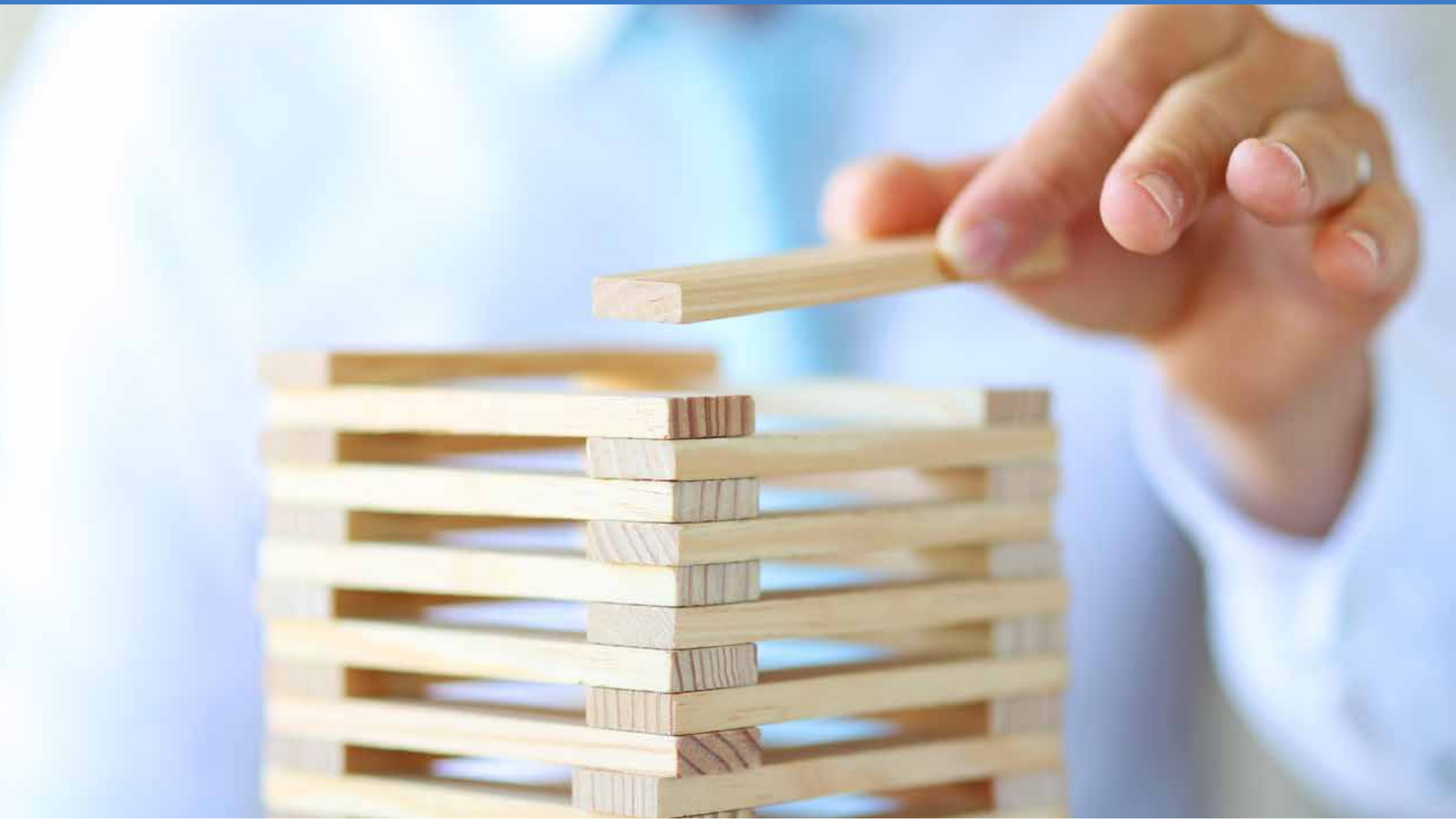

Primary Considerations When Acquiring a Business

INVESTORS
COMMUNITY BANK

WHO WILL GET THE GREATEST VALUE FROM THIS EBOOK

Business owners who are interested in acquiring an existing business (especially when that business complements the owner's other enterprise), and entrepreneurs looking to engage in a new venture by doing the same.

Primary Considerations When Acquiring a Business

There are plenty of reasons for a business to consider acquiring another company, especially if the acquisition target is a quality competitor or a business that's symbiotic to its existing operations. These are just a few of the potential benefits of an acquisition:

- Access to new markets
- An expanded customer base
- Increased production or service capacity
- Improved cost structure
- New products, capabilities and/or technologies

Whatever your motivation to pursue the purchase of a business, this eBook can help you better understand some of the most important factors to be considered before and during the process. We'll take a look at:

- How to value a small business
- Steps to acquiring financing
- The best financing options
- Tips for ensuring management and employee continuity

START BY BUILDING A TEAM

Once you've decided to pursue an acquisition, the first step is to build your team of advisors. Acquisitions are typically complex transactions that involve several months of analysis, consideration and planning, and your team's input will be very valuable.

Start by involving an **attorney** you trust to take the lead in things like creating a letter of intent and business purchase agreement. You'll want to work with an attorney with demonstrated experience doing transactions similar to what you're attempting. If you don't know one, ask for recommendations from your professional network, starting with your banker and accountant.

Likewise, if your current **accountant** isn't comfortable being part of your acquisition team, ask for recommendations from your attorney and banker for an accountant with relevant experience. In both cases, you don't want to be the client they learn with; you want to hire professionals who show up with the experience you need.

You'll also want to involve a **business valuation consultant**. It's this specialist's job to determine what the business you're after is really worth. Again, select a consultant with demonstrated experience with transactions like yours. They'll likely consider several valuation methods to determine the best path forward (read about this in more detail below, in ***"Determining the Value of the Business You Want To Buy"***) and ultimately use one or a combination of methods including asset, market, and income valuation. Discuss with your consultant which makes the most sense in your situation and industry.

Of course you'll also want to involve your **banker** in the conversation as early as possible, as he or she can help you assemble this team. Your banker should have relevant acquisition experience, which means they'll be thinking about the best way to both structure the transaction on the front end, and position you for success by building the best long-term financing post-acquisition.

Additionally, your banker can help you understand all the options by connecting you with key advisors and relevant information to determine the true value of a prospective acquisition and ensure that it makes good business sense. If needed, he or she can also connect you with counseling services such as the SBA's SCORE. Some other resources include:

- **MBBA** (Midwest Business Brokers Association) — A trade association with an active network available to anyone looking to buy or sell a business
- **RMA** (Risk Management Association) — This organization can provide some good "rules of thumb" for benchmarking purposes and to help you know you're paying a fair value for the business

The most valuable guidance your banker can offer is to make sure your financing structure gives you the flexibility you'll need to run the business. Low rates are great, but you'll want to understand what kinds of stress your financing could put on your business as economic conditions and your business performance change moving forward. You want to be confident that your financing provides the flexibility for you to grow if conditions allow, and to survive the inevitable downturn that you're sure to encounter at some point.

DETERMINING THE VALUE OF THE BUSINESS YOU WANT TO ACQUIRE

Once you've identified a business you want to consider for acquisition, the logical next step is to determine the value of that business, so the potential acquisition can be evaluated as an investment.

This should be a fairly rigorous process, whether the subject is a multi-site manufacturer with significant plant and equipment assets or a professional service provider with thousands of customer histories. Regardless, business valuation should be undertaken with a level head that refuses to be influenced by the excitement of the chase.

Business valuations should be approached from multiple methodologies, both for the peace of mind of the acquirer and as an approach to bring buyer and seller closer together around objective views of value.

Here are three common approaches used. When and how they're used will depend on the business type, structure, buyer's intent and opportunity for strategic leverage.

- **Income valuation** — This is the most popular method, basing business value on the economic benefit it's expected to generate. There are several different formulas used with this approach, such as capitalization of earnings/EBITDA, current cash flows or expected future cash flows. An important factor in this method is the capitalization rate. The cap rate calculation is a complex formula and is one of the reasons using a business broker or certified valuation analyst can be helpful in acquisition transactions. Service businesses typically rely on this approach, since there usually aren't many hard assets, and an acquirer is essentially buying the future earnings/EBITDA.

- **Asset valuation** — An asset valuation approach is based on the fair market value of the company's assets less its total liabilities. It starts with the value of balance sheet assets and adjusts them for fair market value. For instance, the company may have 20-year old equipment that's fully depreciated but still has market and economic value because newer technology has not yet rendered it economically obsolete. An industrial manufacturer will usually have physical assets considered as part of the valuation, in combination with the expected future income, if the assets are being acquired with the intention of continuing operations.

- **Market valuation** — While this is not a frequently used method, brokers and valuation analysts may look at similar companies that have recently sold, or comparable companies traded on the public market to determine value. In general, this is the least used method because relevant comparables for small businesses are difficult to find.

Involving a Business Broker and Valuation Analyst

The company to be acquired isn't always conveniently located in your marketplace – in fact, it may be halfway across the country, especially if your business is highly specialized. Understanding the value of a business and its assets located in another region (where economic and market conditions are different from your own) can be tricky and, in that case, connecting with a business broker is a smart first step. If you're affiliated with a trade association, you can reach out for help in pairing you with a professional who offers these services in a specific area as well.

A business broker can often connect you with a business valuation consultant too. Some business brokers and accounting firms offer valuation services in-house, while others might refer you to a third-party valuation firm — regardless, make sure you're using a Certified Valuation Analyst (CVA). These experts work together as a team of advisors to help you with due diligence and even find other companies for sale that you hadn't considered. If the company you're looking to buy is local, ask your banker to provide opinions and feedback on solid brokerage firms and other advisors in the area.

A WORD OF CAUTION

Don't Let Your Emotions Get the Best of You

One critical piece of advice we offer buyers in an acquisition is to base the purchase price on value, not on emotion. Sometimes a seller, especially those who've worked tirelessly for a number of years building the business, may have an inflated idea of what the company is worth. Perform your due diligence, and don't let your own desire to expand your business motivate you to overpay. This is a misstep that could cost you dearly for years to come.

STEPS TO ACQUIRING FINANCING

Anyone who's started his or her own business from the ground up knows that it's an immense amount of work...and risk. Planning, permitting, construction, hiring, marketing, building a customer base, maintaining working capital and more all play a role in whether a startup business will succeed.

When acquiring an established business, however, much of the foundational work has been done and there are fewer unknowns — and, in some ways, less risk. Since there's a proven track record and established customer base, it's typically easier to get financing to purchase an existing business than to start a new one, but there are still important steps that need to be taken as part of the process. Whether you're a manufacturer, distributor or professional service provider looking to expand through acquisition, or an employee buying the business you work for, here are the key steps in the process to secure the best financing.

Align the Business With Your Expertise

The first thing to consider when contemplating an acquisition is your level of experience with that industry, market, or type of business. The bank will want to know that you fully understand the management responsibilities of your new venture and have experience in the day-to-day business operations, as these are critical factors in the company's ability to succeed and service the acquisition loan. For example, if you're an equipment manufacturer looking to acquire a tool and die shop that makes parts for assembly, that may be a natural fit with your existing business. As a customer of the tool and die shop, you already have a good feel for product engineering, quality requirements, and typical pricing, so you're in a good position to hit the ground running.

Conduct Your Due Diligence

Step three is to complete due diligence to make sure you're actually getting what you're paying for and have an accurate expectation of your most likely **rate of return**. You'll need to develop a deep understanding of the company's current cash flow and where growth is likely to come from — what you believe will happen in the first 3–5 years. If the business is concentrated in a relatively small number of customers, studying customers' business patterns and investigating the strength of relationships is definitely prudent.

If property is part of the sale, you'll likely also need to get an **environmental site assessment (ESA)** of the property. An ESA report identifies any existing or potential environmental contamination liabilities in both the property and any improvements (like parking lots and retaining ponds). This step is most important to manufacturing companies and operations that may involve chemicals and pollutants.

Provide Proper Documentation to Your Bank

The fourth step in the acquisition financing process is to assemble all the documents needed by your banker as he or she works at creating financing options. Key documents at this point include:

- A copy of the formal offer to purchase
- P&L and balance sheet trends over time, 3-5 years of history
- A listing of business assets with depreciation schedules
- Customer list and histories, any formal agreements or terms
- Historical and projected cash flow analysis
- An appraisal of the real estate and/or equipment you're purchasing
- A copy of the business valuation that was conducted
- Other relevant information to help the bank determine if you're able to manage the debt required by the business

Your banker will also want to understand your motivations, and the growth potential the acquisition represents, so any evidence, such as a formal business plan, that supports your assumptions and projections will be helpful in discussions about financing.

Proceed with Caution!

The most important point we'd like to make in this business acquisition financing overview is to make sure you're getting what you pay for. It's safe to say that there's no such thing as too much investigating, questioning, probing and evaluating when it comes to knowing exactly what you're about to buy.

With the help of an attorney, an accountant and a banker with experience in business acquisition, you'll be able to pinpoint real and potential problem areas, understand where your businesses are in sync and where you may run into issues that need to be addressed before or after the sale. In the process of conducting due diligence, you'll probably uncover factors you hadn't anticipated, and in these cases, make sure you don't "sugar coat" issues or dismiss severity; instead, be realistic about all the potential impacts — and your abilities to resolve them. The time spent critically assessing all aspects of the company you're buying is well worth the effort; in fact, it's what could mean the difference between your businesses' success or failure.

Following these recommendations can help the process go more smoothly and alleviate missteps along the way. Compared to starting a new business, acquiring an existing business comes with its own unique challenges and considerations, but with proper planning, you can reap many potential rewards as well.

THE BEST FINANCING OPTIONS FOR BUSINESS ACQUISITION

In terms of financing an acquisition, the most appropriate structure will depend on your current situation and the aspirations of the business, as well as the expected volatility or risk anticipated. There are four primary options available for business owners looking to acquire another business. These can be utilized individually or in combination with one another:

1. Seller financing. Sellers often play a role in financing the sale of their business; a recent survey of business brokers by online business marketplace BizBuySell reported that 60-90% of businesses for sale included seller financing as part of the package. There are a few reasons this occurs as often as it does. It may be that small business buyers don't have enough available capital to make a deal work without seller financing. What could also be happening is sellers sometimes prefer to finance all or a portion of the sale in order to reduce or delay his/her immediate tax liability. Seller financing can also be done in conjunction with a Small Business Administration (SBA) loan or with conventional financing.

2. SBA loans (Regular 7(a) or 504). There are two primary government-backed SBA programs available today, and both can be good options for financing an acquisition, if the borrower has at least a 10% down payment (rather than the 20-25% typically required with conventional financing).

SBA 7(a) loan program: For many acquisitions, an SBA 7(a) loan is a better fit than a 504 loan because it has broader uses and a more flexible structure. **Proceeds can be used to expand, acquire or start a business, including real estate, equipment, working capital and inventory purchases.** The benefit of this program is that the interest rate is fixed for the full term of the loan, on the full amount. The SBA guarantees 75% of the loan in case the borrower defaults, reducing the bank exposure to a large degree. These types of loans do have an upfront fee because the SBA charges 3% of the guaranteed portion. However, there are no prepayment penalties if you pay it off sooner than anticipated.

SBA 504 loan program: This type of loan can **only be used for business expansion (commercial real estate, land, construction, building improvements, and equipment)**, so it could be used in an acquisition scenario to finance such assets. An SBA 504 loan is often used when the borrower isn't as rate-sensitive,

A NOTE ABOUT LINES OF CREDIT

While a line of credit is not specifically used for acquisition purposes, talk to your banker when structuring your transaction to determine whether it's a good idea for you to initiate or increase the limit on your line in conjunction with an expansion. You'll want to make sure to account for the need for working capital and any unexpected short-term expenses that come with an acquisition.

Providing your banker with all of the information from your due diligence analysis will help him or her work with you to determine which financing option, or combination of options, is best for your acquisition transaction and beyond.

and when the amount borrowed is over $350,000. With this type of loan, the bank finances up to 50% of the project on a conventional loan in a first lien position. The SBA 504 loan is for 40% of the financing in second position – this is the portion of the loan that the rate and terms are locked in for the full term (up to 20 years). Because the SBA portion is guaranteed with third-party bonds, there are prepayment penalties.

3. Municipal funds. Municipal financing can potentially be used for a portion of the business acquisition cost for buyers who can demonstrate that jobs would be lost if they didn't buy the business (or that they will create jobs by expanding). The amount available is typically based on the number of jobs the purchaser is expected to save and/or create in the community. Typically, a municipality will lend around $20,000 per job, up to a total cap set by the municipality. One advantage of this type of loan is a lower interest rate than would be available through SBA or conventional loans.

4. Conventional bank loan. Banks will consider conventional loans when the buyer is bringing a significant down payment, and the important debt ratios are attractive. Conventional loans are often recommended when a buyer is able to put at least 25% cash down, the company's asset to debt ratio is at least 4:1, and the debt service ratio is 1.2 or higher (meaning that for every $1 of debt you have, you have $1.20 available to repay it). The rates on conventional loans are typically fixed for three, five or seven years, so if you're financing a 20-year deal, rates will be variable and/or you'll need to refinance more often.

TIPS FOR ENSURING MANAGEMENT & EMPLOYEE CONTINUITY

Most every CEO or owner of a business—whether a manufacturing company or a service provider—has a good idea of what they need to understand as they evaluate and consider the purchase of another company: they'll need to dig deep to understand different revenue streams, short- and long-term projections, customer relationships and concentrations, the nature and number of customer and vendor contracts, payroll, union relationships, and all balance sheet elements of the acquisition target company. These are all important factors that are critical in understanding the potential for the new business's long-term success and profitability as well as the expected rate of return as the buyer.

Ownership Transition Period

There’s no substitute for experience, and the trust that comes with it, which is one reason you may want to encourage the seller to stay on board for a period of time. After the purchase is final, you might be tempted to “make a clean break” and take over the running of the business immediately. But don’t underestimate the value of the seller being involved, at least to some extent, during the first few weeks or months of your ownership. He or she can be invaluable in “showing you the ropes” of the business operations, and can also help maintain relationships by introducing you to key customers (and in helping foster good relationships with employees). You may find that your seller is very eager to be part of the transition; he or she has been a big part of the business and might feel uncomfortable not helping you get off to a good start, especially if his or her name will continue to be associated with it.

Training

Ask the seller for some training if the business you’re buying is substantially different from your own. He or she can provide very granular detail regarding how the business is run, how equipment is used, how processes work and how to comply with regulations you might not yet be aware of. You can also benefit from the seller’s insights when it comes to resolving common issues the business faces. He or she has experienced a wide range of situations and conditions that required well-informed critical thinking to arrive at smart solutions. Benefiting from this experience can be extremely valuable in minimizing the potentially painful and expensive trial and error learning that you’d rather avoid.

Who’s the Boss?

If you’re buying a business that’s very similar to your own, you may feel there’s negligible value in keeping the seller on after the sale. But if you’re unfamiliar with how they’ve operated, it’s smart to at least maintain some kind of working relationship. If keeping him or her on results in your employees having trouble knowing “who’s the boss,” though, then it might be time to either limit the seller’s role to select problem-solving or trouble-shooting situations or make the decision to eliminate his or her formal ongoing involvement. If the seller was popular with employees or was seen as the very heart and soul of the company, it may be difficult for them to view you as the new leader until the seller steps down and sends the clear message that they’ve passed the torch.

Employees: What to Expect

In any manufacturing organization, for example, there are employees like welders and steamfitters who've acquired specialized skills, certifications, licensing, training and experience, and these people are key to ongoing operations. There are also executives and staff who play critical roles. People in management roles who are key to relationships with other employees or with customers are also important to your future, and you'll want to spend time identifying who those key employees are prior to purchase. You might consider offering continuity contracts to ensure that valued employees (and their customers) stay on board at least through the ownership transition, to give you a chance to demonstrate the value of staying with you long-term.

Just as important as the financial due diligence you do when buying a business is the thoughtful consideration of how you'll engage with the seller and your new employees. People are often your most valuable asset, and taking time to make sure you're taking utmost advantage of all they have to offer—during the transition and afterwards—could help you ensure a smooth, efficient process and a profitable return on your new investment.

CONCLUSION

Perhaps the most important consideration when pursuing the purchase of a business is to partner with a local banker with deep experience helping businesses succeed. The value of that experience cannot be overemphasized. Bankers who can leverage their knowledge of the area and its businesses will do all sorts of good things for you.

At Investors Community Bank, we pride ourselves on the deep experience of our bankers and their commitment to helping Wisconsin-based businesses thrive. Visit our website to get in touch with a banker today.

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