BUYING AN EXISTING BUSINESS

How Can You Determine if it's a Deal or a Dog?

What the Buyer and the Bankers Want:

- Minimal risk on loan defaults
- Validated cash flow sufficient to support business operations <u>and</u> pay debts back
  - *Existing businesses have historical data – their financial books and tax records*
- The right type and amount of collateral – *are you buying the Good and the Bad?*
  - *Age of Equipment – is it in good shape or inefficient and in need of replacement or updating?*
  - *Age of Inventory – ready to sell or dusty, outdated stock with little or no value*

So How Can You Know?

Do A Thorough Credit Analysis

Credit Analysis is an analytical tool that:

- Helps to distinguish good, bad and grey deals
- Asks the right questions
- Provides trend analysis
- Provides credibility - *speaks banker's language*
- Answers 3 of the C's of Business Credit
  - Capacity
  - Cash Flow
  - Collateral

YOU SHOULD SEEK EXPERT ADVICE FROM RELIABLE PROFESSIONALS
(a CPA or Business Analyst with a forensic financial background)

The Financial Statements

BALANCE SHEET: Snapshot of the Company’s assets and claims against those assets. Shows what the Company owns, owes, and how it is financed.

INCOME or PROFIT & LOSS STATEMENT: Shows revenue and expenses and provides the “bottom line” of profitability over a specified period of time.

CASH FLOW STATEMENT: Shows sources and uses of cash as well as net changes in cash over a specified period of time.

Credit Analysis Process

- **Obtain the company's Accounts Receivable (AR) and Accounts Payable (AP) –** *you may have to sign a non-disclosure agreement*
- **Review three (3) years of the most recent financial statements and tax reports** to determine if the company is being operated profitably
- **Calculate operating cycle**, the average period of time required for a business to make an initial outlay of cash to produce goods, sell the goods, and receive cash from customers in exchange for the goods. *Longer payment terms shorten the operating cycle because the company can delay paying out cash*
- **VERIFY CASH FLOW is greater than anticipated debt service**

Can the current cash flow support the additional expenses the acquisition will require?

Step #1 in the Credit Analysis Process

Analyze the Company's Balance Sheet

- Snapshot of what the Company owns and owes at one date in time

Analyze its Profit and Loss Statement

- How the Company generates and spends its income
- How much profit does the Company make from sales? Enough to make it worthwhile?
- What problems did you and your CPA or Business Analyst identify?

Consolidated balance sheet

AS AT 31 DECEMBER 2014

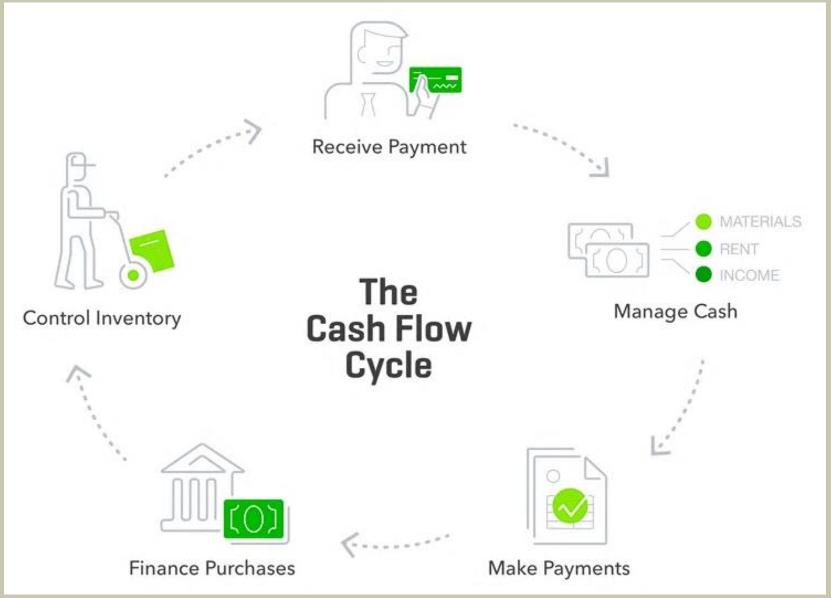
	NOTE	2014 US$M	2013 US$M
Assets			
Cash and cash equivalents	9	**852**	1,238
Investments	10	**27,716**	29,368
Derivative financial instruments		**20**	33
Trade and other receivables	11	**4,748**	5,119
Current tax assets		**5**	16
Deferred insurance costs	12	**2,031**	2,221
Reinsurance and other recoveries on outstanding claims	19	**3,464**	3,461
Other assets		**15**	11
Assets held for sale	13	**1,096**	50
Defined benefit plan surpluses	21	**44**	39
Property, plant and equipment	14	**362**	408
Deferred tax assets	15	**787**	801
Investment properties		**15**	13
Investment in associates		**14**	13
Intangible assets	16	**3,831**	4,480
Total assets		**45,000**	47,271
Liabilities			
Derivative financial instruments		**73**	20
Trade and other payables	17	**1,228**	1,614
Current tax liabilities		**192**	219
Liabilities held for sale	13	**671**	–
Unearned premium	18	**7,366**	8,184
Outstanding claims	19	**20,412**	21,669
Provisions	20	**95**	114
Defined benefit plan deficits	21	**117**	80
Deferred tax liabilities	15	**183**	397
Borrowings	22	**3,581**	4,571
Total liabilities		**33,918**	36,868
Net assets		**11,082**	10,403
Equity			
Share capital	23(A)	**9,391**	9,195
Reserves	23(B)	**(1,405)**	(1,470)
Retained profits		**3,044**	2,631
Shareholders' funds		**11,030**	10,356
Non-controlling interests		**52**	47
Total equity		**11,082**	10,403

The consolidated balance sheet should be read in conjunction with the accompanying notes.

Step #2:

Is the Cash Flow Greater Than the Debt Service?

THREE DEMANDS ON CASH FLOW



1. The Need for Ongoing Working Capital = inventory, administrative and workers' payroll, utilities, etc.

2. Debt Service = short and long-term loan payments

3. Capital Expenditures = the planned purchase of facilities and equipment plus the unexpected need for replacement

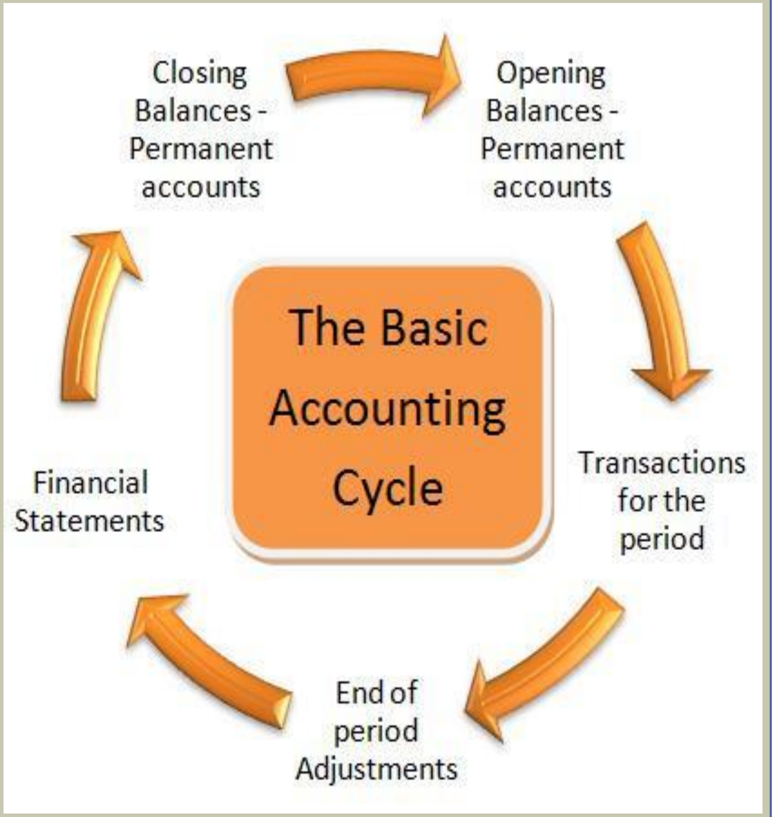
Cash Flows

- Existing cash flow pays for debt service
- Future profits will pay for increases in permanent working capital needs and necessary capital expenditures

Working Capital & Operating Cycles

DEFINITION: Cash invested in the operating cycle of the Company necessary to make profits

- **Operating Cycle** is the number of days cash remains invested in inventory to be sold which then converts to Accounts Receivable, which get paid to the company, turning back into cash



The Financial Statements

BALANCE SHEET: Snapshot of the Company's assets and claims against those assets. Shows what the Company owns, owes, and how it is financed.

INCOME or PROFIT & LOSS STATEMENT: Shows revenue and expenses and provides the "bottom line" of profitability over a specified period of time.

CASH FLOW STATEMENT: Shows sources and uses of cash as well as net changes in cash over a specified period of time.

Operating Cycle

DEFINITION: Number of days the Company currently uses to convert inventory sold back into cash available for use in operations, such as payroll, administrative and production expenses, more inventory purchases, debt service, etc.

Operating Cycle =

(Days of Inventory + Days of Accts Receivable) - (Days of Accts Payable - Days of Accrual)

Sometimes the answer is negative days, particularly for restaurants

Days in Inventory

DEFINITION: Number of days (360 for annual) cash is invested in inventory before being sold and becoming Accounts Receivable.

- **Is the inventory old, outdated and still sitting on the shelf, tying up the company's money?**

$$\text{Days in Inventory} = \frac{\text{End of year Inventory} \times 360 \text{ days}}{\text{Cost of Goods Sold (COGS)}}$$

Days in Accounts Receivable

- Compare days of Accounts Receivable (A/R) to the Company's sales terms and industry norms to determine collection efforts.
- Normal terms net due in 30 days
  - Are customers late in paying? Is anyone at the company paying attention to who is and who is not paying on time?

$$\textbf{Days Receivable} = \frac{\textbf{End of year A/R} \times \textbf{360}}{\textbf{\$ Annual Sales}}$$

Days in Accounts Payable

- Compare days outstanding of Account Payable (A/P) to the company's sales terms to its suppliers and industry standards
- Normal terms net payable in 30 days
  - Is the company late in paying what it owes to suppliers or vendors? Is the company unnecessarily paying late fees? Is anyone paying attention to who is and who is not being paid on time and why?

$$\textbf{Days Payable} = \frac{\textbf{End of year A/P} \times \textbf{360}}{\textbf{Cost of Goods Sold (COGS)}}$$

Days in Accruals

- Focus on Payroll Accruals, not income or state taxes payable
- Check for delinquent sales and payroll taxes – *you could be liable for that!*

$$\textbf{Days Accrual} = \frac{\textbf{Accruals} \times \textbf{360}}{\textbf{COGS (Cost of Goods Sold)}}$$

Debt to Equity Ratio

- Measures financing provided by outside lenders compared to the financing provided by owners and/or investors

$$\text{Debt to Equity} = \frac{\text{(Total Liabilities - Officer Loans)}}{\text{(Net Worth – Intangibles + Officer Loans)}}$$

- **Should be less than 1**

CASE IN POINT: Magic Fingers, Inc.
A Deal or A Dog??

- Magic Fingers, Inc. has been very successful in the past by selling custom window treatments
- Sales strategy: Capture all of the market by beating any advertised price from the "Big Box Stores" competitors
- The owners personally own the warehouse and charge rent to the Magic Fingers Company
- The Magic Fingers Company pays a subsidiary to produce the custom window treatments
- The owners have invested $400,000 in manufacturing equipment to create window treatments in 24 hours by their subsidiary

Let’s Review Magic Fingers Inc.

- These statements have been “compiled by a CPA”. *A compilation is ranked as third in reliability of numbers. Highest to lowest reliability starts with an Audit, Review, Compilation, Tax Returns prepared by a professional down to Self-Prepared Tax Returns*
- What is occurring with total liabilities?
- What is your biggest concern on the Profit and Loss Statement?
- What should you be looking for?

Calculate Days of Inventory

- Locate the inventory section on the Balance Sheet, then find the COGS on the Profit & Loss

BALANCE SHEET				
	1993	**1994**	**1995**	
ASSETS				
Cash and Marketable Securities				
Accounts Receivable				
Inventory	691	829	758	

PROFIT & LOSS STATEMENT			
	1993	**1994**	**1995**
Sales	4673	3827	3543
COGS	2641	2206	2083
Days Inventory	94	135	131
	(Inv/COGS)*360	(Inv/COGS)*360	(Inv/COGS)*360

Calculate the Days Accounts Receivable

- Look for the Accounts Receivable on the Balance Sheet, then find the Sales account on the Profit & Loss

BALANCE SHEET			
	1993	**1994**	**1995**
ASSETS			
Cash and Marketable Securities			
Accounts Receivable	3	4	3
Inventory			

PROFIT & LOSS STATEMENT				
	1993	**1994**	**1995**	
Sales	4673	3827	3543	
Days Receivable	0.23	0.38	0.30	
	AR/Sales*360	AR/Sales*360	AR/Sales*360	

Calculate the Days Accounts Payable

- Find the Accounts Payable under the Liabilities section, then locate COGS on the Profit & Loss Statement

BALANCE SHEET			
	1993	**1994**	**1995**
LIABILITIES & NET WORTH			
Notes Payable-Bank			
Notes Payable-Other			
Accounts Payable	304	377	367

PROFIT & LOSS STATEMENT			
	1993	**1994**	**1995**
Sales	4673	3827	3543
COGS	2641	2206	2083
Days Payable	41	62	63
	(AP/COGS)*360	(AP/COGS)*360	(AP/COGS)*360

Calculate Days Accrual

- Find Accruals under Liabilities on the Balance Sheet, then locate the COGS on the Profit & Loss

BALANCE SHEET			
	1993	**1994**	**1995**
LIABILITIES & NET WORTH			
Notes Payable-Bank			
Accounts Payable			
Accruals	7	5	4

PROFIT & LOSS STATEMENT			
	1993	**1994**	**1995**
Sales	4673	3827	3543
COGS	2641	2206	2083
Days Accrual	1	1	1
	(AC/COGS)*360	(AC/COGS)*360	(AC/COGS)*360

Calculate the Operating Cycle

Operating Cycle	1993	1994	1995
Days Inventory +	94	135	131
Days Receivable +	0.23	0.38	0.3
Days Payable -	41	62	63
Days Accrual -	1	1	1
Number of Days in Cycle	52	73	68

Calculate the Debt to Equity Ratio

BALANCE SHEET				
	1993	**1994**	**1995**	
LIABILITIES & NET WORTH				
Subordinated Officer Debt		162	223	
TOTAL LIABILITIES	697	910	928	
TOTAL NET WORTH	632	512	414	
Debt to Equity Ratio	1.10	1.11	1.11	
	(Total Liabilities-Officer Loans)/(Net Worth + Officer Debt)			

Credit Analysis on Magic Fingers Inc

The Quality Indicator Checklist provides some of the questions necessary to determine if Magic Fingers is a deal or a dog.

Do you notice any trends?

- **Too many days of inventory vs sales?**
- **Why are they late in paying aka "riding" their suppliers**?
- **What matters most to the customer?** Speed of delivery or cost? Are they using Just-In-Time techniques to control inventory? Do they need better supply chains?
- **Are they competitive with the Big Box stores after all?**
  - What should the Company keep doing to maintain profitability or change to improve it?
  - How would you present a loan package to a banker?

Remember: Lenders look for cash flow and collateral to do the loan

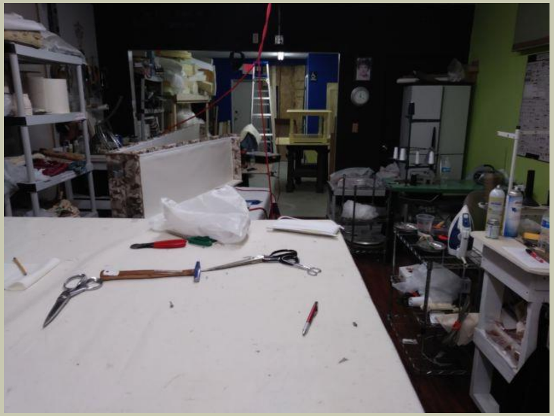
Structuring the Deal

Let’s review Cash Flow from the Profit and Loss

- Is there any Cash Flow?
- What does the negative Gross Profit mean?
  - How could we correct?
  - Which major expense is controllable by the owners?

Collateral

- What are Magic Fingers' assets?
  - The owners lease the real estate to the company. Is the building part of the deal?
  - All the company really has is equipment and inventory that will be depreciated considerably according to its remaining "useful life"
- What else will you, as the buyer, need to offer to the lender as collateral?



Restructuring the Deal

- **OUR STRATEGY**: Concentrate on quality custom window treatments and turn the “price fight” back to more quality issues. Offer fast production time at a premium price. Then the gross profit should increase, thus raising the bottom line.
- Pricing requires market research on similar competitors and careful target marketing to smaller commercial /quality-conscious customers
- If they offer financing, what will happen to the Cash on the Balance Sheet? *Offset materials cost with customer down payments in advance on all orders*

Packaging the Loan

- **OUR STRATEGY**: Keep at least 14 days of cash on hand

  Days Cash = (Cash / Sales) x 360

- Obtain a revolving line of credit with an SBA 7A CAP line from a bank or lender to help finance custom jobs.
- Rent the building or buy it outright? Negotiate rental terms on the building or purchase it outright over 20 years with a SBA 504 mortgage

Moral of the Story

SEEK PROFESSIONAL ADVICE.

Tap into SBA RESOURCES like the VBOC, SBDC and SCORE for no to low-cost counseling and analysis.

Consult with your **BAIL Team (Banker, Accountant, Insurance Agent and Lawyer**) before signing anything!

Content Credit

- Johnny Branch, CPA, MBA

Certified Business Analyst with the Florida Small Business Development Center, Panama City

- Dr. Len Eichler, PhD

Certified Business Analyst with the Florida Small Business Development Center, Panama City

Revised July 2019 by VBOC