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20 Common Mistakes in Buying a Small Business

Buying a business is one of the most complex activities for business owners. The process of negotiating a good deal and coordinating with the seller, legal, insurance, financing and people issues can be overwhelming. But at the same time it can be a wonderfully rewarding experience for a buyer to enter a new phase of their life. Following are some common mistakes we have found when buying a business:

1. **Having insufficient cash to operate the business.** Frequently business buyers fail to adequately project cash flow of the business and forget it takes working capital in the business to make it successful. Most small businesses are sold without accounts receivable or accounts payable. The new owner will need sufficient cash to build up working capital and capital for changes in the business. Changes will happen and always require cash to work through those changes.

2. **Inadequate competent advisors.** Many business buyers try to save money by using inexpensive legal, tax, accounting and insurance advisors that do not have sufficient experience with the purchase of a business to give you the help you need. Your advisors don't have to be the most expensive or prestigious in their area, but they must have sufficient relevant experience to help you navigate the process. Planning on the front end to have adequate cash flow projections, legal structure and insurance can help prevent disasters down the road.

3. **Not controlling your advisors**. As a buyer you should be in control of the process. Frequently, overzealous advisors will kill a transaction with the good intentions of protecting you the buyer. You the buyer has to be willing to instruct the advisors of which risks you are willing to take. If you are not willing to assume any risks, don't buy a business.

4. **Buying a business that is not a good fit for you.** To have a good fit, the buyer must assess their own skills and weaknesses to make sure the business they are buying is a good fit for their background and abilities. Determining how to fill the gaps in your weaknesses before you buy the business will have a big impact on your success in that business. Are you a hands on type of person or a management type of person who gets their work done through other's skills. If your background is with large organizations where there were always sufficient technical skills available in your business to handle complex situations, you will have to find those skills outside of your newly purchased small business. For

example, in most small businesses with under 50 employees, the owner is the main marketing person. Is this a good fit for you?

5. **Failing to set up an appropriate business entity to use for the purchase.** Although sole-proprietorships are still a common form of business ownership, most of the time the buyer will want to have a legal entity that helps protect their other assets from business liabilities. In some states, such as Texas, this type of legal structure may cost you some additional annual state taxes. You should consider this cost as additional insurance against unforeseen events and liabilities.

6. **Inadequate due diligence.** Due diligence is the process of verifying the sellers statements and representations. Understanding how a business operates and verifying the representations of the seller is critical before you buy the business. Financial statements and tax returns can be fake. Just ask about Enron. There may be outstanding lawsuits, judgements, customer complaints, returns and significant warranty work that are not reflected in any of the information supplied by the seller. Also, during due diligence the buyer needs to determine if there are significant assets in disrepair or on the verge of being obsolete. You the buyer needs to manage the due diligence effort and control what your due diligence team is going to do. If you do not have the skills to verify management's statements, you will need to hire experts to do this for you. This is another area where business buyers try to save money and because of this they fail to see a clearer picture of the business. In a well written purchase agreement, a lot of these minor worries can be overcome. If a seller finances part of the purchase, you should have the right of offset in the agreement to help with these potential problems. However, if the problems are significant, the documents alone will not save you the buyer.

7. **Understanding the seller's motivation to sell.** Often business sellers will simply say they want to retire. Sometimes there are other motivations such as new or threatened completion, changes in the business climate, product obsolescence, workforce problems, threatened litigation and many other reasons. The location may be imperative to the success of the business and the seller may know that some governmental entity is going to change roads, bridges, street access or other changes that makes the location not as good as it has been in the past.

8. **Understanding the company's reputation.** The goodwill of a successful business is a significant part of its value. If the reputation or goodwill has been recently tarnished, then the value of the business in the future will most likely be less than it has been in the past. Do you know how to check a company's reputation?

9. **Failing to focus on the purchase agreements.** These agreements are very complex. In real estate there are many standard forms provided by the state real estate commission. However, this is not the case for business sales. There are sample forms available on the internet and for purchase from online information sources. These sample forms can range in size from 2 pages to 200 pages. It is important to have in the document those conditions that are relevant to the business being purchased to provide you the new business owner with adequate title to the assets free of unknown liabilities.

10. **Not knowing your financial requirements.** When small businesses are purchased by a new business owner, frequently the new buyer fails to understand the cash flow requirements of the business and their personal lifestyle financial needs. Most small businesses are purchased with some type of financing. This will be a drain on the business future cash flow. If you or some other investor / owner do not have sufficient capital invested in the business, then the payments to buy the business could cause the business to fail or not be able to grow.

11. **Making too many changes to fast.** When this happens, frequently key employees will become disgruntled and leave. Most of the time, these key employees have the knowledge of how the business operates and are a significant part of the goodwill or value of the business.

12. **Relying too heavily on existing customers.** When the ownership of a small business changes, certain customers will go away. It may be nothing that the seller or the buyer did. From the very beginning of owning the business, the new owner must establish favorable relationships with the customers and obtain new customers.

13. **Overpaying for the business.** In business valuations there are many formulas and methods to value the business. The value of the business frequently depends on the buyer and how the buyer will operate the business. Because the valuation methods are complex and have many small assumptions in their calculation the buyer should have someone familiar with the calculations, evaluate and advise the buyer. The seller's broker most of the time represents only or primarily the seller. Too often business valuation experts fail to consider key factors in their valuation. A key factor may be the seller is not willing to sign a reasonable non-compete agreement. All of the other valuation methods and calculations may be correct but in some businesses, the lack of a non-compete agreement from the seller makes the business goodwill worthless. The business is then worth only the liquidation value of the hard assets.

14. **Not planning the transition period.** This is the time after the sale where the seller transfers to the buyer the skills needed to successfully operate the business. For some businesses this can be as little as two or three weeks of time. However, for more complex business, in particular manufacturing, this is frequently many months. Included in the agreement should be details of the training and the entire transitions period. For example, if customer relations are significant the buyer should specify that customers generating 75% of the revenue should be personally introduced to the buyer. If there are trade secrets on how to make certain products, those processes should be documented by the seller prior to the end of the transition period.

15. **Not being flexible.** If you really want to be your own boss, consider all types of business – initially. Then narrow down to the types of businesses to where you feel your skill set will help you be successful in operating and managing the business. Don't steer away from franchises because you don't want to pay the franchise fees. Many are very successful.

16. **Expecting too much financial information and systems documentation.** If you are looking at businesses of 50 employees or less, good financial information and systems documentation is not the norm. Very few small businesses have this type of information. This does not mean they are a bad purchase you just have to be willing to accept this and adjust accordingly. This makes the transition period planning critical.

17. **Paying all cash for the business.** If the seller is willing to finance as little as 10 percent of the purchase price, the seller has some confidence in the value of the business and their statements to you the buyer. Also, be sure to include the right of offset in this agreement. If the seller is not willing to do seller financing on the business, try to get 10 percent of the sales price put into an escrow account for one year with stipulations on how it can be forfeited to you the buyer.

18. **Waiting to make an offer until you have all the information.** If this is a good business, you will not be the buyer if you wait to make your intentions known to the seller. Your preliminary offer should be in the form of a non-binding letter of intent.

19. **Not closing quickly.** When deals start to linger there are many problems that can come up. Key employees may get wind of the transaction and leave. Customers may find out the business is for sale and start looking for another company to provide what this business provides. Suppliers might get nervous and stop extending normal trade terms. An adage in the business sales environment is good deals close fast and bad deals linger. Make sure you manage your advisors to get it to close quickly.

20. **Seller family members.** If the seller has family members in key positions, be cautious. If a family member is in a sales role and unwilling to sign a non-compete agreement – run and do not buy this business. If a family member is in accounting and is fairly compensated, they can be reasonably replaced with similar compensation. If a family member has a key roll in a manufacturing or process business, be careful and make sure this is a replaceable position. If you are uncertain, pass on this business and go on to another opportunity.