Buying and Selling a Business

If You’re Not Careful You Can Get Stuck, But Buying and Selling a Construction Business Can be a Rewarding Undertaking if Done Intelligently.

By Arthur B. Hollander

On the surface, buying an existing contracting business seems to solve all the problems of starting a business from scratch. After all, you are purchasing a package deal, complete with stock and equipment as well as sometimes, an instant clientele. Quite possibly, the price may be reasonable, too, since sometimes construction businesses are sold in haste by owners with health problems or by survivors of recently deceased owners.

On the other hand, unless you’re very careful, you could get stuck. Often, a business is sold simply because it isn’t doing well. And, if the owner isn’t honest, you may overpay, thinking you are getting more than you actually are. It’s also possible that the owner is not well-liked or respected in the construction community. In this case, you may be buying someone’s bad will—and that’s a hard thing to shake, even if you put a sign in the window saying “under new management.” Perhaps the existing business doesn’t have the best equipment or materials, or perhaps it isn’t in the greatest location.

My advice to someone interested in buying a going construction business is: proceed with care. Don’t be taken in by smooth talk. You’ll need to estimate the bidding ratio and profits that can be expected over the coming few years. To do this, you must examine the financial statements of the business you are interested in buying. Balance sheets and income statements are helpful to see how the company has fared in the past.

A good accountant should be able to analyze these records thoroughly. It should also be ascertained whether or not the statements were verified by an audit. It is desirable to go back at least five years—preferably, ten—in examining these financial statements. You may also want to see other records. If the financial statements are incomplete, look at annual income tax returns. Again, you should see them for at least five years, if possible. Ask which records have been audited by the IRS.
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By examining these statements, you should be able to see whether profits have been increasing or decreasing over the years you’ve examined. If the profits don’t seem to be satisfactory, is there a possibility of improving them?

You’ll also need to find out what component of the market the business is in—commercial, residential, drywall, plaster, etc. This includes not only where the business stands at the present, but how the business may be able to grow in the future. To find this out, you must analyze factors such as the state of the market, the amount and type of competition, etc. If you do a thorough job in investigating, you should be able to decide whether or not to proceed further with assessing the business.

A lot of information you seek will depend on the nature of the business you are thinking of buying. Look into the history of the business. Depending on the size of the business, job information records may range from being very thorough to very skimpy.

Information can come from a variety of sources—from sophisticated bookkeeping systems to sales tax records to accounts receivable. It’s up to you to explore as many sources as you can: use your imagination!

You can also study records—shipper receipts, vendor invoices, etc.—to study the cost of goods (this includes the price of inventory as well as shipping and other charges). The gross profit is the difference between billing and the cost of goods. Obviously, the more goods cost, the lower the net profit will be. High freight costs, for instance, can affect the cost of goods measurably.

Be sure to check out the headquarters and storage facilities carefully. Look into any projected plans for change in the area. Plans for eventual urban renewal could be in the works—and that means you might soon be hunting for a new location should you buy the business. Sometimes major highways are rerouted, and businesses once on busy thorough-
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fares find themselves in virtual isolation. It has happened that a business owner is fully aware of prospective changes that will adversely affect his business, but he sells the business to an unsuspecting buyer.

**Fully Investigate . . .**

If you're new to an area, you may not be aware of rumors of change: make it your business to investigate. You should be up on building ordinances and find out if you would be allowed to expand if necessary.

You must also analyze the population of the city: the number, income and age of the populace. You can obtain census figures from the Federal government.

Find out what the general market picture is for your business within your own specific radius. But don't stop there. Perhaps you may want to contact suppliers for more information. Or his banker. (Although the banker has a wealth of information, he may not divulge it.) Perhaps credit agencies, or trade associations can be a source of information.

In addition to all this groundwork, you should ask the owner to prepare a projected statement of income as well as profit or loss for at least the coming year. The owner will estimate the net profit. You, the buyer, can prepare your own estimate, as well, after analyzing at least five years' worth of back profit and loss statements.

When it comes right down to deciding what price to pay for the business, the decision should be based on the capitalized value of future earnings. Let's say that projections estimate the profits of a business over the next 5 years to average $20,000 a year. Using the usual rate of from 20% to 25% for capitalizing the earnings of a small business, the buyer should pay from $80,000 to $100,000 for the business.

The usual way of pricing a business, however, is based on the purchase and sale of assets. When this method is used, the buyer must consider a number of tangible as well as intangible things.

The tangible items include materials inventory, which is generally valued by using the cost of last purchase and the current market price. Before the merchandise is counted, examine the inventory to ascertain its quality. It would be wise for you to have only someone knowledgeable in the type of merchandise you are buying to assist you in the inventory examination and counting.

If real estate is to be purchased, rather than leased, as part of the deal, the general rule is to have an independent appraiser arrive at a value for real property. In the same way, an independent appraiser can be useful in evaluating a price for personal property equipment. It's a good idea for the buyer to consider each asset individually, and not purchase them as a package deal.

Before he gets into the actual negotiation, the buyer should be aware of the legal risks he will assume should he buy a business. Here, again, sleuthing will pay off. Some assets can be examined through contracts and documents, while others can be ascertained only by questioning the seller.
Existing contracts that will affect both the buyer and the seller as far as liability should be examined. Generally, only rights and not obligations may be transferred to another without express consent from the other party of the original contract.

Contractual rights, however (unless stated otherwise), are generally assignable. In the case of a nonassignable contractual right, the only alternative is to renegotiate the contract.

Check Out Contracts . . .

Be on your toes, and ask for copies of contracts from the seller. Leases, for instance, should be examined with a fine tooth comb. Check out all the terms, including subleasing clauses, renewal and expiration dates, etc.

Also get copies of any financing agreements the seller has negotiated, paying heed to finance charges, interest rates, and loan terms. These agreements can be helpful as future reference should the buyer wish to get a loan.

Examine copies of employee contracts and union agreements. Check out insurance policies to get an idea of the scope of coverage. If an exclusive dealership or license is involved in the purchase, be sure to get a copy of the contract and be sure the exclusivity is transferable. The same goes for any trade-name, patent or copyright registrations.

Ask to see evidence of ownership for real estate as well as other major items of personal property being transferred.

Court records will indicate whether there are any judgment liens against any real estate, or any pending lawsuits. Check with tax authorities to be sure no liability exists for unpaid taxes.

If all of this sounds nit-picking, it’s not. I know several buyers who thought they were buying something that actually wasn’t the seller’s to begin with. I’ve also known buyers to be hit with a breach of contract suit for an incident that took place before the business was purchased. These unpleasant incidents happen all the time, and can be avoided only by careful examination of all legal information.

Before signing a contract, both the buyer and seller should also consider tax consequences. By planning carefully before signing the dotted line, tax savings may be possible. Check with
the IRS for their tax guide for small businesses.

Contract terms, of course, must contain more than just price. Both parties (particularly the buyer) need protection to cover them from possible future problems.

Aside from stating the purchase price and method of payment, a typical buy-sell contract includes: clauses pertaining to the buyer’s assumption of contracts and liabilities; extensive warranties from the seller (stating no liabilities are outstanding, for instance); a list of seller’s obligations during the period between contracting and actual transfer of ownership; a seller’s covenant not to compete; conditions preceding Closing: time and place of the actual closing; indemnification by the seller as well as provisions for a seller’s security deposit for these indemnities (usually held in escrow for a year after closing); and provisions for arbitrating any disputes.

And that is, basically, that. Assuming you’ve done all your homework thoroughly, you should be fully aware of the value and potential of the business you’ve purchased. Hopefully, there will be no rude awakenings or out-and-out shocks after the deal has been closed.

**Should You Sell?**

But let’s move along and assume that you are the owner of a successful business. Let’s say you have reached a point where you no longer have to work the long, grueling hours that you put in when your business was new. Should you sell your “baby”: the business you built from scratch?

Actually, there may be a number of reasons for considering such action. Perhaps you are thinking ahead and want to diversify your personal holdings while increasing your liquidity. If you are thinking of your heirs, and planning your estate, selling now can prevent the forced sale of your business at a distressed price. In addition, your heirs will have the needed cash to pay estate taxes.

That’s only one reason, of course. But if vague thoughts have been stirring in your head about selling your business, the next question is: when?

It’s only natural for a business owner to think that the worst time to sell is when he’s doing the best. In reality, the opposite is true. When the future looks bright and rosy for a business, it can be sold for its full market value. And that’s the time that you have the most powerful ability to negotiate.

You should prepare extensive information about your business: including its marketing, management, financial statements and profit potential. While you shouldn’t ignore the weak aspects of your business, be sure and emphasize the positive strengths.

Putting a selling price on your business is a difficult task for many business owners. To arrive at a value, the fundamentals of the business must be examined: present and past financial statements, earning power, intangible values such as goodwill, the going market price for similar businesses, the present and future outlook on the market in general.

An important point in valuing your business is to be able to see it through the eyes of the prospective buyer. Since every business has its strengths, you should be able to see the major attractions of your business to the would-be buyer. Placing a value on your business’ strong points can help you negotiate the best deal with the buyer.

When you decide to sell, don’t overlook the effect of taxes and accounting. The money you obtain from selling your business may be taxable, partly taxable, tax-free, or tax-deferred. If you can arrange the deal so that you can defer or reduce taxes, it may be advantageous for you to accept a lower price.

When you receive your payment can also be important. Most sellers naturally would like to receive their money as soon as possible. Tax considerations, however, could make a deferred payment desirable. Be sure, of course, that the buyer has enough financial backing to eventually pay.

On certain occasions, buyers might ask for a contingent payment based on future earnings. Problems can arise if this method of payment is adopted, however, unless it is worked out skillfully.

In writing out the contract, you must include retrogressive liabilities and any continuing obligations. Before the contract is written, however, be very careful about giving the buyer too much inside advice without a deposit accepted in good faith. Remember, it is a dog-eat-dog world out there. I’ve know of sellers who have supplied oceans of inside information to a person they supposed was a prospective buyer. In actuality, however, the fellow turned out to be a competitor-or, on a few occasions, a future competitor. I have advised bona fide buyers to investigate a business-for-sale as thoroughly as possible. I advise you—the seller—not to supply too much information to so-called buyers, unless you’ve first checked out their authenticity.