TAking over an existing business
OK, so you’re taking this class or reading this book because you want to create the next “Uber for [insert your favorite service here],” but there may be other ways for you to get there. The timing may be much better for you to buy an existing business or take over one that is family-owned.

Think of the demographics in the United States. How many of the huge Baby Boomer generation are close to retirement age? The California Association of Business Brokers predicts that with Boomers holding more than 12 million privately owned businesses, 70 percent of them will likely change hands in the next few years—that’s a LOT of opportunity for young entrepreneurs. The Bureau of Labor Statistics says that by 2022, 25.6 percent of the workforce will be Baby Boomers and 46 percent will be Millennials.

Statistics show the average person will change jobs 10 to 12 times during his or her career. It is a trend that continues to accelerate. This statistic means that transitions need to be meaningful and fulfilling. The reasons for all of these transitions can vary greatly, but for this chapter we will focus on young business owners purchasing an existing business from an older generation . . . or younger family members taking over a family business from an elder generation.

**Concept Module 6.1: Business-Buyout Alternative**

- **LO 6.1:** Compare the advantages and disadvantages of buying an existing business.

Suppose you are a prospective small business owner. You possess the necessary personal qualities, managerial ability, and capital to run a business, but you haven’t decided on the approach you should take to get into business. If you aren’t inheriting a family business, then you have three choices for getting started:

- You may buy out an existing establishment.
- You may acquire a franchise business.
- You may start a new firm yourself.

This chapter discusses the many factors to be considered in buying an existing business and taking over a family business.
Advantages of Buying a Business

The opportunity to buy a firm already in operation is appealing for a number of reasons. Like franchising, it offers a way to avoid some beginners’ hazards. The existing firm is already functioning—maybe it is even a proven success. Many of the serious problems typically encountered by start-ups should have been either avoided or corrected by now. The ongoing business is analogous to a ship after its “shakedown cruise,” a new automobile after the usual small adjustments have been made, or a computer program that has been “debugged.” But remember one thing: Just as there are no perfect ships, cars, or software programs for sale out there, neither are there any perfect businesses on the market. You are searching for an opportunity, so some flaws in a business can make it more attractive. You just have to be able to correct them while keeping all the parts that work going strong.

Buying an existing business is a popular way for would-be owners to acquire a small business. At any given time, there are tens of thousands of small businesses available for sale in dozens of industries and many, many sectors. But not every type of small business for sale is right for every buyer. How do you know if a business for sale is right for you?

- **Personal Interests.** Start-ups can begin from expanding a hobby or personal passion. Not so with buying a business. Your acquired business will immerse you into specific work for an extended period of time—be sure you’re going to enjoy it.

- **Skills, Talents, and Experience.** Passion is great, but it’s not enough. Be honest with yourself in what you can actually do.

- **Capital Requirements.** Some industries (like manufacturing) just take more cash than others. Do your resources realistically match the money needed?

- **Market Research.** Buying a business is one of those many decisions that must be made on data—not emotions.

- **Business Network.** Your personal business network will be a valuable source of customers and strategic partnerships so buying a business outside your network means starting from scratch—delaying achievement of your goals.²

One of the messages in this chapter is to make your decision about purchasing a business based on analytics as much as possible. Don’t let emotions cloud your business decisions. There are several advantages to buying an existing business as compared with the other methods of getting into business. Because customers are used to doing business with the company at its present address, they are likely to continue doing so once you take over. If the business has been making money, you will break even sooner than if you start your own business from the ground up. Your planning for an ongoing business can be based on actual historical figures, rather than relying on projections, as with a start-up. Your inventory, equipment, and suppliers are already in place, managed by employees who already know how to operate the business. Financing may be available from the owner. If the timing of the deal occurs when you are ready to buy a business and the owner needs to sell for a legitimate reason, you may get a bargain (see Table 6.1).

Disadvantages of Buying a Business

Could this business that you’re considering buying be what is called in the used-car business a “lemon”? Most people don’t sell their cars until they feel the vehicle needs considerable mechanical attention. Is the same true of selling businesses?
Chapter 6 • TAKING OVER AN EXISTING BUSINESS

There are disadvantages to buying an existing business as a way to become your own boss (see Table 6.1 again). The image of the business already exists and may prove difficult to change should you desire to improve it. The employees who come with the business may not be the ones whom you would choose to hire. The previous owners may have established precedents that can be difficult to change. The way the business operates may be outmoded. The inventory or equipment may be outdated. The purchase price may create a burden on future cash flow and profitability. You may pay too much for the business due to misrepresentation or inaccurate appraisal. The business’s facilities or location may not be the best. You may be held liable for contracts left over from previous owners.

<table>
<thead>
<tr>
<th>TABLE 6.1</th>
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<tbody>
<tr>
<td><strong>Advantages and Disadvantages of Buying a Business</strong></td>
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<tr>
<td><strong>Advantages</strong></td>
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<tr>
<td>1. Customer base is established.</td>
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<td>2. Location is already familiar to customers.</td>
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<td>3. Planning can be based on known historical data.</td>
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<td>4. Supplier relationships are already in place.</td>
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<td>5. Inventory and equipment are already in place.</td>
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<td>6. Employees are experienced.</td>
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<td>7. Possibility of owner financing exists.</td>
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<td>8. Quick entry is available.</td>
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<td>9. Control systems are already in place (e.g., accounting, inventory, and personnel controls).</td>
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<tr>
<td>10. Business image is already set in minds of customers.</td>
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<tr>
<td><strong>Disadvantages</strong></td>
</tr>
<tr>
<td>1. Business image may be difficult to change.</td>
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<td>2. Employees may be ones you would not choose.</td>
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<td>3. Business may not have operated the way you like and could be difficult to change.</td>
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<td>4. Inventory or equipment may be obsolete.</td>
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<td>5. Financing costs could drain your cash flow and threaten the business’s survival.</td>
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<td>6. Business’s location may be undesirable, or a good location may be about to become not so good.</td>
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<td>7. Potential liability exists for past business contracts.</td>
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<td>8. Misrepresentation is possible (yes, the person selling the business may be lying).</td>
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**Concept Check Questions**

1. What are some arguments for buying an established business rather than starting one yourself?

2. Should one ever consider purchasing a presently unsuccessful business (that is, a business with relatively low or no profits)? Explain.
Concept Module 6.2: How Do You Find a Business for Sale?

• LO 6.2: Propose ways of locating a suitable business for sale.

If you have decided you’re interested in purchasing an existing business and have narrowed your choices down to a few types of businesses, how do you locate one to buy? Perhaps you are currently employed by a small business. Is there a chance it may be available for purchase sometime soon? Because you know the inner workings of the business, it might be a good place to start. Newspaper advertising is a traditional place for someone who is actively trying to sell a business to start marketing it. Don’t stop your quest with the newspaper, however, because many good opportunities are never advertised. Word of mouth through friends and family may turn up businesses that don’t appear to be available through formal channels.

People who counsel small businesses on a regular basis, such as bankers, lawyers, accountants, and Small Business Administration representatives, can be good sources for finding firms for sale. Real estate brokers often have listings for business opportunities, which include real estate and buildings. Trade associations generally have publications that list member businesses for sale.3

Don’t overlook a direct approach to finding a business. If you have been a regular customer of an establishment and have an attraction to it, why not politely ask the owner if he or she has ever thought of selling it? The timing may be perfect if the owner is considering a move to another part of the country or is exploring another new business. Perhaps this is an unlikely way to find a business, but what do you have to lose by asking?

Nearly every city has one or more business brokers. Most inspect and appraise a business establishment offered for sale before listing and advertising it. Some also assist a buyer in financing the purchase, but not all of them will provide you with the same level of service. A few will work very hard for you in trying to find a business that matches your talents and needs. Most will tell you what is available at the moment, but not much more than that. Some will do you more harm than good. Remember, business brokers normally receive their commission from the seller, so their loyalty is to the seller, not to you.

Unfortunately for prospective buyers, the market is rife with “business opportunity” scams. As with any scam, the individuals most likely to be targeted are those venturing into unknown territory and trusting the wrong people. The practice of selling unprofitable (and unfixable) businesses to unwary buyers has been around as long as business itself. The ruse is most common in the retail field, where a single business unit can wreck a dozen or more owners through successive sales and resales to a steady stream of newcomers, each confident he or she can succeed where others have failed.

Naturally, the brokers who promote these sales make more in commissions the more frequently the business changes hands. Check for recommendations from bankers, accountants, and other businesspeople who have used the broker in the past. You need to be on guard to keep from being included among that group immortalized by the late P. T. Barnum, who allegedly said, “There’s a sucker born every minute.”

Brokers must take classes and pass examinations to become certified business intermediaries (CBIs). To find a reliable business broker, check the International Business Brokers Association at www.ibba.org.

Curtis Kroeker, general manager of bizbuysell.com and bizquest.com (two of the largest and most heavily trafficked business-for-sale sites online) recommends five important tools and resources every business buyer should consider:

• Business Brokers—invaluable source of information (even on opportunities that are not publicized) and navigator of obstacles that always arise.
BUY AN ONLINE BUSINESS . . . ONLINE

Going into business leaves everyone with a lot of questions, especially for online businesses. Do you have the resources for building your brand? Can you monetize your idea (can it generate more money than it costs)? Can you develop a solid business model?

Buying an existing online business rather than starting one may be your answer to questions like these. Of course, having early questions answered means you still have to successfully manage the business—but it does allow you to go right to business development and growth. If buying an online business is right for you, what are your options?

- **Exchange**—exchange.shopify.com is a cool marketplace to buy and sell online businesses. You can search by category like “fashion and apparel,” “sports and recreation,” or “electronics and gadgets.” You can also search by selling price such as “$0 to $250” or “$500 to $2,500.” With such an online marketplace you get accurate data on revenue or online traffic to analyze.

- **Direct purchase**—If you have a specific online business in mind to buy you can contact the owner to check interest in selling it. Find the owner either via the business About Us tab or do a “who.is” search of domain names or IP addresses. Before initiating contact you can begin due diligence with sites like www.semrush.com, for analytics reports about online strategies in display, advertising, organic and paid searches, and backlinks. You can also check backlinks (quality, quantity, and relevance of backlinks indicate how much traffic a site receives) via Open Site Explorer (moz.com/researchtools).

- **Online business broke**—Are you bored with the idea of shopping for a business in the old-fashioned ways, such as through classified ads and business brokers? Then go online—specifically, go to www.bizbuysell.com, a very comprehensive site for buying or selling a business that offers a database of thousands of established businesses for sale. You begin by choosing where you want your business to be. All 50 states, plus Africa, Asia, Australia/New Zealand, Canada, the Caribbean, Central America, Europe, and South America, are represented. Next, you choose the type of business that interests you. You can choose all business categories or pick from retail, service, manufacturing, wholesale, construction, transportation, finance, and several other miscellaneous categories.


Concept Check Question

1. Discuss the advantages of working through a business broker. What precautions should one take when dealing with a business broker?
Concept Module 6.3: What Do You Look for in a Business?

- **LO 6.3:** Explain how to measure the condition of a business and determine why it might be offered for sale.

To successfully analyze the value of any business, you should have enough experience to recognize specific details that are most relevant to the type of business. You need enough knowledge to take the information provided by sales, personnel, or financial records and (1) evaluate the past performance of the business and (2) predict its probable future development. You need objectivity to avoid excess enthusiasm that might blind you to the facts.

At a minimum, you should ask the following questions to gather information about the business you are considering buying:

- **History:** How long has the business existed? Who founded it? How many owners has it had? Why have others sold out?

- **Inventory:** What is the current status of all products and materials? What is present now? What existed at the end of the previous fiscal year? Have the inventory appraised, keeping in mind you do not have to accept the value set by the seller. The salability and value are major points of negotiation.

- **Tax returns for the past five years:** Investigate how comingled the seller’s personal and business dealings had been—were business funds used to purchase personal items or trips? You and your accountant need to analyze returns to get an accurate financial net worth for the business.

- **Financial statements for the past five years:** Compare these with the seller’s tax returns to determine the true earning power of the business. What is the profit record? Is profit increasing or decreasing? What are the true reasons for the increase or the decrease?

- **Sales records:** Yes, sales revenues are on the financial statements, but you need to evaluate sales by month for the past 48 months. Analyze by product line and by other factors such as cash sales versus credit. This will give you a picture of the seasonality of the business and trend lines. Do further analysis on the top 10 (or whatever break number makes sense) customers. It’s fine if the seller does not want to identify them by name—a code is fine since you are more interested in trends.

- **Contracts and legal documents:** This would include all leases, purchase agreements with suppliers, sales contracts with customers, union contracts, and employment contracts. If the business involves intellectual property, such as patents, have those documents analyzed by a specialist. Real estate leases are especially sensitive since location can be a huge competitive advantage for your small business. What are the terms and length of the lease? Is it transferable? Does the landlord have the right of first refusal (i.e., does the landlord have to approve you?)? Can the lease be renewed?

- **List of liabilities:** You are looking for liens by creditors against any assets. There may be claims such as employee benefits or out-of-court settlements still being paid off that do not show up on financial statements that a savvy accountant can find.

- **List of accounts receivable:** While A/R are on the balance sheet, you need to see an aging schedule breaking them down by 30, 60, and 90+ days. The longer accounts are outstanding, the less value they have.

- **List of accounts payable:** You need to see a schedule just like accounts receivable because of the impact on cash flow.
• **Sales taxes:** When buying the assets of a business, you can avoid responsibility for the seller’s debts and liabilities—except *sales taxes*. If the seller has been underreporting (or not paying) sales taxes, the state can (and will) come after you for the entire amount owed. You can sue the seller and get a settlement, but if that person has skipped the country, you are stuck. Do not pay a cent for a business until you have a *clearance certificate* from the state tax authority (ask your lawyer).

• **Furniture, fixtures, and equipment:** FF&E is a standard comparison for what you are physically buying. As with inventory, the valuation, condition, age, and whether equipment is purchased or leased have an impact on value.

• **Marketing:** How has the seller communicated with customers? Get copies of all advertising and sales literature. This will give you insight into the image of the business and how customers perceive it.

• **Suppliers:** Are there dependable sources of supply for all the inventory, supplies, or materials the company needs? Evaluate current price lists and discount schedules.

• **Organizational chart of current employees:** Since employees are a valuable asset, you need to understand how they work together. You need to be especially careful to see if key people are willing to remain. Are any salaries inflated, or does the seller have a relative on the payroll who does not work for the business?

• **Industry and market region trends:** What about present and future competition? Are new competitors or substitute materials or methods visible on the horizon? What is the condition of the area around the business? Are traffic routes or parking regulations likely to change?

• **Key ties:** Does the present owner have family, religious, social, or political connections that have been important to the success of the business?

• **Seller’s plans:** Why does the present owner want to sell? Where will the owner go? What is he or she going to do? What do people (customers, suppliers, local citizens) think of the present owner and of the business?

• **Buy or build:** How does this business, in its present condition, compare with one you could start and develop yourself in a reasonable amount of time?

**Due Diligence**

For the buyout entrepreneur, preparation is the key to a successful business purchase. You need to analyze your own skills, find good advisers, write a business plan, and, most important, do due diligence. Due diligence means investigating financial, organization, and asset information (including physical and intellectual property) relating to the business for sale. Think of due diligence as doing your homework. Many prospective buyers mistakenly view due diligence as a financial review, but in fact it goes far beyond the numbers. This step comprises a complete investigation and review of a business that begins the moment you become interested in a business.

Due diligence begins by addressing the overall financial health of the company. What trends have occurred with revenues, expenses, and profit margins? Have they grown, stagnated, or declined? Will the products become obsolete in the foreseeable future? If a small business does not have audited financial statements signed by an accountant (and many don’t), then insist on seeing the owner’s tax returns (because it’s more difficult to lie about those documents). Beyond inspecting the owner’s financial documents, you should visit the local county courthouse to check for any existing or pending litigation or liens filed against the business or its owners. The Better Business Bureau can tell you about past or current complaints.
Although the financial scandals of the past few years have centered on large corporations, they have created a heightened level of skepticism about mergers and acquisitions of all sizes of businesses—and increased the emphasis placed on due diligence. The Sarbanes-Oxley Act increases the extent to which executives are held responsible for the accuracy of their company’s financial statements. Because business buyers may be liable for any financial-reporting discrepancies found after the business purchase, they have a strong incentive to be thoroughly knowledgeable about the firm’s accounting practices.

Since buying a business is risky no matter how much due diligence is performed, a new type of insurance has recently been developed to shift some risk to a third party. This insurance, consisting of representations and warranties policies, covers financial losses suffered if a seller makes false claims in the representations and warranties section of a sale contract.

General Considerations

If you aspire to try entrepreneurship by buying an existing business, don’t rush into a deal. Talk with the firm’s banker and verify account balances with its major customers and creditors. Be sure you get any verbal understandings in writing from the seller.

Put the earnest money in escrow with a reputable third party. Before an agreement to purchase is signed, have all papers checked by your accountant and attorney.

If the business you are buying involves inventory, you need to be familiar with the bulk-sales provisions of the Uniform Commercial Code. Although the law varies from state to state, it generally requires a seller to provide a list of all business creditors and amounts due to each buyer. You, as the buyer, must then notify each creditor that the business is changing hands. This step protects you from claims against the merchandise previously purchased.

Why Is the Business Being Sold?

When the owner of a business decides to sell it, the reasons he gives to prospective buyers may be somewhat different from those known to the business community, and both of these explanations may be somewhat different from the actual facts. There are at least as many factors that could contribute to the sale of a business as there are reasons for business liquidations. Be careful. Business owners who are aware of future problems (such as a lost contract for a strong line of merchandise or a new law that will affect the business unfavorably) may not tell you everything they know. For a prospective buyer, a discussion with the firm’s customers and suppliers is recommended. Check with city planners about proposed changes in streets or routing of transportation lines that might have a serious effect on the business in the near future.

Although anyone can be misled or defrauded, a savvy business buyer with good business sense will rely on his or her ability to analyze the market, judge the competitive situation, and estimate the profits that could be made from the business, rather than relying on the present owner’s reasons for selling. These “reasons” are often too difficult to verify.

One point to consider as you search for a business is the list of alternatives in which you could invest your money, such as the stock market, money market funds, or even a savings account. By viewing the purchase of a business as an investment, you can compare alternatives on the same terms.
Financial Condition

A study of the financial statements of the business will reveal how consistently the business has rewarded its previous owner’s efforts. As a prospective purchaser, you must decide if the income reported thus far would be satisfactory to you and your family. If it is not, could it be increased? You will want to compare the firm’s operating ratios with industry averages to identify where costs could be reduced or more money is needed.

The seller’s books alone should not be taken as proof of stated sales or profits. You should also inspect bank deposits for at least five years or for as long as the present owner has operated the business.

When analyzing the financial statements of the business, don’t rely strictly on the most recent year of operation. Profits can be artificially pumped up and expenses cut temporarily for almost every business. Check whether the business employs the same number of people as in previous years; most businesses can operate shorthanded for a while to cut labor expenses. Maintenance on equipment, vehicles, or the building can be cut to increase short-term profit figures. Profits that appear on the books may also be overstated by insufficient write-offs of bad debts, inventory shortages and obsolescence, and underdepreciation of the firm’s fixed assets.

Ask to see the owner’s tax returns. This request shouldn’t create a problem if everything is legitimate. Compare bills and receipts with sales tax receipts. Reconcile past purchases with the sales and markup claimed. Make certain that all back taxes have been paid. Make sure that interest payments and other current obligations are not in arrears.

Realize the financial information you need in order to analyze the overall condition of the business is sensitive information to the seller, especially if the two of you don’t know each other. You can decrease the seller’s suspicions about your using this information to aid a competing business or for some other improper use by writing a letter of confidentiality.

Independent Audit. Before any serious discussion of purchasing a business takes place, an independent audit should be conducted. This exercise will identify the condition of the financial statements. You will want to know whether the business’s accounting practices are legitimate and whether its valuation of inventory, equipment, and real estate is realistic.

Even audited statements need some subjective interpretation, however. For example, owners may underreport their income for tax reasons. A family member may be on the payroll and paid a salary although unneeded by the business. Business owners who use a company car or a credit card for nonbusiness purposes also misrepresent their business expenses.

Profit Trend. The financial records of the business can tell you whether sales volume is increasing or decreasing. If it is going up, which departments or product lines account for the increased volume? Did the increased volume lead to increased profitability? In other words, what is the profit trend? Many businesses have failed by concentrating on selling a high volume of goods at such low margins that making net profits proved impossible.

If the sales volume is decreasing, is it due to the business’s failure to keep up with competition or its inability to adjust to changing times? Or is the decline simply due to a lack of effective marketing?

Interpret net profit of the business you are considering in terms of the amount of capital investment you will have to make in the business as well as sales volume. In other words, a $5,000 annual net profit from a business that requires a $10,000 investment and sales of $20,000 is much more attractive than a business that generates the same profit but requires a $100,000 investment and sales of $200,000.
Expense Ratios. Industry averages comparing expenses to sales exist for every size and type of business. Industrywide expense ratios are calculated by most trade associations, many commercial banks, accounting firms, university bureaus of business research, and firms like Dun & Bradstreet and Robert Morris Associates, now Risk Management Association (RMA).

For example, RMA publishes industry averages for 392 specific types of businesses in the manufacturing, wholesale, retail, and service sectors in its *Annual Statement Studies: Financial Ratio Benchmarks*. Comparisons are made in terms of percentages of assets, liabilities, and income data. RMA also provides industry averages of 16 common financial ratios, such as current ratio, quick ratio, sales/working capital, and sales/receivables. (These and other financial ratios are explained further in Chapter 8.)

Imagine you are interested in buying a health club. The location is good, the advertising has caught your attention for several months, and the club boasts state-of-the-art equipment. You are very excited about the possibilities and are now looking over the financial statements. You divide the total current assets by the total current liabilities to calculate the club’s current ratio, which shows the ability of a business to meet its current obligations. Let’s suppose you get a current ratio of 0.5 for this business.

Now you want to get an idea of management performance, which is shown by the operating ratio, so you divide the profit before taxes by total assets and multiply by 100 (to convert to a percentage). This computation gives you 4.8 percent. You ask yourself, “Are a current ratio of 0.5 and an operating ratio of 4.8 percent good or bad for a health club?” They could be either. You need something to compare them with to tell you whether they are in line. You go to the library at a nearby university to compare your figures with RMA industry averages. You look in the RMA reports under “Service—Physical Fitness Facilities,” where you find the median current ratio listed at 0.9 and the median percentage profit before taxes divided by total assets at 7.5 percent. Your figures are well below the industry averages, so you decide to dig deeper to find out why such large deviations exist between the business you are interested in buying and the average for other similar-sized businesses in the health club industry.

Expense ratios are standards or guides for comparison. Their effective use depends on your ability to identify existing problems and to change conditions that have caused any ratios to be appreciably lower than the standard.

Other Measures of Financial Health. Profit ratios are excellent indicators of a business’s worth, but you should also examine other aspects of its financial health. A complete financial health examination consists of the calculation and interpretation of a variety of other financial ratios in addition to those relating to profit. Of particular interest to you and your accountant will be the following factors:

1. The working capital and the cash flow of the business (is there enough of both to adequately keep the business going?)

2. The relationship between the firm’s fixed assets and the owner’s tangible net worth

3. The firm’s debt load, or leverage

Another key factor in business valuation is what other companies in your industry have sold for. Each year, *Inc.* magazine, in partnership with Business Valuation Resources of Portland, Oregon, publishes an issue that contains a comprehensive business valuation guide with graphics and tables that illustrate which types of companies are selling for a premium or below their annual revenue. For example, companies in the life sciences, energy, financial services, and technology sectors boast high sale prices and robust sale multiples.10
Concept Check Questions

1. When buying an established business, what questions should you ask about it? From whom might you seek information about the business?

2. What factors warrant special attention in appraising a firm's (a) inventory, (b) equipment, and (c) accounts receivable?

3. What should a prospective buyer know about the seller’s inventory sources and other resource contacts? How is this information obtained?

4. You are analyzing the financial records of a business you have been thinking about buying. You discover that although the firm has excellent current and quick-asset ratios by industry standards (meaning its current assets are higher than its current liabilities), its cash is low, and it hasn’t paid its bills on time. What might have caused this problem? Would it influence your decision to buy the business?

Concept Module 6.4: What Are You Buying?

- **LO 6.4:** Differentiate between tangible and intangible assets, and assess the value of each.

When buying an existing business, you need to realize the value of that business comes from what the business owns (its assets and what it earns), its cash flow, and the factors that make the business unique, such as the risk involved (Figure 6.1).
Part III
EARLY DECISIONS

Tangible Assets

The tangible assets of a business, such as inventory, equipment, and buildings (Figure 6.2), are generally easier to place a fair market value on than intangible assets, such as trade names, customer lists, and goodwill. If the firm is selling its accounts receivable, you should determine how many of these accounts are collectible and discount them accordingly. Receivables that are 120 days or older are not worth as much as those less than 30 days old, because the odds are greater that you will not collect them. This process is called aging accounts receivable. Of the other tangible assets of a business that are up for sale, inventories and equipment should be examined the most closely, because they are most likely to be outdated and therefore worth less than what the seller is asking.

Inventory. Inventory needs to be timely, fresh, and well balanced. One indication the business has been well managed is an inventory of goods people want; that are provided in the proper sizes, designs, and colors; and are priced to fit local buying power and purchasing habits.

Your biggest concern about inventory should be that you aren’t buying dead stock (merchandise that has no, or very little, value) that the seller has listed as being worth its original value. The

FIGURE 6.2
Types of Tangible Assets
loss in value of dead stock should be incurred by the original buyer, and you must ensure the loss is not passed on to you as part of the sale.

**Equipment.** It is important that a business be equipped with current, usable machines and equipment. *Book value* (discussed under “What Are the Tangible Assets Worth?” later in this chapter) of electronic office equipment, especially computers, becomes outdated quickly. A cash register designed for the bookkeeping requirements of a generation ago, for example, will not record the information now required for tax reporting or scan UPC codes for efficient inventory control.

Often the usefulness of the firm’s equipment was outlived long ago and its value depreciated. The owner may have delayed so long in replacing equipment it has no trade-in value, and without this discount the owner finds the price of new equipment to be exorbitant. This reason alone could lead to his or her decision to sell the business. Anything the owner makes on the fixtures and equipment is new, clear profit, an extra bonus on his or her period of operation.

**Intangible Assets**

Businesses are also made up of intangible assets that may have real value to the purchaser. Among these are goodwill; accounts receivable; favorable leases and other advantageous contracts; and patents, copyrights, and trademarks.

**Goodwill.** Goodwill is an intangible asset that enables a business to earn a higher return than a comparable business with the same tangible assets might generate. Few businesses that are for sale have much goodwill value.

We all know businesses in existence for years that have not established enough goodwill for the average customer to see the business as being “special.” If strong competition existed, such companies would have been driven out of business long ago. From a consumer-preference standpoint, they are at the bottom of the scale. This public attitude cannot be changed quickly. A good name can be ruined in far less time than it takes to improve a bad one.

A successful business has goodwill as an asset. Taking over a popular business brings with it public acceptance that has been built up over a period of many years, which is naturally valuable to the new owner. (Goodwill is discussed further later on in this chapter.)

**Accounts Receivable.** Not all accounts receivable are created equal. Those that have been owed the longest are worth less because they are the least likely to be collected. In other words, the longer someone takes to pay his or her account, the more likely it is this person will never pay the debt. Therefore, in valuing a business for sale, you need to reduce the cash value of long overdue accounts so as to reflect the odds that they will not be paid.

Determining how much to reduce the value of old accounts should be based on the debtor company’s past payment trends. In the hypothetical example of a company we’ll call Fabio’s Floral Wholesalers, accounts receivable 30 days and younger have a 100 percent likelihood of being paid. Accounts 31 to 60 days old have historically had a 70 percent probability of being paid, those 61 to 90 days old have had a 50 percent probability of being paid, and those older than 90 days have had a 25 percent probability of being paid (Table 6.2). These percentages were determined by looking at the company’s accounts receivable history—a fair and logical request to make of the business owner.

You can see there’s a significant difference in the aged value and the book value of the accounts receivable: $52,500! When you’re buying an existing business, play it smart and be sure to value accounts receivable accurately.

**Leases and Other Contracts.** A lease on a favorable location is a valuable business asset. If the selling firm possesses a lease on its building, or if it has any unfulfilled sales contracts, you should
determine whether the lease and other contracts are transferable to you or whether they must be renegotiated.

**Patents, Copyrights, and Trademarks.** *Intellectual property*—which includes patents, copyrights, and trademarks—can also be a valuable intangible asset. *Patent rights* give protection to your machine, your process, or a combination of the two against unauthorized use or infringement for only a limited period of time, after which they are open to use by others. Thus it is important for the prospective buyer of an existing business to determine precisely when the firm’s patent rights expire and to value these rights based on the time remaining.

*Copyrights* offer the best protection for books, periodicals, materials prepared for oral presentation, advertising copy, pictorial illustrations, commercial prints or labels, and similar intellectual property. Unlike patent rights, copyrights are renewable.

Registered *trademarks* protect you against unauthorized use or infringement of a symbol, such as the Mercedes-Benz star or McDonald’s arches, used in marketing goods. The function of trademarks is to identify specific products and to create and maintain a demand for those products. Because trademark protection lasts as long as the trademark is in continuous use, you should consider its value when purchasing a business that owns a trademark.

**Personnel**

When purchasing a business, you should regard the people working there as being equally important as profits and production. Retention of certain key people will keep a successful business going. New employees rarely come in as properly trained and steady workers. To help you estimate expenses related to finding, hiring, and training new employees, you will want to know if there are enough qualified people presently employed. Will any of these people depart with the previous owner? Are any key individuals unwilling or unable to continue working for you? The loss of a key person or two in a small business can have a serious impact on future earnings.

**The Seller’s Personal Plans**

As a prospective purchaser of an existing business, you should not feel that all sellers of businesses have questionable ethical and moral principles. Nevertheless, you should remember that *Caveat emptor*—“Let the buyer beware”—has been a reliable maxim for years. There are laws against fraud and misrepresentation, but intent to defraud is usually very difficult to prove in court.

You can reduce your risk by writing protective clauses into contracts of sale, such as a *non-compete clause*, in which the seller promises not to enter into the same kind of business as a competitor within a specified geographic area for a reasonable number of years. If the seller resists agreeing to such a clause, it may be a signal he or she intends to enter into a similar business in the future.
For a noncompete clause to be legally enforced, it must be reasonable. For example, setting a 25-mile noncompete zone when selling a New York City business would take in a market of about 20 million people—probably an unreasonable restraint that might prevent the seller from earning a living in the future.

An example of a noncompete clause would read as follows:

Seller shall not establish, engage in, or become interested in, directly or indirectly, as an employee, owner, partner, agent, shareholder, or otherwise, within a radius of 10 miles from the city of __________, any business, trade, or occupation similar to the business covered by this sales agreement for a period of three years. At the closing the seller agrees to sign an agreement on this subject in the form set forth in Exhibit _____.

Concept Check Questions

1. Does every business for sale have an intangible asset of goodwill? Explain.
2. Which type of asset would be more difficult to value—tangible or intangible? Why?

Concept Module 6.5: How Much Should You Pay?

• LO 6.5: Calculate the price to pay for a business.

Even if you don’t plan to buy an existing business, the methods of evaluating one are useful to know so you can appraise the success of a firm. But if you are planning to buy a business, certain additional factors come into play. When you make a substantial financial investment in a business, you should expect to receive personal satisfaction as well as an adequate living. A business bought at the wrong price, at the wrong time, or in the wrong place can cost you and your family more than the dollars invested and lost. After you have thoroughly investigated the business, weighed the information collected, and decided the business will satisfy your expectations, a price must be agreed on.

Small Business Valuation

Small business valuation is a tricky subject—a “subjective science.” The science part is what you learn in earning finance degrees or business valuation credentials. The subjective part considers every buyer’s and seller’s circumstances as being different and that multiple people can see the same financial documents and interpret them differently. If you are selling, you don’t want to set the asking price so high that you turn off interest. Nor do you want to leave money on the table.

The intersection of formal scientific parts and subjective applied parts of valuation gets a little confusing. For example, the term fair market value is widely accepted by certified public accountants, certified valuation analysts, and the IRS. The definition of fair market value is the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

Sounds reasonable. But, this stiff definition does not fit you. You are not hypothetical, you have real, specific goals you want to accomplish. You do have compulsions—in the real marketplace you have to move quickly and decisively because of competitors. I’ll bet you even have specific knowledge not known by everyone that will give you a competitive advantage.
Determining the purchase price for a business involves analyzing several important factors: (1) valuation of the firm’s tangible net assets; (2) valuation of the firm’s intangible assets, especially any goodwill that has been built up; (3) expected future earnings; (4) market demand for the particular type of business; and (5) general condition of the business (including location, industry, company size, completeness and accuracy of its records, employee esprit de corps, and physical condition of facilities).

There are key numbers to value your company. In this example we’ll say the company you are trying to sell has $4 million in annual revenue and $400,000 net income. For simplicity we’ll say EBITDA (earnings before interest, taxes, depreciation, and amortization) is also $400,000. Historically, you have increased revenue about 10 percent each year, and EBITDA runs about 10 percent of your revenue. Buyers are especially interested in

1. **Multiple of revenue.** Buyers consider what the future stream of cash flows from your company will be worth. A buyer who thinks your business is worth five times EBITDA will value it at $2 million. The common term for this value would be “5x.”

2. **Growth in revenue.** Even though your business has grown at 10 percent, buyers will likely make more conservative projections. In this example, if we assume a 5 percent compounded growth rate your $4 million annual revenue will grow to $5.2 million over the next five years.

3. **Amount of leverage.** Because your business generates nice positive cash flow and would be able to service new debt, a buyer can exercise more leverage rather than use more of his or her own cash. In this case, we can assume an investor can finance half of the purchase price using $1 million in cash for a $2 million business.

Other factors affecting financial buyers include tax implications for both buyer and seller, and cost of interest paid on debt.

**Approaches to Small Business Valuation**

One of the reasons business valuation is such a complicated issue is that there are many acceptable valuation methods. Rather than using a “one-size-fits-all” valuation approach, buyers and sellers have to pick one (or more) to fit the circumstances of the sale.

**Asset-based business valuation** is a straightforward method in which the value of the business is determined by the total value of the company’s tangible and intangible assets minus its debts. For example, a landscaping business has assets like mowers, trimmers, tractors, trailers, trucks, and so on, and these have a value that could be totaled. This valuation method typically generates the lowest value for a business because it ignores other factors that can influence the price—like revenue. So it’s commonly used for liquidating closed businesses, but not so much for thriving ones.

**Price multiples business valuation** is the quickest way to get a ballpark price for a small business market value. Multiples can be made on revenue or free cash flow. Free cash flow is calculated by subtracting the seller’s income and benefits from EBITDA. Once you have selected the appropriate number you apply the appropriate multiplier. The trick is finding the correct multiple based on industry or business type. Analysis from bizbuysell.com shows the average U.S. sales price for sold businesses is 0.6 times revenue and 2.4 times cash flow. The biggest upside of using multiples is the ability for the potential buyer to translate the purchase into earnings that can be converted into an informed return on investment (ROI). For small businesses, you have to use some sanity check as revenue multiples can get a little wild. A fast-growing small business can relatively easily go from $300k to $600k in revenue, but that makes a huge difference in the multiple.
Discounted cash flow is often considered the preferred tool with which to value businesses. What sets this approach apart from the other approaches is that it is based on future operating results rather than on historical operating results. As a result, companies can be valued based on their future cash flows, which may be somewhat different than the historical results, especially if the buyer expects to operate some aspects of the business differently. Discounted cash-flow analysis consists of projecting future cash flows (generally for five years) before debts are subtracted and after taxes are paid. A discount rate (expressed as a percentage that represents the risk associated with the investment) is then derived and applied to the future cash flows and terminal value (a current value for a company’s long-term future cash flows). This detailed analysis depends on accurate financial projections and specific discount-rate assumptions. For the purpose of this explanation, don’t get as hung up on specific calculations as understanding the concept: (1) how much profit the business is expected to make in the future, and (2) how reliable those estimates are.18

Multiple method business valuation is based on a formula that applies a weighting factor to the owner-benefit figure of the previous year(s) in order to arrive at a possible purchase price. The owner benefit is a combination of several factors:

\[ \text{Pretax Profit} + \text{Owner's Salary} + \text{Additional Owner Perks} + \text{Interest} + \text{Depreciation} \]

Most small businesses will sell for a one- to three-times multiple of this figure. Granted, this is a wide range, so how do you determine which multiple to apply? Use a multiple of 1 for those businesses where the seller is “the business”—such as consulting businesses, professional practices, and one-person businesses. Multiples of 3 are more appropriate for businesses that have been in existence for several years, have demonstrated sustainable growth, boast a solid base of clients, own assets that will not have to be replaced in the immediate future, and are involved in growth industries, among other things.

Comparables approach is a technique to look at the value of comparable companies that have recently sold. By identifying and evaluating recent examples of businesses that have sold in your industry and geographic location, you can develop a good sense of a likely sales price for your business in question.

Tina Aldatz, who sold her Foot Petals shoe-accessory company for $14 million says “Entrepreneurs have a tendency to place value in the potential. But this doesn’t work for bankers and bean counters who only want cold, hard facts and figures—and you have to be OK with that. Otherwise, it’s very difficult to become comfortable with any number.”19

Even the best valuation tools for placing a value on a business for sale can only deliver two numbers—an asking price and an offering price. What’s in between? Negotiation . . . finding the amount that will make both parties get to “I accept.” Some tips for negotiation include the following:20

- Stay rationally focused on the issue being negotiated. Don’t try to sidestep issues to avoid telling the truth. Norm Brodsky advises, “The more forthright you are with the other party, the more likely you are to arrive at a satisfactory outcome.”21
- Exhaustive preparation is more important than aggressive argument. The more knowledge you have of a situation, the better you will be able to negotiate. The more you are able to demonstrate you know what you are talking about and are reasonable, the more you will be able to set discussion parameters.
- Think through your alternatives. The more options you feel you have, the better a negotiating position you’ll be in.
- Spend less time talking and more time listening and asking good questions. Sometimes silence is your best response.
• Embrace your fear. Bob Woolf, sports and entertainment attorney, stated that “95 percent of the folks you’ll ever negotiate with feel just as nervous and, yes, as scared as you do.”

• Let the other side make the first offer. If you’re underestimating yourself, you might make a needlessly weak opening move.

• Have confidence. You probably underestimate your experience. We all negotiate every day—the skills you develop back-and-forth with spouses, colleagues, children, professors, and fellow airplane passengers all improve your business negotiation skills.

The magic number you and the seller both agree upon may not exist for every deal. Be prepared to walk away from every deal, or you’re not really negotiating.

**What Are the Tangible Assets Worth?**

The worth of tangible assets is what the balance-sheet method of valuation seeks to establish. Their value is determined based on one of three factors:

• **Book value.** What the asset originally cost or what it is worth from an accounting viewpoint; the amount shown on the books as representing the asset’s value as a part of the firm’s worth.

• **Replacement value.** What it would cost to buy the same materials, merchandise, or machinery today; relative availability and desirability of new items must be considered.

• **Liquidation value.** How much the seller could get for this business, or any part of it, if it were placed on the open market.

There are significant differences in these three approaches to determining value. Book value may not hold up in the marketplace. Buildings and equipment may not be correctly depreciated, whereas land may have appreciated. Replacement value may not be a reliable figure because of opportunities to buy used equipment. It is significant as a measure of value only in comparison to what it would cost to start your own business. Liquidation value is the most realistic approach in determining the value of tangible assets to the buyer of a business. It may represent the lowest figure that the seller would be willing to accept.

You have to determine the value of the following physical assets before serious bargaining can begin:

• Cost of the inventory adjusted for slow-moving or dead stock

• Cost of the equipment less depreciation

• Supplies

• Accounts receivable less bad debts

• Market value of the building

Don’t make an offer for a business based on the seller’s asking price. You may feel as if you got a real bargain if you talk the seller down to half of what he or she is asking—but half might still be twice as much as the business is worth.

**What Are the Intangible Assets Worth?**

An established business may be worth more than the sum of its physical assets, and its owner may be unwilling to sell for liquidation value alone. The value of a business’s intangible assets
is difficult to determine. Intangible assets are the product of a firm’s past earnings, and they are the basis on which its earnings are projected.

Goodwill is the term used to describe the difference between the purchase price of a company and the net value of the tangible assets. Goodwill is the most difficult asset to value at a price the seller will think is fair. It includes intangible but very real assets with real value to the prospective purchaser. Goodwill can be regarded as (1) compensation to the owner for his or her losses on beginner’s mistakes you might have made if you had started from scratch and (2) payment for the privilege of carrying on an established and profitable business. When justified, goodwill should be small enough to be made up from profits within a reasonably short period.

What is goodwill worth? To determine a company’s goodwill, you can start by using the income-statement method of valuation. To do so, you should capitalize your projected future earnings at an assumed rate of interest that would be in excess of the “normal” return (earnings adjusted to remove any unusual occurrences like a lawsuit settlement or a one-time gain from the sale of real estate) in that type and size of business. The capitalization rate is a figure assigned to show the risk and expected growth rate associated with future earnings.

For example, suppose the liquidation value of the firm’s tangible net assets is $224,000 and the normal before-tax rate of return on the owner’s investment in this business is 15 percent, or $33,600 per year. We will assume the actual profit during the past few years has averaged $83,600, exclusive of the present owner’s salary (which may have been overstated or understated).

From the profit, we will deduct a reasonable salary for the owner or manager—what he or she might earn by managing this type of business for someone else. If we assume a going-rate annual salary of $40,000, then the excess profit to be capitalized (that is, the amount of profit based on goodwill) is $10,000 ($83,600 minus $40,000 salary minus a normal profit of $33,600).

The rate of capitalization is negotiated by the buyer and the seller of the business. It should be appropriate to the risk taken. The more certain you are of the estimated profits, the more you will pay for goodwill. The less certain you are (the higher you perceive your risk to be), the less you will pay.

If you assume a 25 percent rate of return on estimated earnings coming from goodwill, then the value of the intangible assets is $10,000/0.25, or $40,000. Usually this relationship is expressed as a ratio or multiplier of 4, “four times (excess) earnings.” You would expect to recover the amount invested in goodwill in no more than four years. When you put these two figures together, you come up with an offering price of $264,000 for the business—net tangible assets of $224,000 at liquidation value plus goodwill valued at $40,000.

If the average annual net earnings of the business before subtracting the owner’s salary is $73,600 or less, then there is no goodwill value. Even though the business may have existed for a long time, the earnings would be less than you could earn through outside investment. In that case, your price would be determined by capitalizing the average annual profit (net earnings minus all expenses and owner’s salary) by the normal or expected rate of return on investment in this business. For example,

\[
\text{Profit} = \$73,600 - \$40,000 = \$33,600 \\
\text{Offering Price} = \$33,600/0.15 = \$224,000.
\]

Valuing goodwill is a highly subjective process. The value of intangible assets comes down to what you think they are worth and what you are willing to pay. You will need to negotiate with the seller to reach a consensus.
Concept Check Questions

1. Which is more important in appraising a business: profitability or return on investment? Discuss.

2. Discuss the ways in which the tangible assets of a business may be valued. What is the most realistic approach to determining a business's true value? Why?

3. What is goodwill, and how may its value be determined?

4. How can a buyer determine the rate of return to use in evaluating the worth of a business?

Concept Module 6.6: Buying the Business

• LO 6.6: Discuss factors that are important when finalizing the purchase of a business.

To complete the purchase of your business, you need to negotiate the terms of the deal and prepare for the closing.

Terms of Sale

After a price for the business has been agreed upon, the terms of sale need to be negotiated. Few buyers are able to raise the funds required to pay cash for a business. A lump-sum payment may be in neither the buyer’s nor the seller’s best interests for tax reasons, unless the seller intends to reinvest in another business. Paying in installments is often the most practical solution.

By building installment payments into your cash-flow projection, you should be assured that the business can be paid for out of earnings. Installments assure the seller that his investment in the business will be returned on a tax-deferred basis, as opposed to paying all taxes at one time with a lump-sum payment. With an installment sale, the seller has some motivation to help with the buyer’s success.

A seller may need to take steps to make the business more affordable. One way to do so is by thinning the assets. That is, the seller can adjust the assets to be more manageable for the new owner in one or more of the following ways:

• Separate real estate ownership from business ownership. The new owner leases rather than purchases the building. The buyer has less to borrow, and the seller receives a steady rental income.

• Lease equipment and/or fixtures in the same manner as real estate.

• Sell off excess inventory.

• Factor accounts receivable or carry the old accounts.

If you are buying the stock of a business rather than just the assets, you need protection from unknown tax liabilities. The best way to accomplish this is to place part of the purchase price (anywhere from 5 percent to 30 percent) in an escrow account. This holdback money is earmarked to pay for any corporate liabilities, including taxes owed, that arise after the deal has closed.

Closing the Deal

When you and the seller have reached an agreement on the sale of the business, several conditions must be met to ensure a smooth, legal transaction. Closing can be handled by using either a settlement attorney or an escrow settlement.
A settlement attorney acts as a neutral party by drawing up the necessary documents and representing both the buyer and the seller. Both parties meet with the settlement attorney at the agreed-upon closing date to sign the papers after all the conditions of the sale have been met, such as financing being secured by the buyer and a search completed to determine whether any liens against the business’s assets exist.

In an escrow settlement, the buyer deposits the money, and the seller provides the bill of sale and other documents to an escrow agent. You can find an escrow agent at most financial institutions, such as banks and trusts that have escrow departments, or through an escrow company. The escrow agent holds the funds and documents until proof is shown that all conditions of the sale have been satisfied. When these conditions are met, the escrow agent releases the funds and documents to the rightful owners.

**Concept Check Question**

1. What is meant by “thinning the assets”? Cite examples.

**Concept Module 6.7: Taking Over a Family Business**

- **LO 6.7:** Describe what makes a family business different from other types of businesses.

A fourth route into small business (besides starting from scratch, buying an existing business, or franchising) is taking over a family business. This alternative offers special opportunities and risks.

**What Is Different about Family Businesses?**

Family businesses are those in which two or more members of the same family control, are directly involved in, and own a majority of the business. From Berkshire Hathaway and
Wal-Mart to small stores everywhere, family businesses account for about 70 percent of all businesses in the United States and are responsible for nearly 50 percent of the U.S. gross domestic product (GDP). They are obviously an important part of our economy, but what makes them different from nonfamily businesses? Two critical factors are (1) the complex interrelationships of family members interacting with one another and interacting with the business, and (2) the intricate succession planning needed.

Harper Lee reminds us in *To Kill a Mockingbird*, “You can choose your friends, but you can’t choose your family.” Let’s look at four reasons why it may be a good idea to start a family-owned business—and four reasons why it may not:

**Advantages:**

- Loyalty to each other is highly likely, which creates a significant support system. Employees outside the family may be good workers, but they are looking out for themselves first. Family members are in for the long haul.
- Family members provide greater flexibility to each other in business settings than do nonrelated workers. For example, taking off an extra day to celebrate an anniversary or leaving early for a dance recital are not under the same scrutiny.
- The fact that your business is family owned is a great marketing point. Customers often prefer to frequent a family business more than faceless nonlocal corporations.
- Especially during the early years, operating expenses can be lower. Outside employees aren’t as excited about working for free or minimal compensation to get the business off the ground.

**Disadvantages:**

- Harper Lee has already reminded us that we can’t choose family, and there may well be people who are not the best fit. Family members may be lazy, dishonest, unreliable, or just plain unskilled. Firing a family member is not easy and includes a whole new level of awkward at holiday celebrations.
- Within every family lie rivalries and divisions. Patterns of behavior and dispute settlement tactics from youth are not appropriate for solving business problems.
- Among the less obvious of family disadvantages are limited viewpoints and perspectives. Everyone having common business philosophies and getting along would seem to be a good thing—but is it always? Blind spots can be dangerous.
- Family businesses generally lack clear business structure. Families take an “all hands on deck” mentality and believe everyone is of equal importance. This approach can diffuse solid decision-making processes.

We discussed the failure rate of small businesses in Chapter 1, where it was pointed out that most businesses do not survive to see their 20th birthday. Family-owned businesses are much harder, but still not invincible. For each generation, the odds of a business surviving decline. Thus one way to measure business success, beyond revenues generated, profits earned, or societal impact, would be longevity. Ever wonder what the oldest family business in the United States might be? Perhaps not, but it’s an interesting question. Making the list of the top 100 are some household names like number 68, Levi Strauss (founded 1853), and number 88, Anheuser-Busch (founded 1860).
But the hands-down endurance award goes to a business that has lasted through 74 generations and was started in 1623! Zildjian Cymbal Company of Norwell, Massachusetts, was founded in Constantinople by Avedis I, who discovered a metal alloy that created superior-sounding, more durable cymbals. The sultan named him “Zildjian,” Armenian for “cymbalsmith.”

The Zildjian family arrived in the United States in 1910, moving here to escape persecution of Christian Armenians in their native land. The company was brought here in 1929. It was good timing, as Avedis Zildjian III was able to supply his cymbals to the jazz drummers of the day. Those instruments have remained synonymous with hot drummers throughout the Jazz Age, the big band era, and today’s rock and roll. Avedis’s son Armand applied new technology to the company’s traditional approach by creating a modern factory.

As you might have guessed, not all has gone smoothly over the past 385-plus years. When company leader Avedis died in 1979, his sons Robert and Armand locked horns in a nasty courtroom battle for control over the company (cymbaling rivalry?). Robert left Zildjian and set up a competing cymbal company, Sabian, in Canada. He was legally barred from referencing the family history or name in his business or even using the letter “Z” in his company name.

Today Armand’s daughters Craigie (the company’s CEO) and Debbie (vice president of human resources) are the first female chiefs in Zildjian’s long history.

Complex Interrelationships

When you run a family business, you have three overlapping perspectives on its operation (see Figure 6.3). For example, suppose a family member needs a job. From the family perspective, you would see the business as an opportunity to help one of your own. From the ownership perspective, you might be concerned about the effect of a new hire on profits. From a management perspective, you would be concerned about how this hire would affect nonfamily employees.
Everyone involved in a family business will have a different perspective, depending on each person’s position within the business. The successful leader of this business must maintain all three perspectives simultaneously.

Planning Succession

Many entrepreneurs dream of the time when they will be able to “pass the torch” of their successful business on to their children. Unfortunately, many factors, such as jealousy, lack of interest, or ineptitude, can cause the flame to go out. Less than one third of family businesses survive through the second generation, about 12 percent make it through the third generation and 3 percent operate into the fourth generation or beyond.28 The major cause of family business failure is lack of a business succession plan; only 44 percent have a written plan. There appear to be four reasons for family inability to create such a document:

1. It is difficult for senior family members to address their own mortality.
2. Many senior family members are worried that the way younger family members run the business will not maintain its success. Only 20 percent are confident of the next generation’s commitment to the business.29
3. Transfer of control is put off until too late because of seniors’ concern for their personal long-term financial security.
4. Seniors (like most small business owners) are too personally tied to the business and lacking in outside interests to be attracted to retirement.30

If the potential successor wants to take over the family business, she must gain acceptance and trust within the organization (see Figure 6.4). When a family member enters the business, he is not usually immediately accepted by nonfamily employees. This skepticism increases when that person moves up to a leadership position within the business. The successor must earn credibility by showing that she is capable of running the business. Only after being accepted and earning credibility will the new manager have legitimate power and become successful as the new leader.31

Family businesses need to establish good governance practices that separate the family from the business in order to manage internal talent or attract talented outsiders. Governance, even for small family businesses, can mean developing a level of professionalism.

How do you decide the right leaders for a family firm? All talent, and especially family members, must be assessed on competencies, potential, and values.

Competencies most frequently identified include strategic orientation, market insight, results orientation, customer impact, collaboration and influence, organizational development, team leadership, and change leadership. Leaders of family businesses need to understand the ownership dynamics, including that the company is important to multiple generations.32

General Family Business Issues

Because family businesses have situations and problems unique to them, they need a set of policies that are not needed in other types of businesses. Such a set of policies can help prevent problems such as animosity from nonfamily employees, which can decrease their motivation and productivity.33

- To be hired, family members must meet the same criteria as nonfamily employees.
- In performance reviews, family members must meet the same standards as nonfamily employees.
FIGURE 6.4
Business Succession Planning

- Separate family from business
- Assess competencies and values of successors
- Open and clear communication
- Establish clear order to decision-making

- Communicate vision of portfolio to next generation
- Communicate plan for succession of family members to rest of company

- Skill development of successor
- Talent management of successor
- Mutual development of portfolio plan

- Maintain alignment throughout organization
- Be open and communicate plans and goals to all members of organization
- Maintain objectivity
- Ask for feedback from others in the organization
- Involve the board in the planning
- Develop a clear strategy and operations plan
- Begin to foster a healthy climate to the change in ownership

- Implement vision of portfolio
- Communicate vision to all family members
- Exert confidence in abilities and communicate aspirations


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Part III
EARLY DECISIONS

FAMILY FEUD

A family in the Pacific Northwest owns a retail-clothing store. Two brothers work in the business, and their mother is president of the company. Sibling rivalry was a problem while the boys were growing up, and now that they are in the family business together, it is reappearing. In addition to her role as president, the mother often finds herself playing the role of referee and “chief emotional officer” when the young men fight. The continued rivalry between the brothers and the mother’s need to intervene between them has interfered with a normally functional business. The family realizes its business system is entangled with its family system, but they are not sure what to do about it.

Questions
1. What should the mother do to help her family (and her business) operate more normally?
2. Would bringing in a nonfamily manager with direct-line control over each brother help or cause more problems? How can they ever decide who will eventually take over control of the business?

- Family members should be supervised by nonfamily employees when possible.
- If family members are younger than age 30, they are only eligible for “temporary” employment (less than one year).
- No family member can stay in an entry-level position permanently.
- All positions will be compensated at fair market value.
- For family members to seek permanent employment, they must have at least five years’ experience outside the company. Family members must prove their worth to another employer to be useful here.34
- It’s important to set clear boundaries within the workplace, such as referring to people by name rather than relationship (“Mary” rather than “Mom”) and not discussing family drama at the office.35

Want more information about family businesses? Check out www.fambiz.com (more than 300 articles on family business issues and additional links) and www.familybusinessmagazine.com/index.html (Family Business magazine online).

Concept Check Question

1. A mother believes that all of her family’s children should have equal ownership of the family business regardless of their participation in the business. The father sees the situation completely differently; he believes the children who are actively involved should receive more ownership. How can this dispute be resolved?

CHAPTER REVIEW

SUMMARY

LO 6.1 Compare the advantages and disadvantages of buying an existing business. The advantages of buying an existing business include the fact that it is an already functioning operation, customers are used
to doing business with it, and you will break even sooner than if you started from the ground up. The disadvantages include the difficulty of changing the business’s image or the way it does business, outdated inventory and equipment, too high a purchase price, poor location, and liabilities for previous contracts.

**LO 6.2** Propose ways of locating a suitable business for sale.

Newspaper advertising is one source for finding a business for sale, and word of mouth through friends and family may be another. Bankers, lawyers, accountants, real estate brokers, business brokers, and Small Business Administration representatives can be other good sources.

**LO 6.3** Explain how to measure the condition of a business and determine why it might be offered for sale.

Profitability, profit trends, comparison of operating ratios to industry standards, and total asset worth are all measures of the financial health of a business. There are as many reasons for selling a business as there are businesses to sell. As a prospective buyer, you must cut through what is being said to determine the reality of a situation. You must develop an ability to analyze a market and estimate potential profits and worth.

**LO 6.4** Differentiate between tangible and intangible assets, and assess the value of each.

Tangible assets are those that can be seen and examined. Real estate, inventory, and equipment are important tangible assets. Intangible assets, though unseen, are no less valuable. Goodwill; leases and contracts; and patents, copyrights, and trademarks are examples.

**LO 6.5** Calculate the price to pay for a business.

The offering price to pay for a business is calculated by adding the adjusted value of tangible assets to the value of intangible assets (including goodwill, if appropriate).

**LO 6.6** Discuss factors that are important when finalizing the purchase of a business.

Once the price of a business is agreed upon, the terms of sale need to be negotiated—including setting up installment provisions and thinning of the assets. Before the closing date, the buyer puts an agreed-upon amount of money into an escrow account.

**LO 6.7** Describe what makes a family business different from other types of businesses.

The two primary differences between family businesses and other businesses are the complex interrelationships among family members and their interaction in the business, and the intricate succession planning needed.

**KEY TERMS**

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**EXPERIENTIAL LEARNING ACTIVITIES**

**6.1: Advantages/Disadvantages of Buying a Business**

**LO 6.1:** Compare the advantages and disadvantages of buying an existing business.

Read the following scenario and create a table that lists the advantages and disadvantages of buying this established business. When you have completed your assessment, break into groups of 3–5 and discuss your assessment. Make sure to focus on advantages/disadvantages, not just what you would prefer to do in the case.
Karli has just finished her culinary degree and is looking forward to starting her own bakery. Elaborately decorated and wonderfully decadent cakes as well as unique wedding cakes are her specialty. A family friend (Nicole) owns a small bakery, which Nicole has run successfully for over 20 years. The bakery has focused on breads and rolls with seasonal desserts also offered. The bakery has a loyal customer base, which is needed since the bakery is two blocks off the main avenue that goes through town. The kitchen was updated five years ago so all equipment is new and energy efficient. Five loyal employees have worked for the bakery for years, one an established bookkeeper who has developed a wonderful inventory system. Nicole is very excited with the prospect of Karli buying her business.

However, Karli has also found an empty building on Main Street where she could start her business from scratch. She could then design and develop the business entirely the way she wants, which she finds very appealing. The building is empty, so Karli would need to purchase equipment, counters, tables, and so forth. Karli does not know which way to go in starting her own bakery.

After reading through the scenario, answer the following questions.

1. What are the advantages/disadvantages of buying the established business?
2. What would you do if you were Karli?

### 6.2: Tangible and Intangible Assets

**LO 6.4:** Differentiate between tangible and intangible assets, and assess the value of each.

**LO 6.5:** Calculate the price to pay for a business.

Complete the below activity. Be prepared to share with other students and/or the entire class.

<table>
<thead>
<tr>
<th>Item</th>
<th>Intangible/Tangible</th>
<th>Valuation Method</th>
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<tbody>
<tr>
<td>Inventory</td>
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<td>Customer list</td>
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<td>Equipment</td>
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<td>Favorable leases</td>
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<td>Goodwill</td>
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<td>Accounts receivable</td>
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<td>Buildings</td>
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<td>Patents</td>
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<td>Key personnel</td>
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</table>

For each item listed below, decide if the item is an intangible asset or a tangible asset. Then provide one method to assess the value of the item. Be prepared to justify your valuation method choice.

### CHAPTER CLOSING CASE

**A Question of Value**

Chris Angelis looked at his watch—he would have enough time. At this point in his career he knew about Washington, D.C., traffic and how to leave enough time so that he was never late. He hoped the guy he was meeting—Charlie Peters—was equally conscientious. Chris was founder and chief executive officer (CEO) of two companies that dealt in respiratory health, and Charlie was an entrepreneur who had developed a homeopathic product that might be the basis for a lucrative business partnership. Chris was on his way to meet Charlie to structure a deal.

**History**

Chris Angelis had originally practiced and taught in the field of respiratory care and extracorporeal circulation before joining a major pharmaceutical company in New England in 1985. From 1985 to 1990, Chris held six positions of growing responsibility while he oversaw the successful launch of three new products in the United States, and the development of...
the global strategy that salvaged the company’s failing flagship product.

After a series of professional successes, Chris chose to strike out on his own. He founded his first company, Strategic Implications International (SII), which provided strategic consultancy and marketing support to health care organizations. SII quickly became phenomenally successful through organic growth, mergers, and acquisitions before it was acquired in 1998 by a company that is now a division of Cardinal Health Inc.

In 1992, Chris met physicians Mike Kale and Bill Sager—they had served as consultants to SII while it was producing educational programming for pharmaceutical giant Glaxo Inc. (now GSK). Mike and Bill believed, based on their experience, that they could improve the way doctors are educated about new medicines and treatment, and that this education could be supported by the pharmaceutical industry because it would be beneficial for pharmaceutical products. Such education had to appeal to doctors—it could not merely be marketing—it had to illustrate the way these solutions helped patients, be inclusive of all available products, and be fairly balanced. The idea was to create innovative and relevant educational content using novel yet appropriate formats delivered by and to a network of doctors. Mike and Bill Sager were specialists in allergy and asthma, and they started to implement their vision in that niche.

Mike and Bill had sought Chris out based on his reputation and expertise, and because they “needed a business guy” to run the operation. In late 2003 Chris agreed to join them and to form SMA. Chris would serve as the new company’s CEO. SMA was incorporated in 2004, and used the original concept of education created for physicians by physicians to grow and expand. The organization now encompasses multiple therapeutic specialties and an ever-expanding network of physician advisers spanning the globe. Chris Angelis continues to serve as the CEO of SMA and oversees this continued growth while Mike Kale and Bill Sager maintain their strong link to clinical practice and serve as independent consultants to SMA.

In 2006, Chris formed PharmaSciences in partnership with a Hong Kong–based concern that owned the patent to a promising compound with many possible applications in the pharmaceutical industry worldwide. Chris would serve as CEO. PharmaSciences’ main product was a chemical compound that was designed to provide more effective delivery of medicines to mucous membrane surfaces (e.g., nose and mouth). Their product, MuAd™, is a patented muco-adhesive pharmaceutical composition, developed on the basis of a synthetic polymer. Muco-adhesive solutions, in general, establish reversible contact with the mucosal surface, which enhances the effect of drugs dissolved in them. Unlike other bioadhesive drug delivery systems (gels, powders, microparticles, and liposomes) muco-adhesive solutions possess the property of fluidity, which enables them to cover maximal mucosal area when placed on its surface.

MuAd™ offers a means to achieve an optimal adhesiveness to fluidity ratio for whatever drug or substance is being delivered using MuAd™. This is done in production using the patented processing methods of PharmaSciences.

The Companies

SMA

SMA was in the business of knowledge and education. In the highly regulated and highly complex world of pharmaceutical marketing, SMA had a team of in-house experts and key opinion leaders across a variety of medical domains. These were people who understood what clinicians want and need because they were clinicians themselves. It also meant that they knew about the pressures and values of clinicians, and could therefore “speak to them in their own language.” This enhanced the message credibility, and as such the impact of any educational programs SMA created.

Products have different marketing needs from prelaunch planning to mature product life-cycle management, and so SMA positioned itself to possess knowledge appropriate to each stage and for each stakeholder. For example, for newer products SMA had in-house experts and clinical advisers to help with the design of the actual clinical development programs. As a product became viable, more interaction had to happen with regulatory bodies. This was a particularly nuanced issue, and so SMA’s clinical advisers also had to be knowledgeable about regulatory strategy. They provided guidance for New Drug Application and Investigational New Drug submissions, and could deliver expert testimony as necessary for the U.S. Food and Drug Administration (FDA) and other regulatory authorities. This was another reason that it was critical that members of the SMA advisory team be made up of highly respected, practicing clinicians.

PharmaSciences

Whereas SMA had marketing expertise, PharmaSciences had a patented product that was proven effective as a medicine delivery vehicle using clinical trials. Their product, MuAd™, had been clinically tested with different respiratory medicines, and studies reinforced the product’s effectiveness. It was found to qualify for a Class I designation, which means that it is well tolerated and virtually devoid of any mucosal irritation. The legitimacy of the product was bolstered by the rigorous research behind it. Another important finding was that MuAd™ increased the potency of certain drugs. This finding was important for drugs where the efficacy could change over time and continual use. By pairing these medicines with MuAd™, patients were effectively able to have longer congestion-free periods using the compound because smaller and less frequent doses would yield a similar clinical effect.

In sum, in vitro and in vivo studies have shown that MuAd™ was a useful and usable product. But there were two additional advantages of the MuAd™ compound. The company’s patented technology includes the methodology and devices required to...
assess and adjust the optimal muco-adhesive properties. This would allow fine-tuning of drug delivery. In addition, the significant advantage to licensees is that MuAd™ has been developed for existing pharmaceutical compounds. Securing drug approvals based on existing data of older drugs is easier than those of new compounds. In addition, licensees are afforded new patents to drugs with expired or expiring patents, helping them with their life-cycle management strategies.

Nose-Clear

Charlie Peters had inherited a nasal-clearing formula from his grandmother. It was basically a mixture of hot peppers that was minimally irritating but very effective for sinus congestion and headache. It was one of two homeopathic products with similar ingredients targeting the same market.

Nose-Clear had launched in 2005, and had been praised for its effectiveness. By 2007 it had cumulative U.S. sales of $1.3 million, largely due to direct-to-consumer magazine and commercial radio advertising campaigns. But by 2008 sales had fallen below $100,000. Advertising and promotion had ceased, and retail presence was minimal. Most sales came from online purchases. Clearly this was a company in need of help.

Nose-Clear was effectively a mom-and-pop shop running on a shoestring budget that contracted all manufacturing and related expertise to third parties. It had tried unsuccessfully to attract partners and/or capital to fund the operation, but so far had been unable to do so.

Deal or No Deal?

The way Chris saw it, investment in Nose-Clear had a lot of potential because of the size of its market. Seventy-two million people use headache and sinus/allergy medications, with an estimated $13 billion market in the United States and $20 billion market worldwide. Right now, Nose-Clear was one of hundreds of branded and generic over-the-counter products for relief of sinus congestion and headache. But the treatment was homeopathic, a medical system based on the belief that the body can cure itself. In some demographics, homeopathies are appealing for minor medicinal treatment. This trait also made it cheaper and easier to manufacture, and free of regulatory entanglements. However, this strength was also a liability.

The first problem had to do with the nature and strength of the claims one could make about Nose-Clear’s effectiveness. People are naturally (and legitimately) suspicious of inflated effectiveness claims in homeopathic products because there is no third-party scrutiny or review. The second is that because Nose-Clear was homeopathic, it was not patentable. Nothing that you can make from natural ingredients is patentable. But MuAd™ was patented. By combining Nose-Clear with MuAd™, you would have a new, patentable product. The way the law works, if you add something to your patented compound, the entire formulation is now patentable.

So what kind of deal should be structured? There were many options.

The simplest deal would be just to buy Charlie out. Give him $X for the formula and be done with it. It would require some market analysis to figure out what a reasonable valuation of this product could be. At the same time, Chris already had two companies; did he want to run a third? There would need to be a good reason to do that. There was also the question of whether Charlie was just in it for the money. This was his grandmother’s recipe, and so maybe he was attached to the idea of making it into a product himself. Or maybe he wanted to be CEO. In talking to Charlie, he definitely seemed to have ambitions and aspirations.

If Charlie really wanted to be in control, then they could set up his company as a wholly owned subsidiary company. Here again, the parent company (whether SMA or PharmaSciences) would be in a position to extract all the value from this product. Again, there was risk. Both of Chris’s companies had reputations to uphold, and Charlie was a bit of an unknown in terms of his management competence. But Chris would really hold all the cards if one of his companies owned Nose-Clear; and maybe Charlie could be groomed. Or maybe Charlie was not looking to be groomed, and would not be okay with being “CEO junior.”

Charlie could be given more autonomy if instead of a wholly owned subsidiary, they formed a joint venture. This would almost certainly be more attractive to Charlie as it would make him more of an equal partner. Of course, there was a huge cost to that, for what was Charlie really bringing to the table? Chris had the contacts, the know-how, and the capital resources to make this venture work. With a joint venture, he would almost surely get less of the profits for lack of control of the process. But maybe that risk could be mitigated.

Of course, they could just establish a buyer–supplier relationship. Chris provides access to marketing, branding, clinical tests, and production services, and Charlie pays for it. This could be straightforward, but the upfront work was daunting. How was Charlie going to pay for anything given his meager earnings from this product? They could charge royalties on the back end, but then how would Charlie get his operation up and running?

Analytical Questions

1. Based on the case, what are the identified risks and rewards for Chris in terms of working with Nose-Clear?

2. What are the risks and rewards for Charlie in terms of working with Chris?

3. Below is a list of possible negotiable issues that can be used to structure a deal. Use these to create potential offerings for Charlie under each of the business structures (buyout, wholly owned subsidiary, joint venture, and buyer–supplier).
a. Be sure to articulate an ideal but realistic deal (your goal) and a minimally acceptable deal (your resistance point).
b. Are there any other issues that you could add to expand the pie?
c. Having looked at the different business structures, which one would you advocate and why?
d. Could you develop a hybrid structure for this partnership?

Negotiable issues (although each could potentially break down into sub-issues as well):
- Ownership percentage of any jointly owned organization
- Royalties for sale of product
- Profit sharing on sale of product
- Licensing fee for services (marketing, clinical, and production)
- Pay for service
- Marketing support in terms of advertisement
- Branding support in terms of product
- Clinical tests on efficacy of product
- Production management of product
- Exclusivity in terms of markets and products, as well as subsequent deals
- Managerial control of the various business functions
- Introduction to key opinion leaders

Discussion

Given your choice of business deal, what information should you be looking for as the deal is executed in order to minimize your risk and maximize your return? Put differently, how will you identify whether your original business deal is optimal once you begin to work with Charlie?