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Fundamental Considerations When Purchasing A Business

This article addresses a number of fundamental questions and issues with respect to purchasing an existing business or establishing a new business.

A. Introduction:

The desire to achieve entrepreneurial success provides the determination and drive that can transform a company formed in one's basement into an organization on the coveted *Fortune 500*.

However, to navigate a business from infancy to maturity requires hard work, business savvy and luck. There are many entrepreneurs who succeed in their business ventures, but for every success there are numerous failures. Failure can be the result of various factors including poor planning and strategy, inept management or bad luck.

To succeed in business and avoid the many potential pitfalls on the path to success, a businessperson should implement a strategy that is ambitious yet achievable, visionary yet practical, broad in opportunity but focused in direction. This Newsletter provides questions and issues to consider when deciding whether to acquire an existing business or start a new business.

A fundamental economic concept - ***opportunity cost*** - should always guide a businessperson's decision making process. The *Economist* describes the concept in these terms: "*the true cost of something is what you give up to get it*". Opportunity cost can be understood as a choice - that for each action (or omission) there is always an alternative choice available which will be sacrificed. For example, if you can only spend $500 on a typewriter or a new computer, you would choose the product that provides you with greater **value**. The new computer allows you to utilize word processing, email and the internet. The typewriter's functionality is comparatively limited. However, if you require a typewriter to perform certain tasks that a computer cannot (*i.e.*, completing a document that is not available in electronic form) then the typewriter will provide you with more value and you will forgo the purchase of the computer in favour of the typewriter.

When considering whether to buy or start a business, it is important to make an **informed** decision. Consideration of alternative choices, informed decision making and an overall understanding of opportunity cost will allow you to avoid the potential pitfalls on the path to success.

When you have the option of buying a business, you must ensure that the acquisition is truly an opportunity. For it to be an opportunity you should answer one simple question: Why am I buying this business? If you can provide a comprehensive answer, then you have adequately placed a value on the prospective opportunity. If you find that your answer has significant gaps, you should re-evaluate your options.

B. Issues Prospective Purchasers Should Consider

Before you set your sights on a specific target company to acquire, undertake a comprehensive analysis of the target's business and industry and your relative position with respect to such factors.

A strategic objective should be achieved as a result of the transaction. This objective could be as simple as "owning and operating a coffee shop business because I can make it a success and the business provides me with a sense of personal satisfaction", or "I want to buy company X and merge it with company Y in order to achieve a 52 % market share in widgets".

As part of your initial planning, develop and implement an acquisition strategy that addresses:

i. Why you want to purchase a specific business or enter a specific industry (*i.e.*, why do I want to buy Canadian Tire? or alternatively, why do I want to buy a hardware store?);
ii. Your plan to achieve the overall acquisition strategy (*i.e.*, should I buy the target's shares or only its assets?); and
iii. What are your plans for the business once it is acquired (*i.e.*, I will merge the operations with my other hardware store, or, I will sell the tools that my tool production company makes in the hardware store).

The acquisition strategy must be part of your overall vision.

It is advisable to identify a variety of suitable targets and initiate contact with the targets on a confidential basis to assess the possibility of a transaction. After you make your initial assessments, it is important to start implementing your strategy with the use of professional advice from your lawyers and accountants and begin to lay the groundwork for the transaction. The information below will provide you with questions you should ask, issues you should consider and steps that you should take after you identify a suitable target and are preparing to acquire it.

I. BASIC QUESTIONS A PURCHASER OF A BUSINESS SHOULD ASK:

1) Why do I want to buy this particular business? What is the value of this business to me?
2) What are the advantages and disadvantages of purchasing this business? Have I compared the cost of buying the existing business with the cost of starting a new business within the same industry?
3) Can my resources (time, money, capital etc.) be utilized in a more productive alternative investment which better suits my goals, requirements, skills and vision? What is the **opportunity cost** of this acquisition?
4) Have I obtained enough information, conducted enough research and properly evaluated all the data to satisfy my informational requirements regarding this particular business, the general industry and the overall economic value of the business?
5) What skills and resources can I bring to this business to make it more profitable, efficient and productive?
6) Do I have the time and access to the knowledge, skills and resources required to enhance the value of the business? How easily accessible are the required knowledge, skills and resources?
7) What is my previous exposure to this industry? What lessons have I learned from my past dealings within this industry and, if applicable, with this particular business?
8) Do I have the network to provide the base of contacts required for this business venture or will I have to develop a new set of contacts?
9) What am I willing to give up in terms of price, assets and financial capital in order to acquire this business? What do I expect in return? Are my expectations reasonable?
10) What financing arrangements should I make? Have I raised enough capital to sustain the business in the early stages? It is important not to be undercapitalized and in search of financing when you should be spending time managing the business, especially in the early stages.

II. WHAT IS THE BUSINESS THAT YOU ARE BUYING?

1) What is the business that you are buying? Is this going to be a purchase of the business by way of assets or shares? Do you understand the difference and corresponding benefits and risks between an asset or share transaction?
2) How will the purchase price of the business be determined and allocated (*i.e.*, will it be based on multiple of earnings, revenues, goodwill, book value etc.)? How has the transaction been structured, is it for cash, shares, property or some other form of consideration or a combination thereof? Have you considered all potential closing costs and expenses when calculating the purchase price and required capital? What is the adjusted cost base of the shares (if it is a share transaction)?
3) To obtain a comprehensive understanding of the business, use a number of sources including the vendor and if possible, the vendor's customers, competitors, present or former employees or business partners. This research should be done in addition to the market, industry and other research required.
4) What liabilities will you be assuming when the transaction closes?
5) What legal obligations will you inherit by buying this business? What licenses and permits do you require (*i.e.*, liquor license if a bar) and what environmental and other standards have to be met in order to operate the business? Do you require any governmental approvals or consents in order to purchase or operate the business?
6) What tax issues should be considered with respect to this business and structuring the transaction?
7) If you are not buying the entire business (*i.e.*, you buy specified assets such as machines or trucks), what investment is required before you can make the business "whole"? How much investment in terms of capital and labour will you have to invest before it can be a "complete business" as you envision? Can you afford the investment of time and resources?
8) Have you established the benchmarks and parameters (financial, structural, negotiating etc.) upon which you will conduct this transaction? Have you defined what you require from the business and how it fits in your overall goals and vision?
9) Who is the vendor, and why is he/she selling the business? For example, does he/she feel that the industry has matured and there is no further potential for growth? Does he/she have alternative business opportunities that he/she is pursuing? Does the target or its principal(s) have a bad reputation in the industry and is the target having trouble generating business (and if so, will you inherit that bad reputation)? If you can understand the vendor's motivation for selling then you can design and implement appropriate strategies to counter any setbacks or capture any opportunities when you buy the business.
10) What critical information can you extract from the vendor regarding the business? How can you extract such information if the vendor is not motivated to provide it?
11) What strategy are you going to pursue for this business post closing? It is vital to have a clear, concise and coherent strategy before you purchase the business. The proposed strategy should be proactive and further your vision and goals for the business and the relevant industry.
12) Have you and the vendor agreed upon the general terms of the transaction? If so, what are the terms? How have you papered the transaction thus far (*i.e.*, letter of intent, oral agreement, correspondence)?
13) Have you obtained the advice of professionals such as lawyers, business consultants, accountants, business valuators and others with specialized business knowledge? If so, who are the advisors

and what is their experience, knowledge base and track record? Do they have experience within the specific industry in question?

14) What legal structure should you use to complete the transaction (*i.e.*, sole proprietorship, partnership or a new/existing corporation)?

III. OTHER ISSUES TO CONSIDER:

1) What are the terms and conditions for remaining at the current location of the business? Is the property leased? If so, what is the term of the lease and the rent? Is the lease in good standing? Will the landlord give consent to transfer the lease? Will you be able to execute any renewals at the expiry of the lease? How soon will the lease terminate? Can you negotiate a renewal as part of the transaction and if so, should you negotiate a renewal and at what rent?
2) What proportion of the value of the business is tied to its specific physical location? If you are required to move locations does the value of the business diminish significantly or is the business flexible in its viability to move to different locations and still generate the required client base and revenues?
3) Is the value of the business based on its tangible or intangible assets? Is the equipment/inventory modern and in good condition? Do you have a complete list of the assets? Which assets are not for sale and why? Have the assets/equipment in question been appraised to determine their value vis à vis the purchase price? Has the target protected its intellectual property by using trademarks, patents and copyrights?
4) How strong are the bonds between the core business and the possible losses that may result (for example, with respect to employees, goodwill, contacts, reputation) after you purchase the business? Does the business hold significantly the same value to you if such losses are included in your assessment?
5) Have you talked with other business owners in the area (geographic/industry) to determine their thoughts and input with respect to the business and the general economic viability of the area/business/industry?
6) Who are the key employees of the business? Do you require their services post closing? Who are the leaders and who are the followers among the employees? What is their relationship with the vendor? Can you successfully transfer the vendor's employees without losing value in the relationship (and the business)? If not, what can you do to minimize any negative consequences that will arise due to the transfer? How do you plan to terminate employees that do not meet your requirements? How do you maintain the balance between employees you want to retain and those you want to terminate without diminishing value from the business? Is there a union involved? Are the employees' compensation arrangements and government withholdings up-to-date and is their compensation in line with industry standards?
7) Who are the critical suppliers to the business? What is required to ensure a long term supply of these goods/services? What terms exist with the business at present for supply of goods and services, and if they are favourable, will the suppliers continue providing you with such terms? What leverage do you have with suppliers? How can you utilize such leverage to improve the business? Are there better alternative suppliers to consider (*e.g.*, more cost-effective, better quality or logistics)?
8) Who are the competitors of the business, and what are their strengths and weaknesses? What opportunities and what threats can you map out for the business? Can the competitors use the transfer of the business from vendor to purchaser as an opportunity to take advantage and acquire

customers, goodwill and suppliers from the business? If so, what value does the business hold for you in such an event? What is the likelihood of customer, employee and other losses to competitors? What would be the result of such losses to the business? How can you attract business away from the competitors? Do you have other businesses, skills or knowledge that may allow you to offer a better "value" of goods and/or services to your competitor's clients? How do you convey this message to competitors' clients?

9) Are the vendor's principals required during a transition period? Is the vendor willing to sign a Consulting Agreement to provide support and training for you for a defined period of time and on defined terms if required post-closing?
10) What is the target's customer profile? Does the target have small, medium or large customers (or a mix of all three)? What is the bargaining power of the target's customers? What credit terms do customers enjoy? What is the quality of the target's receivables? Does the business suffer from a high percentage of bad debts? Does the business have consistent sales throughout the year or is it subject to seasonal sales?
11) Are there opportunities to engineer growth and expansion of market share, client base, and product/service lines? How will you capitalize on such opportunities and what resources will be required? Have you prepared strategies to immediately seize upon any such opportunities? What unexpected events can you compensate for that might hinder achieving success in pursuing such opportunities (*e.g.*, can you use insurance to mitigate certain uncertainties)?
12) Can any synergies be identified and quantified which will assist you in calculating the purchase price? Can you immediately exploit such synergies post closing without added expense or resources? If not, what expense and resources are required to realize such synergies?

IV. FINANCIAL AND FISCAL BASICS:

1) Have you been provided with financial statements (or pro-forma financial statements) for the business? Try and obtain financial statements for the past three fiscal years if available.
2) What do the projected calculations and forecasts for performance indicate about the first year, post closing? Have you developed detailed and quantified projections and forecasts based on reasonable assumptions and expectations? Have you had the forecasts checked by a professional, and if so is there any bias in the reporting or is it an arms length calculation?
3) In your projections/forecasts, are there any periods when cash flow will be tight and supplementary financing may be required? Is there a margin in the financing you have available to cover fixed and other costs in case of a downturn?
4) Will additional investment capital be required in the business and at what intervals will such investment be required? Do you have a list of specific priority based investments to apply cash and capital towards that will provide immediate dividends in terms of productivity, marketing, sales or other valuable aspects of the business?
5) Do you have the finances required to maintain your lifestyle without having to divert funds away from the business?
6) What are the potential negative setbacks to buying the business? How will you deal with the failure of this business or a significant downturn upon completion of the transaction? Are you, your family and/or your other businesses able to cope and withstand a significant economic loss as a result of this transaction?
7) How sensitive is the business to certain risk factors (such as industry and/or economic downturn)? What strategies can be put in place to cushion such risk factors (*i.e.*, can the business' assets and

resources be utilized in another capacity to generate revenue if the core business is suffering from a downturn)?

V. FINANCING THE BUSINESS:

1) Upon completion of the transaction, it is important to ensure that the business can meet its commitments. Therefore, prior to purchasing the business you should assess whether the business will be able to meet its financing obligations and other commitments (*i.e.*, pension plan contributions).
2) What is the suitable level of debt to equity in the industry for this business (will your ratio be within industry standards)? Can the target afford to pay the financing expenses by itself, or does it require funds from alternative sources? If so, what sources will you be using (*i.e.*, your own personal finances or bank financing)?
3) Have you considered all transaction costs (*i.e.*, professional fees, taxes etc.) in determining the necessary financing and overall costs of the transaction?

VI. IMPORTANT TERMS IN THE AGREEMENT:

1) Have you considered having a portion of the purchase price be in the form of a deferred payment? If you are issuing or selling shares in your other properties, investments or businesses, have you considered the potential impact on issues such as control?
2) Have you considered the use of vendor take back financing? What are the terms of such financing compared to rates and terms available from alternative sources of financing? What are the costs and benefits of using the vendor as a source of financing?
3) Have you structured the transaction to include an earn-out provision or other mechanism which can adjust the purchase price based on the target's future performance or performance up to the date of closing?
4) What agreements are required from the vendor in order to protect your investment? Do you require comprehensive Non-Competition, Non-Solicitation and Confidentiality Agreements to be in place for the vendor to execute?
5) What are the representations, warranties and conditions that you require from the vendor as part of the transaction? How do these representations, warranties and conditions compare with the industry standards?
6) What are the indemnities the vendor is willing to provide? Does the vendor have the resources to meet its obligations pursuant to such indemnities? Should you require collateral security for such indemnities or the right to set-off part of the purchase price?
7) What steps are the vendor and related parties taking to provide a smooth transition of the business at closing?

VII. THE DUE DILIGENCE DUTIES:

1) What is the "quality" of the financial statements/other information that you have received? Does the information reflect the reality of the business? Does the information meet your requirements - does it provide value or is it superficial? Is the information current or stale and out of date? Who prepared the information - was it prepared by a professional accountant with an arms length relationship to the vendor or was it prepared internally by parties that may have non-arms length

relations with the vendor? Have the statements been prepared in accordance with GAAP? What is the possibility of misstatements with respect to sales, revenue, expenses etc.? Do the target's financials show consistency? Do you suspect that the financials may not reflect the reality of the business? Does the balance sheet reflect fair values or is there a risk of an overstatement of assets and/or an understatement of liabilities? Ensure all forecasts and projections are normalized and adjusted to realistic market-based values, and that all facts, figures and numbers used are reasonable.

2) Have you had the financial information reviewed by your financial consultant and accountant?
3) Have you conducted all the appropriate searches including PPSA, bankruptcy, internet and other corporate searches on the target and its principal(s)?
4) Have you engaged in "boots on the ground" research (*e.g.*, going in front of the business and assessing the customer flow, taking samples of inventory in the warehouse, conducting environmental and other assessments, observing compliance with health and safety regulations etc.). Do some legwork and try and gather a "real world" perspective on the entire operation of the business. Speak to stakeholders in the business such as customers and suppliers about all aspects of the vendor and its business.
5) Who in your organization will be responsible for due diligence?
6) Do you want to examine senior or selected employees of the business, or will it be better for the business if they are kept out of the due diligence examination and instead allowed to focus on their duties?
7) Have all the material contracts been examined thoroughly? Are there any "toxic" documents that can negatively affect ownership and obligations after the transaction is consummated (*i.e.*, warranty obligations, litigation etc.)?
8) Are the people conducting the due diligence for you on the target experienced in the business the target is active in, and do they understand the industry jargon?
9) What information do you still require?

A checklist of tasks and issues is limitless but it is important to identify the scope and sophistication of the business you are purchasing (or starting) and adjust your parameters of investigation accordingly.

C. Contact Information

If you require any further insight into starting or buying a business, or regarding any other business law issue, please contact Brooks Barristers & Solicitors at:

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