickly enough to managerial/employer/ownership roles. The major distinction between the two types of positions is because as a manager, employer or owner, unlike the other roles where you "work in the business", you need to "work ON your business," (as well as) "work IN your business".

When we talk about buying an existing business, that is a whole different ball game. Yes, there are the benefits of having an existing business structure. Branding, marketplace, employees, customer base, established supply chain and resources for example. There are also liabilities, many of which, are not always properly exposed or researched, leading up to, or at point-of-sale.

As with buying a house, overwhelming excitement and the naïve belief that "everything will work out," is why buyers need to be careful. As with any other large purchase in your life, taking care properly is paramount. That is why you need to carefully research, conduct proper due diligence, and engage professionals which have no emotional attachment to the targeted business, to conduct an unbiased analysis. These actions will either support your enthusiasm, raise pertinent questions, or help avoid an unforeseen financial and emotional disaster.

Let's face it, there are many positive attributes about buying another business. I suspect you already know many of these positives when contemplating the takeover of your targeted business. What you may not be so aware of, or take the time to research, or conduct due diligence properly, are the negatives of this business.

Before proceeding further, here are a few real-life examples which illustrate some of the negatives of taking over an existing business.

REAL-LIFE STORIES

The Desperate Buyers

Many years ago, an old man was contemplating selling his business. A final decision had not been made nor had the business been advertised for sale. As if on cue, a major business from overseas decided they must have his business. The potential buyer completed due diligence and offered the old man $10 million. He counteroffered and said he wanted $20 million.

After rechecking their figures, the buyer said they believed the business was only worth $10 million. The old man stuck to his sale price of $20 million. In the end, the buyer, desperate to gain a foothold in the Australian marketplace, paid the $20 million.

On taking over the business, the buyer found out that the business was only worth $10 million.

The Former Owner Started a Similar Business

Some years ago, a friend purchased an existing business. Soon after, he found that the owner had not repaired the building to the agreed standards in the sale contract. It took financially expensive and emotionally draining legal action to force the previous owner in to completing the repairs properly.

Later on, my friend found that the previous owner had also set up a rival business in contravention of the sales agreement and was directly contacting his former customers. This of course affected my friend's business negatively. After taking legal action my friend was able to obtain further compensation. The win however was in many ways a hollow victory. The process, associated stress and legal costs were barely covered by the compensation for the loss of business and the distraction from growing the business.

The Employees Abandoned Ship

Many years ago, one of our customers sold his business. The transaction included retaining the existing employees and their associated liabilities, (holiday pay, long service entitlements etc.).

Like the earlier example, the previous owner set up in direct competition and enticed his former employees to join the new business. They did so, in mass, and the new owner of the old business had to pay the employees all their entitlements. In doing so, the owner used up all his working capital and savings and had to close the business.

The new owner's loss may have been avoided by seeking professional advice because they might have then understood the issues which are involved when buying another business. Instead of having a promising business future, the new owner lost everything due to their naivety, blind faith and the unscrupulous behaviour of the previous owner.

Failing to Listen to Professional Advice – (Not Their real Names)

A number of years ago, an acquaintance of mine who we'll call Fred, shared with me a story about one of his customers who we'll call Jim.
Jim owned one business and was considering purchasing a competitor's business. Fred engaged his professional consultant Peter, to advise Jim on the business acquisition. After talking through the issues with Jim, Peter provided Jim a takeover strategy. However, Jim not wanting to spend any extra money, declined Peter's recommended action and then proceeded with his acquisition, without having a professional validated strategy.

Fred went on to tell me, that after a year of Jim operating the consolidated business, Jim had suffered a considerable downturn in cashflow and sales. In the end, Jim had ended up having to finally implement the consultant's advice. The takeover costs had increased and the cashflow had failed to meet Jim's expectations.

Effectively, the lack of respect for professional advice had caused a delay in the development of Jim's new business by a year and all benefits of the takeover were lost.

The moral of these stories

The rationale behind including these real-life examples is to alert you to actual outcomes that you may not have considered before you enter into or sign a contract of sale.

In addition, I cannot emphasise the vital importance of reading and FULLY UNDERSTANDING ALL the fine print of the sales contract. If you're not TOTALLY SURE about each and every insertion and clause, then, without question, engage unbiased experts to decipher the legal terminology – so YOU KNOW what you are legally agreeing to.

Then, even if you are confident in understanding the contract, I strongly urge you to seek a second opinion – from unbiased professionals which specialise in business acquisitions.

BUYING OR TAKING OVER ANOTHER BUSINESS – THE PROCESS

As with any investment, buying an existing business is not without risk. While it may be very exciting, this enthusiasm for the purchase, can override common sense.

On completion of the buying process and taking control of the targeted business, there will be times when you doubt you've made the right decision. There may even come a time when the investment you envisioned, has not materialised and what you bought has turned out to be something else.

Buying another business rarely goes smoothly, irrespective of how much due diligence and investigation is completed. The nature of any business is that it is always in a state of change and the financial reports are always historical. In essence, there is no guarantee the results of the past can be repeated in the future.

In stating that nothing will go smoothly, does that mean you should never buy or take over another business, especially if it is not perfect? No, of course not. Nothing is that simple and a case of too much caution, means you might miss out on a great buying opportunity. What I'm recommending is that you take care in your decision making after identifying all the issues revealed by your due diligence investigations. Your investment decision must account for all the identified problems, costs for improvements and catering to the extent of your available capital.

Please note, "capital" in this sense means cash in your bank balance, not the extent of your finance facilities, (borrowing power). The difference is that cash in your bank account is your money and debt is other peoples' money. Debt allows you to use other peoples' money to pay for your wants today. Debt is not free however and needs to be repaid WITH INTEREST. Repaying debt and interst increases your operating costs. In today's troubled world, taking on debt could well be the additional liability which ends up destroying your dreams.

COVID-19 and Recession Warning

With due respect, now that the COVID-19 virus has struck and the recession is already here, greater care is required like never before. Failing businesses will be offered for sale. Not all of these businesses will be a good buy because of hidden liabilities. A small number, however, may offer a wonderful opportunity to make a really profitable investment. The two main problems you face will be ***(i)*** sorting out the the good businesses form the bad, and ***(ii)*** not overemphasising the potential of the targeted business to be profitable.

Where to begin and what to look for?

Obviously, you have started with a vision of what you expect your new business to deliver. Having made your decision, you start your investigations on all aspects of that business.

The following information is a brief overview on what I would be looking for as a professional risk manager.

There should also be reviews by other suitable professionals on the areas of the business in which you lack the expertise. Depending on your level of expertise, a second opinion in the areas of your expertise might also be wise.

No one specialist can provide a complete picture of all the benefits and negatives of your targeted business. Therefore, it is recommended that you engage the advice of a professional whose sole job is to find the negative aspects of the targeted business. Once the negative factors are identified, you can calculate the costs required to fix them, plus the revised future operating costs and projected income. Obviously, the potential costs must fall within your available cash resources to repair, improve and operate the business.

Again, as with any investment, acquiring a business is not without risk. This feature is simply trying to help you understand the risks involved, some of which may be otherwise overlooked, when making your informed decision.

The following areas requiring proper research and are in no particular order of sequence or priority. As a prompt decision-making is usually preferred, several of these factors can be reviewed simultaneously.

The financial reports

The financial reports should be and are usually the first items to be studied. Most financial reports that have caused problems for investors were designed to tell a story in favour of the current management and business owners' interests. As such, and based on my experiences, many financial reports are less than reliable for the potential purchaser.

You may consider the above observations unkind and unprofessional. The truth is however, I have seen far too many new business owners of acquisitions caught out because of the exaggerated and blatantly misleading figures provided by the sellers.

At best, financial figures always present a historical picture of the targeted business and with the pace of business and change today, they are often soon out of date and unreliable.

Should we disregard financial reports then? In my opinion, no. A review of the financial reports with an open mind and a bit of common sense, plus a second opinion, is essential. If completed properly, your review provides a wonderful insight in to the behaviour, operating strengths and weaknesses of the current management and business owners. If you complete your due diligence on the financial reports properly, you soon start to see:

- whether the financial figures were reasonably accurate;
- the operating ethos of the existing management and the business owners;
- what type of management reports are available;
- the culture of the organisation; and better still,
- a more realistic value of assets and liabilities, both tangible and intangible etc.

Based on my experience, the most important aspects of the financial reports would include:

- the valuation and process of valuing goodwill;
- ascertaining how valid is the goodwill figure compared to how the business is viewed in the business community;
- whether all payable and receivable accounts are reconciled;
- comparing invoices raised for products and services from orders received;
- identifying how many forward orders or how much work in progress is subsequently

actually invoiced and paid, and whether part payments or deposits have been made;

- identifying profitability per customer;
- identifying repeat business per customer;
- the reports on processing errors, including the nature and costs of the errors:
- amounts outstanding and write offs;
- systemisation from procuring sales, all the way to invoicing and prompt payment, etc.

The quality and professionalism of existing employees

The reason for raising two categories of employees, quality and qualifications, is that the quality work by an employee is just as important as the academic or trade qualifications of the employee. After all, there are employees without academic or professional qualifications who are just fantastic employees in every sense of the word. For instance, they take ownership and pride in their work, and know how your customers and suppliers operate. These employees are usually also customer friendly and focused on presenting your business in the best possible light.

Equally, there are employees which may have appropriate qualifications, which can cause a lot of trouble for your business if not managed properly. For instance, you may have highly qualified people who are without peer in their chosen field of operations. Some however, should never be let near your suppliers or customers. Other people may also be very good, yet because of their behaviour, sabotage your efforts to create and operate a team environment that benefits the business overall.

If a business is to be truly successful, it is essential for all employees to operate together as a team, in harmony and with due respect for one another. There is one great disadvantage of “teams” or departments however. It is their endless competition for resources, kudos and attention as they each seek to prove their worth to management.

What should never be forgotten however, is that the real enemy is outside your business, and I don’t mean just your competitors. The enemy ranks include manipulative customers, untrustworthy or incompetent suppliers, fraudsters and don’t forget government regulators and Non-Government Organisations (NGO) bureaucrats.

The fact is that many regulators and bureaucrats may have never worked in the real world, let alone owned or operated a business. Therefore, although their intentions in enacting Legislation and Regulations may well be intentioned, in fact, many of their interventions have negative and unintended consequences. As a result, people seeking to avoid their responsibilities and fraudsters benefit, and honest businesses and credit providers are penalised unfairly.

Finally, and not least, since the advent of social media, you can also add the trolls and those which cause mischief by posting false and fraudulent stories online. In today's modern world, no one is ever truly safe from those with bad intentions.

Do you have enough of the right employees?

This may appear to be a strange question when taking over another business, you usually find there are too many employees. History shows however, despite the increased numbers of employees, often there are not enough of the right type of employees to make the purchase profitable. To reshape the newly formed business and continue to trade efficiently and profitably on a day-to-day basis, is a different proposition to actually merging two businesses in to one.

When buying a business, there will usually be problems which have been hidden from view, some of which are with the support of management. Such problems are hidden to show the business in a better light to complete a quick sale. These problems could be caused by poor operating procedures, disenfranchised employees, or the mistakes of overworked employees etc.

In such situations, you are also likely to find that file maintenance has been neglected and often out-of-date, which means the business is:

- trading with customers with a changed business identity, which in turn invalidates any trading terms previously agreed upon;
- the trading/credit contracts are also out of date, which renders them useless in protecting the business's goods and services;
- key personnel at your suppliers and customers have changed and previously respected relationships lost;
- supplier operating systems have been changed which causes delay in buying essential products and services;
- customers' operating systems have changed, producing delays in purchase orders and/or invoices being authorised and paid, etc.

These problems are further magnified when one business takes over another business.

What is not factored in the costs of buying the targeted business are the amount of time and costs required to create an efficient new business. These include;

- re-establishing valid and respected trading contracts and relationships;
- creating and obtaining new and updated trading terms and conditions suitable for the current business environment;
- having suppliers and customer sign and agree to new business terms;
- the cost of identifying and fixing the previously hidden problems of the business;
- the costs of fixing outstanding mistakes;
- resolving existing disputes with customers
- resolving existing disputes with employees
- designing improved systems for each department for improved efficiencies, etc.

Other employee costs

Whenever you takeover another business, there will be unforeseen additional employee costs. For instance, you might need to take on all existing employees initially in good faith.

In time however, more than likely, you will have to “let go” a number of the employees who prove superfluous or unsuitable for the needs of your new operation. It is always best to do this legally and pay-out their entitlements properly. Today, not doing so, usually results in an additional financial and emotional costs which could be better used in the development of your new amalgamated business.

Alternatively, you may need to employ new people capable of fulfilling the needs of your new business.

Furthermore, you may need to pay out and replace all your employees who decide to leave your business for other opportunities, or because they decide to retire. Then again, perhaps the previous business owner may attract your employees away because they started another business in opposition. Refer to our earlier story on this subject.

To survive, it is essential you understand and have the finances available to cover all these situations before you buy the targeted business.

The suppliers

Irrespective of the type of business you buy, or marketplace you operate in, it is essential you know whether your suppliers can be relied upon and what terms of sale or credit they might offer if you buy the business.

It is no good going in to business if there is only one supplier. After all, if that supplier should go out of business, you don’t have a business

The situation is similar if you need to buy your goods from overseas. What happens if you become unable to purchase and/or receive product due to international circumstances? For example:

- international trade agreements change causing downsizing or cancelation of production;
- a change in tariffs and or duties;
- problems with shipping,
- payment issues or other unforeseen circumstances?

In today's world, we are experiencing previously unconceivable events, proving that anything is possible

What is the on-going quality and source of your suppliers' products and services? These days, the source, quality and ethical purchasing of products and/or services is another important part of your business success.

Additional questions pertaining to your suppliers include the following.

- Do your suppliers offer credit, or do they insist on COD?
- Will your suppliers even give you credit because you are a new and unknown customer?
- Do you need to pay upfront and if so, what are your assurances of receiving what you ordered, not only in quality, but quantity and agreed delivery date?
- Are discounts available for early payments or cash upfront?

Unfortunately, you cannot simply buy a business today and expect the existing suppliers will accept your application for business, let alone, on credit. In today's environment, there is also no assurances the suppliers are financially viable. How can you be assured these suppliers will remain in business after your takeover? Should that happen, what alternative brands, products and/or service providers are available, and will they accept you as a new customer?

Your customers

Customers are one of the key components of business success. They are often not treated as such when assessing the true value of the targeted business, because a business without or with too few customers will soon not survive. You also need to know whether the targeted business has profitable trading relationships with its customers. Without a level of comfort on the level of profits, you cannot be sure there will be enough profit from sales in the future to pay your ongoing bills.

When you take over an existing business therefore:

- you need proof that existing customers pay within terms of credit, if it is offered;
- are there verified and documented evidence of the customer's legal entity which operates the business;
- are there agreed terms of trade which have been signed off by authorised officers; and
- is there a separate statement of any potential liabilities or problems that might exist?

Many new buyers will only take a cursory review of the Debtors Ledger. All too often AFTER taking over the business they find the value of the Debtors is nothing like what they were "sold" and paid for because it hid a thousand problems. What usually has caused the discrepancy in value was ***(i)*** the customer accounts were poorly maintained, ***(ii)*** the accounts employees were inexperienced and did not allocate payments correctly, and ***(iii)*** management had refused to clear liabilities prior to the sale to inflate the value of the business.

Whichever the case, it's most unlikely you will be compensated for the difference in value of the Ledger because the loss was avoidable. After all, if you had completed a reconciliation of the customers' accounts, all the problems would have been exposed.

The lesson therefore, is when acquiring an existing business, don't just reconcile the Ledger, reconcile all the accounts themselves, or at least the major accounts.

A reconciliation of the Debtor's Ledger only reconciles is major components, not the individual accounts, which shows up the specific outstanding items in each of the customers' accounts. An unbiased, professional audit is highly recommended. It may appear expensive, (and may be discouraged by the seller, which in itself should raise alarms). That cost will however pale in significance compared with the disastrous post purchase reality of finding that the cash you expected to collect from customers is far less than expected.

Reconciling customer accounts also provides a wonderful insight to the business's operations, quality of employees, business disciplines and opportunities to improve the profitability.

It would also be wise to understand the former operating ethos behind the sales and accounts receivable operations. It is this understanding which enables you to identify the areas in which you can add value to your investment.

There are no secrets anymore

One advantage we all have today when buying another business, is that there are no secrets anymore. Better still, you do not have to take any illegal action to find out about your targeted business. There is plenty of public information or reputable researchers available if you don't have the time and/or expertise yourself.

Whether it is public databases, or social media, you can soon discover the financial reputation, social footprint, employee relationships, or quality service ethos etc. There is no excuse for not investigating the status of your targeted business. After the purchase, it would be devasting to realise your business was:

- a front for criminal activity;
- always in trouble with government bodies and regulators;
- considered to have a deplorable customer service ethos;
- often refused credit and has to pay cash upfront;
- always causing problems for suppliers and customers;
- a poor workplace where the employees hated their work and/or management;
- found to have employees which were lazy, incompetent and rude;
- considered to be poor corporate citizen and thereby alienated a large part of their potential market who refuse to buy from them; etc.

At the end of the day, failing to properly complete research of the targeted business and seek out the secrets of the business could be a costly investment, especially when there are no secrets anymore.

Reading between the lines

During the evaluation process, you and your advisors are likely to spend a great deal of time with the existing owners and/or management. During this time, it is imperative that you become absolutely convinced as to WHY the business is offered “for sale.”

When all is “said-and-done” your pending purchase is an “investment” opportunity that you are relying on to increase your wealth. You are also going to pay good money for it, and rightfully expect value and a positive “return-in-profit.” Meanwhile, the sellers will be doing their utmost best to convince you that buying their business is a great investment.

Again, while investigating the physical value of the business, that is the time to identify and convince yourself that the owners are selling the business for the right reasons. It is not unheard of for a business to be sold because of pending problems or potentially heavy liabilities which may not be known or readily visible.

As part of the process of evaluating the targeted business, don’t forget to ask the question about buyer interest. For instance, why aren’t management, friends and family already trying to buy the business? If they aren’t a potential buyer and the business is such a great buy, that may be another indication of future problems. If there are no other potential buyers, are you really buying the opportunity of a life time?

It is not just good enough to complete the physical tasks of due diligence you also need to understand the value of the “gut feel” after completing the physical checks. You may not have the experience to have a gut feel about the value of the business. The truth is, most of us do not have the luxury of having dollars to lose if the investment fails. You should therefore listen to what your experienced advisors have to say about their own feelings. An experienced business person never discounts the gut feeling they have when reviewing a business proposition.

CONCLUSION

When we talk about buying an existing business there are the benefits of having its business structure, branding, marketplace, employees and resources in place when you take it over. There are also liabilities, many of which, are not always properly exposed or researched prior to purchase.

There's little doubting the advantages of an existing business' structure, (assuming they are as genuine as reported). It is the purchaser's responsibility however, to discover any and all shortfalls which may have been hidden.

Let's face it, there are many positive reasons for buying an existing business. What you may not be so aware of, or take the time to research, or conduct due diligence properly, are the negatives of this business.

Buying another business is not without risk. It can be very exciting and because of this excitement, or perceived need to buy the business, these factors can override your better judgement or common sense.

After buying and actually taking over the targeted business, there will be times when you will wonder whether you made the right decision. In reality, buying an existing business rarely goes smoothly, irrespective of how much due diligence and investigation is completed. The nature of any business is that it is always in a state of change and the financial reports are always historical. Therefore, there is no guarantee you will be able to replicate the past results. In addition, you still need to be aware of the possibility of any "creative accounting practices" which may have been created to produce a rosier picture of the business.

In stating that nothing will go smoothly, does that mean you should never buy or take over another business, especially if it is not as perfect as you might want? No, of course not. A case of too much caution, means you might miss out on a great buying opportunity. What is recommended is that you take due care in your decision making after identifying all the issues revealed by your due diligence investigations. Afterall, the ideal acquisition is of a business where you see possible improvements which lead to greater profits.

Your decision needs to account for all the negatives according to the size of the targeted business and your bank balance. In today's troubled world, taking on debt is not always a good option for many reasons. At the end of the day, taking on additional debt could be the additional liability which ends up destroying your dreams.

Finally, do not forget the COVID-19 and recession warning

With due respect, now that the COVID-19 virus has struck and a recession is already here, greater care is required like never before. Failing businesses will be offered for sale. Not all of these businesses will be a good buy because of hidden liabilities. A small number, however, may offer a wonderful opportunity to make a really profitable investment. The two main problems you face will be ***(i)*** sorting out the good businesses from the bad and ***(ii)*** not overemphasising the potential of the targeted business to be of value and profitable.

If you would like to discuss any aspect of this feature in more detail, or would like more information, please contact us at info@creditmatters.com.au

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Your Cash Flows Defence Against Profit Robbers

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