Chapter 1

Sourcing the Deal

Sea Story

Endless Possibilities

I huddled against the back wall of the elevator as it slowly ascended to the 12th floor of the Merchandise Mart building in downtown Chicago. It was raining outside, causing the passengers to keep a few inches apart so as to not make one another even wetter. The rain storm had broken the uncomfortable mid-September humidity only to replace it with the discomfort of soggy shoes and socks.

Even so, I was excited, if still a bit uncertain. Today was the day my business partner Matt and I would start our business acquisition search. When the elevator finally reached my destination, I gently pushed past those not exiting into a large and mostly empty hallway. I was headed to 1871, an *office space for rent* outfit reminiscent of WeWork.

1871 is the home of hordes of aspiring entrepreneurs just leasing a work space, several Chicago startup companies, and Bunker Labs - a network of military veterans and spouses working to start their own businesses. As former naval officers, Matt and I qualified to work in the Bunker Labs space free of charge.

I gave my name to the 1871 receptionist and told her that I was part of the Bunker Labs group. She quickly rifled through a thick packet of papers, found my name, and opened the clear plexiglass gate. Once inside I made the first right down a second hallway until I found Bunker Labs. The far wall had a bar setup with a few cases of beer stacked against it. Clearly, networking among veteran entrepreneurs was a focus here. The right side of the room contained four long tables that would sit two on each side. The wall behind the tables was painted a distinct burnt orange that Bunker Labs had chosen for its branding. The wall also contained the Bunker Labs logo – its name in stylized font with a lightbulb on the righthand side and four orange lines emanating from the base of the lightbulb. The symbolism was obvious – *here ideas are put into motion*.

Matt was already there waiting for me. As I approached, he quickly transitioned from staring at his computer screen deep in thought to greeting me with a smile. I hung my damp raincoat on a chair on the opposite side of the table and then sat down next to him. "So," I said, "where do we start?"

Deciding to buy a company is a monumental decision. But how do you *execute* that decision? Businesses don't typically have a "For Sale" sign sitting out front. Where do you start looking? How do you know which businesses are on the market? How do you approach companies *not* on the market?

Matt glanced over at me and smiled. "I'm way ahead of you," he said as he turned back to his computer screen and continued typing.

Intrigued, I leaned to my right to see what he was working on. Matt was filling out fields in the advanced search form of a website that I didn't immediately recognize. After providing the required information, Matt leaned back and hit the "Enter" button on his keyboard with a distinct sense of completion. The website took only seconds to generate a list of businesses for sale. Impressed that we were already making progress, I glanced up to the top of the web browser. There was a URL with which I was not familiar – *BizBuySell.com*.

The Process

Use Available Resources to Collect Vital Information

Before diving into the various resources listing businesses for sale, I recommend you start by developing a planning spreadsheet to collect vital business information. Like most, I use Microsoft Excel, but any spreadsheet program will do. This spreadsheet should capture the key metrics for and vital information about the businesses you are considering.

Create a spreadsheet with (at least) the following categories:

- **Business name or description** – Business owners usually don't want word getting out that the business is for sale. It tends to spook both employees and customers, which could lead to attrition of both and result in the business becoming less valuable. When that is the case, use the business description as an identifier.

- **Location** – Be as specific as possible. Location will determine your commute, the amount of time you spend onsite, who your customers are, who your employees are, and many other important aspects of the business.

- **Business Type** – Make a note regarding what *type* of business you are evaluating. I recommend the following categories: service business, retail, manufacturing, and restaurant. You may also want to make note of whether the business is a franchise or a stand-alone entity.

- **Asking Price** – If available, include the seller's asking price. It's good to have an upfront understanding of the seller's expectations. Otherwise, you risk spending a lot of time studying the business only to find out there is a deal breaking misalignment in perceptions of value. However, be aware that a seller will not always advertise his or her desired price. Some sellers will present a potential buyer with several years of company financial data, allowing the buyer to present the initial valuation. This usually occurs with larger transactions, such as business selling for $5 million or more.

- **Revenue** – This is the amount of money the business receives from sales. It is independent of expenses. Revenue is the first metric to consider in understanding the business from a financial standpoint. Revenue is sometimes called "income" – don't let that confuse you. Revenue should be assessed on an annual basis.

- **Earnings** – This is the amount of profit the business (claims to) make. At a high level, this is just revenue *less* (accounting speak for *minus*) expenses. Earnings is a tricky metric; business owners play a lot of games with it in order to claim the highest possible value for their business. Cash Flow, net operating income, net income, EBITDA, adjusted EBITDA, and seller's discretionary earnings (SDE) are all different takes on this idea of *earnings*. We will discuss the differences later; for now, it is enough to understand we are interested in how much profit the business claims. This profit represents the money that will be available to meet the new obligations you put on the business – including debt service, new investments in the business, and your take home pay. Earnings should also be assessed on an annual basis.

- **Margin** – Earnings divided by revenue presented as a percentage. This is a measure the business' profitability.

- **Asking Price Multiple** – Asking Price divided by Earnings. This shows the seller's asking price as a *multiple* of the business' annual earnings. There are standard conventions, usually on a *by industry* basis, for what multiples are appropriate and what are unreasonably expensive.

See below for an example of a Business Search Spreadsheet.

Business Search Spreadsheet

Business Name or Description	Location	Business Type	Franchise or Stand Alone	Asking Price	Annual Revenue	Annual Earnings	Margin %	Asking Price Multiple Relative to Earnings
Working Man's Window Washing	123 Alphabet Road Elgin, IL 60123	Service Business	Stand Alone	$ 1,250,000	$ 1,000,000	$ 250,000	25%	5x
Terrible Tree Service	Batavia, IL	Service Business	Franchise Location	$ 900,000	$ 1,100,000	$ 200,000	18%	4.5x
Barbara's Book Store	Geneva, IL	Retail	Stand Alone	$ 480,000	$ 800,000	$ 120,000	15%	4x
Gatecheck Greeting Cards	West Chicago Suburbs	Retail	Franchise Location	$ 675,000	$ 750,000	$ 150,000	20%	4.5x
Paula's Print Shop	987 Oak Lane Naperville, IL 60540	Manufacturing	Stand Alone	$ 1,225,000	$ 1,750,000	$ 350,000	20%	3.5x
High Volume Signage Franchise	Downtown Chicago	Manufacturing	Franchise Location	$ 800,000	$ 1,333,333	$ 200,000	15%	4x
Tommy's Tavern	Cook County, IL	Restaurant	Stand Alone	$ 650,000	$ 1,380,000	$ 240,000	17%	2.7x
Cary's Coffee	Downtown Naperville	Restaurant	Franchise Location	$ 659,000	$ 1,229,209	$ 227,110	18%	2.9x

Having developed a spreadsheet that will capture essential business metrics, you are ready to begin your search. We will focus the following four lead generators: public websites, business brokers, proprietary opportunities, and cold letter writing.

<u>Public Websites</u>

When starting your "businesses for sale" search, the easiest place to start is the internet. There are several sites with this specialty. BusinessesForSale.com, WebisteClosers.com, and BusinessBroker.net are all viable options.

I've personally used BizBuySell.com. First, create an account using your personal email address. Then, using the site's advanced search feature, create and save a search that meets your needs. You can narrow your search by:

- Business category and subcategory
- States
- Counties
- Cities
- Keywords
- Seller's Asking Price (Price Range)
- Earnings (Cash Flow)

Your refined search will generate a list of businesses for sale. Review the descriptions and financial metrics; save those businesses that appeal to you. Be sure to record the key business information in your Business Search Spreadsheet. Provided you have signed into your account, the "My BizBuySell" feature will give you access to all your previously saved searches and businesses.

Axial (axial.net) is an online deal aggregation site and a noticeable step-up from BizBuySell and the like. The site requires verification and approval to setup an account, provides a live web conference tutorial, allows the user to define deal parameters, and enables deal status to be tracked. Axial has become my primary platform for sourcing brokered deals.

However, while public websites are a good place to start, sophisticated entrepreneurs tend to be dismissive of their listings. Many believe that the best deals are presented directly to well networked buyers, while the rest end up online. I'm even familiar with one investor who calls online deal sourcing "dumpster diving". Maybe so, but don't forget that, every once in a while, something valuable ends up in the dumpster.

<u>Intermediaries - Business Brokers and Investment Bankers</u>

As you use these websites, you will discover they are a consolidated internet listing of businesses for sale. Each individual listing must be posted to the site. This posting is most often created by a business broker.

A business broker is a professional who lists the business for sale, represents the seller, and facilitates negotiations between the seller and interested buyers. An SAT-type analogy might be: *a business broker is to a business as a real estate agent is to a house*.

When contacting prospects through public websites, you will usually be put in touch with the listing's business broker. Nevertheless, it is a good idea to develop relationships with business brokers directly. A simple internet search will provide you a list of business brokerages in whatever geographic area you select. Be sure to reach out to these firms; meet in person if possible. Let the brokers know you are actively looking for a business to acquire, the types of business in which you are most interested, and any other information you deem critical.

Do not, however, define your interests too narrowly. The idea is to develop a professional relationship that will lead brokers to proactively bring you acquisition leads. Such relationships will be helpful throughout your career, especially if you hope to grow your business through multiple acquisitions.

Proprietary Opportunities

Acquisition leads found through a website or business broker have put themselves on the market. This indicates they are motivated to sell. Sometimes the desire to sell is benign. For instance, the current owner has reached retirement age and has no succession plan. This often occurs when the owner has no children or has children who are not interested in the business.

However, the desire to sell can also be an indication of underlying problems. The current owner may be trying to cash out before the ship runs aground. We will exam how to fetter out the health of a business for sale in a subsequent discussion of *due diligence*.

For now, let us consider the pursuit of businesses not publicly for sale, but that *might* be willing to sell if approached by the right partner and, of course, offered the right price. *How do you find these companies* -and- *how should you approach these companies once identified?*

Discovering acquisition prospects not publicly listed is most easily accomplished if your search is focused on a particular industry. This is because these opportunities are often discovered by partnering with an industry insider. These industry insiders tend to have spent a long time (usually a full career) either working in that industry or being attached to the buying and selling of businesses in that industry. Over many years, they develop intimate knowledge of industry economics, the competitive landscape, and the customer base. Sometimes this knowledge is at a national level, but more often it is specific to a region. Because industry insiders have relationships with the key players, they can introduce you to businesses owners willing to talk sale.

We have worked extensively with a semi-retired business broker who knows all the ins and outs of the print industry in the Chicago metro area. In order to avoid the brutal Chicago winters, he now resides in South Carolina. Even so, he is able to pick up the telephone and introduce us to great printing companies which might sell. If a deal closes, the buyer owes him a finder's fee based on the business' trailing twelve month (TTM) revenue. See his fee breakdown below:

TTM Revenue Level	Finder's Fee
$500,000 - $1,500,000	3.0%
$1,500,000 - $2,500,000	2.5%
$2,500,000 and thereafter	2.0%
Under no circumstances shall the Finder's Fee be less than $15,000	

For example, if our industry insider were to steer us toward an acquisition with $1.7 million in TTM revenue. We would owe him **$30,000** (3% of the $1 million between $1.5 million and $500k) plus **$5,000** (2.5% of the $200k between $1.5 million and $1.7 million). That might seem expensive, but it is a small price to pay to acquire a healthy business.

If you are just starting your entrepreneurial journey or are new to an industry, it may be difficult to identify this type of partner. We didn't meet ours until we already owned three printing companies. I encourage you to start your search by looking at publicly listed companies and to network along the way. As discussions progress, you never know who you might meet.

Cold Letter Writing

Lacking an industry insider to make acquisition overtures on your behalf? You might consider approaching an established business yourself. This is best initiated with a letter or email expressing your interest. See the example letter below:

To: Joe Doe, Owner at Working Man's Window Washing
From: Jeffrey Payne, Chief Financial Officer at Entrepreneurship LLC

Dear Mr. Doe,

My name is Jeffrey Payne. I am the Chief Financial Officer at Entrepreneurship LLC. I also work on our company's business development projects.

We are impressed with the business you've built! We see potential synergies between your business and ours and were hoping to meet with you to discuss the possibility of a strategic merger. Such a partnership could take many forms – from full acquisition (resulting in a large cash payout to you) to a merger in which you retain ownership of a combined entity and work with us to grow the business nationally.

Please reach out to me at 410-123-4567 or jeff@entrepreneurshipllc.com to discuss the possibilities.

Very respectfully,

Jeffrey Payne
CFO, Entrepreneurship LLC

Based on the way this example is written, it should be clear that we have primarily used this approach for *subsequent* acquisitions. We generally use the previously discussed conventional lead generation tactics to establish ourselves in an industry. We then utilize cold letters to approach competitors we might want to acquire.

The example letter was written to be vague. The purpose is to entice interest and start a conversation. Be complementary! Express a desire to work together! Hint at the possibilities of growth through partnership! This approach will most often be ignored or lead to rejection, but, on occasion, can eliminate a competitor by adding its strength to your own.

Sea Story

NDA Awkwardness

I pulled my champagne-colored Subaru Outback into a tight parking space diagonally aligned to a drab building constructed of concrete and beige stone. It was nearly indistinguishable from every other building in this industrial park - located just far enough west of Chicago to avoid the city's draconian taxes. I leaned my seat back to await Matt's arrival – he was running just a few minutes behind. As I did, I noticed the company's roadside sign over my right shoulder. The logo was dated – a design you'd expect from the 1970s. It may as well have been; its colors were badly faded by the sun and the decal showed the faint cracks one would expect of cheap material left out in the weather for too long. It was mid-February and soot-stained snow sat wedged between the bottom of the sign and the cinderblock supports holding it up. The snow was slowly melting, forming a trickle that flowed back towards my car.

No matter. This was an industrial manufacturer of print. It's customers generally didn't visit the plant and, thus, there was no need to create the ambience of a retail store. The financials looked good and, if we agreed to buy the real estate as well as the business, there was a chance of making a profitable deal.

Matt pulled into the parking space next to mine just a few minutes later. We got out of our cars and congregated by his passenger side door. There we continued our early conversation about the businesses' operational capabilities while waiting for the business broker to arrive.

We had just finished exchanging concerns regarding how well differentiated this company was relative to its competitors when Randy pulled in at the other end of the small parking lot. He drove a teal sedan that badly needed a paint job and rode too low on its tires to be entirely safe. He opened the driver's side door and swung his legs out, then reached back to grab his leather satchel. His shirt was untucked in the back and the satchel was overly full, loose papers protruding from the loosely buckled top flap. He hastily put on a tweed sports jacket and began walking towards us.

He shook hands with Matt and exchanged pleasantries. Before Randy extricated himself from Matt's grasp, he looked over and eyed me suspiciously through thick rimmed spectacles. "Who is this?" he asked.

I smiled and extended my hand, which he hesitantly accepted, "Hi, I'm Jeff – Matt's business partner."

Randy worryingly looked back at Matt, "Has he signed an NDA?"

Matt, already heading for the door, glanced back over his shoulder, "I signed as CEO. That covers our company – including its officers."

Randy stopped dead in his tracks. His face soured; sweat glistened on his brow.

"I can sign one now…" I chimed in, hoping to put Randy at ease.

Matt shrugged and continued toward the door, "I'm sure it'll be fine--"

Randy exploded, "I'm just trying to do my job!"

Matt and I exchanged awkward glances. This acquisition was off to an uncomfortable start.

The Process

Sign the NDA, Get the Confidential Memorandum

Randy's emotional outburst was needless and unprofessional, but his heart was in the right place. Nondisclosure agreements (NDAs) are important documents that protect the seller. An NDA is a legal document that prevents the signer (in this case the prospective buyer of a business, supporting officers, and service providers) from revealing sensitive information about that business (in this case the fact that the business is for sale and anything learned about the business in due diligence).

As previously mentioned, the value of a business can be compromised if it is publicly known that the business is for sale. Also, if the sale of the business to a prospective buyer falls through, the business owner must be protected against his or her proprietary information falling into the hands of competitors. Be sure to take an NDA seriously. Violation of a signed NDA constitutes cause to sue for damages.

The NDA will be provided by the seller, usually by the representing broker. Review it carefully – with the assistance of legal counsel if possible. Make sure you understand what you're agreeing to – then sign and return to the seller.

In return, the seller should send you a confidential marketing slide deck called a *confidential information memorandum (CIM)*. These marketing decks are designed to present the opportunity to potential buyers. The following list of subjects are likely to be addressed:

- Summary of the Opportunity

    - Company Overview
    - Growth and Efficiency Opportunities
- Business Overview
    - Services
    - Facilities
    - Equipment
    - Management Information Systems
    - Sales & Marketing
    - Customer Segments
    - Human Resources
- Financial Statements
    - Income Statement
    - Balance Sheet
    - Capital Expenditures (CAPEX)

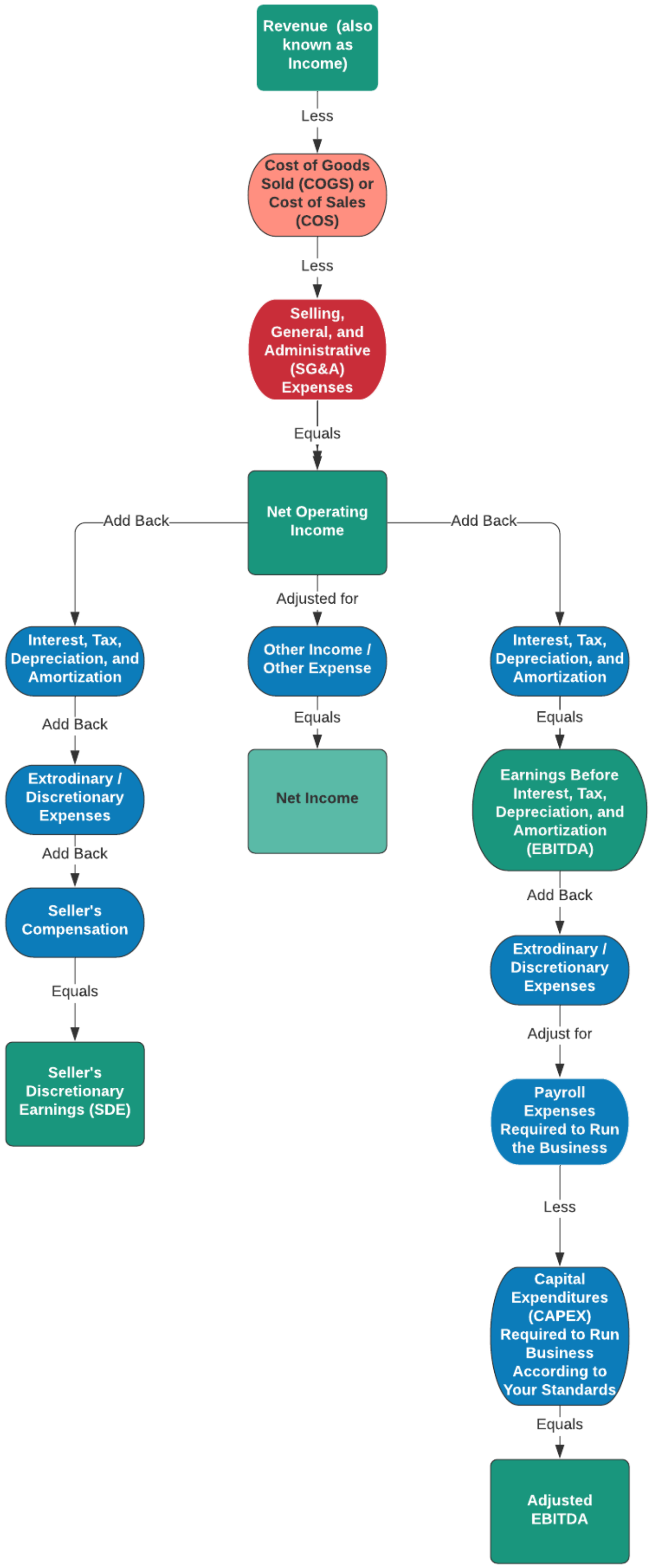
The CIM will likely start with a high-level overview of the business and the industry that it is in. Even before receiving the deck, much of this will be familiar to you.

In addition to the basics, many CIMs provide their selling proposition right up front. This is typically framed in terms of the financial opportunity the business represents to a prospective buyer. Such financial opportunity generally consists of three components: 1) stable profitability resulting in predictable cash flows, 2) growth opportunities, and 3) the opportunity to increase profitability through greater efficiency.

Before diving into specific examples of how a CIM might present the financial opportunity, we must describe in detail the nuances and various expressions of business profit.

An Essential Aside: Understanding Indicators of Profit

I will describe the terms used to express profitability in a manner consistent with my academic training and experience in business acquisition. Some of the definitions below, adjusted EBITDA and SDE in particular, are my own – developed by looking at countless marketing decks that use different financial nomenclature and trying to simplify to a common set of terms. I will use the flow chart below to guide the discussion.


Revenue (also known as Income)
Less
Cost of Goods Sold (COGS) or Cost of Sales (COS)
Less
Selling, General, and Administrative (SG&A) Expenses
Equals
Net Operating Income
Add Back
Add Back
Adjusted for
Interest, Tax, Depreciation, and Amortization
Add Back
Extrodinary / Discretionary Expenses
Add Back
Seller's Compensation
Equals
Seller's Discretionary Earnings (SDE)
Other Income / Other Expense
Equals
Net Income
Interest, Tax, Depreciation, and Amortization
Equals
Earnings Before Interest, Tax, Depreciation, and Amortization (EBITDA)
Add Back
Extrodinary / Discretionary Expenses
Adjust for
Payroll Expenses Required to Run the Business
Less
Capital Expenditures (CAPEX) Required to Run Business According to Your Standards
Equals
Adjusted EBITDA

Profitability, or lack thereof, is expressed via the financial statement known as the *income statement*. The income statement is more commonly referred to as the *profit and loss statement* or *P&L*. The P&L starts with revenue, also sometimes called income. Because revenue appears at the top of the P&L, business people will sometimes refer to it as the "top-line". The P&L then reduces revenue by the first of two classes of expenses – *cost of goods sold (COGS)*. COGS are those expenses directly attached to the product being sold. Payroll expenses for production employees, raw materials used to manufacture the product, and shipping costs to get the product to the customer are all examples of COGS. Businesses that sell services rather than products sometimes refer to this category as *cost of sales (COS)*. COGS or COS scale with revenue. As you sell more, revenue will increase, but so will the cost of providing your goods and services. Revenue less COGS equals *gross profit*. Gross profit is an indication of how profitable your business activities are *before overhead*. The P&L then reduces gross profit by a class of expenses known as *selling, general, and administrative expenses (SG&A)*. SG&A includes all other normal business expenses and is sometimes called *overhead*. The term overhead speaks to the idea that these expenses are generally incurred regardless of what revenue is achieved. For instance, even if sales are down in a particular month, you still need to pay the rent and your office manager's salary. Gross profit less SG&A expenses equals *net operating income.* Net operating income is the P&L expression of the business' profitability from normal business operations.

Net operating income is further adjusted by other income and expenses *not* from normal business operations. For instance, when one of our companies sold a printing press to make room for more modern equipment, the $18k we received from the sale was recognized as *other income*. This is because the company is in the business of selling printed products - not selling print manufacturing equipment. The sale of the press was business activity outside the company's normal business lines. Net operating income plus other income less other expenses equals *net income*. Net income is the basis of the business' tax liability.

However, when you buy a business, you are really buying its economic engine. The closing price of a business acquisition should be a direct representation of useful profitability acquired. Thus, we must appropriately express useful profitability. *Other income and expenses* are, by definition, outside normal business lines, nonrecurring, and *not* part of the business' economic engine. Therefore, we back out from net income and make net operating income our starting point. From net operating income, we will develop two expressions of profitability. The first is *seller's discretionary income (SDE)* – usually appropriate for smaller businesses in which the buyer intends to run the business in essentially the same manner as the previous owner. This includes the buyer personally performing all the business functions currently performed by the seller. The second is *adjusted EBITDA* – usually appropriate for larger businesses in which employees perform all essential day-to-day business functions and the owner provides executive oversight.

Seller's Discretionary Earnings (SDE)

First, let's adjust net operating income to SDE. Interest expense, tax, depreciation, and amortization must be added back to net operating income.

Interest is an expense paid on the company's debt. That debt may be from the seller's loans used to buy the business, to invest in production equipment, or to obtain working capital. Most acquisitions result in the seller settling those debts before the buyer takes procession of the business. As a result, interest expense incurred by the seller does not apply to the buyer.

Business taxes should be added back if included in the P&L provided. Corporations are taxed at the corporate tax rate, while limited liability companies (LLCs) pass the tax burden to its owners to be paid as income tax. Regardless, these taxes are usually omitted from the P&L and no action is generally required.

Depreciation and amortization are non-cash expenses on the P&L resulting from the reduction in value of company assets (real estate, production equipment, etc.) over time. Non-cash expenses reduce the business tax burden in the year they are recognized, but skew the P&L as a representation of the business' economic engine. Thus, they should be added back to create a representation of profit indicative of the business' capabilities.

Having added back interest, tax, depreciation and amortization, net operating income has been adjusted to *earnings before interest, tax, depreciation, and amortization (EBITDA)*. EBITDA is an important financial metric for many purposes, but just an initial adjustment when determining SDE.

Next, the buyer will wish to increase profitability by extraordinary and discretionary expenses. These are often called "add-backs". For instance, consider a situation in which the business incurred a large expense from implementing an enterprise resource planning (ERP) system. ERP systems provide the benefit of enhanced inventory management, sales and account management tools, and automated accounting functionality. Not only does an ERP improve the business, but its setup costs are non-recurring. Thus, these costs should be deemed extraordinary and added back to profitability. Discretionary expenses are expenses incurred, but not required for business operations. In the due diligence process, the seller should explain these in depth. As a prospective buyer, it pays to be skeptical.

Finally, there is the issue of the owner's compensation. To arrive at SDE, the seller will add-back all compensation he or she extracted from the business. As a business owner, your personal compensation is indeed at your discretion. Viewing profitability in terms of SDE is fine if you are comfortable stepping in, replacing the seller, and running the business as it had previously been run. *But beware* – businesses that present themselves in terms of SDE are usually small and the owner is usually heavily involved in critical day-to-day business functions. If you are valuing a business in terms of SDE, it is more accurate to say you are *buying a job* than it is to say you are *buying a business*.

Adjusted EBITDA

For larger businesses, those valued at $5 million or more, I do not recommend the owner-operator mentality for which SDE is designed. Rather think about profitability in terms of *adjusted EBITDA*. This expression of profitability includes all the expenses necessary to run the day-to-day business operations in a professional manner. Starting at net operating income, interest, tax, depreciation, and amortization are added back to achieve (true) EBITDA. Just as with SDE, add back extraordinary (non-recurring) and discretionary expenses.

Next adjust for payroll expenses required to run the business. Identify the business functions that the current owner is providing. Determine what it will cost to replace those functions by paying yourself a salary to fill that role and/or hiring new employees to assume those responsibilities. With respect to adjusted EBITDA, the current owner's compensation should indeed be an add-back increasing profitability, but must be replaced with a realistic assumed expense to replace that owner's role. Also, be sure to add assumed payroll expenses for any employee headcount shortfall. If the current owner saved money by not hiring a receptionist, but, in your view, the business needs a receptionist to be professionally run, reduce profitability by what it would cost you to hire someone to fill that role.

Necessary capital expenditures (CAPEX) should be treated much like payroll expenses. If the current owner has failed to properly invest in the business over time, profitability should be reduced by some reasonable amount. After all, you will have to incur those costs after the acquisition closes. We have acquired printing companies in which a great deal of production equipment modernization was needed. Insisting on an off-setting discount to profitability (and thus a reduced acquisition price) was key to making those acquisitions successful.

After making these adjustments, profitability is expressed in terms of adjusted EBITDA.

Cash Flows – Disclaimer

Beware of "cash flows" as an expression of profitability. This expression is used on BizBuySell.com listings, but it is unclear exactly what is meant. Cash flows are typically expressed on the *statement of cash flows* financial statement. A statement of cash flows shows the cash flows into and out of the business' bank account. It is a true expression of how a business builds (or draws down) cash over time. However, this rigorous definition is not what is meant when *cash flows* are used to express profit. When presented "cash flows", I recommend you file the information away in the back of your mind as a ballpark idea regarding how profitable the business is. Then proceed with the more exact work of using financial data to arrive at either SDE or adjusted EBITDA.

The Process

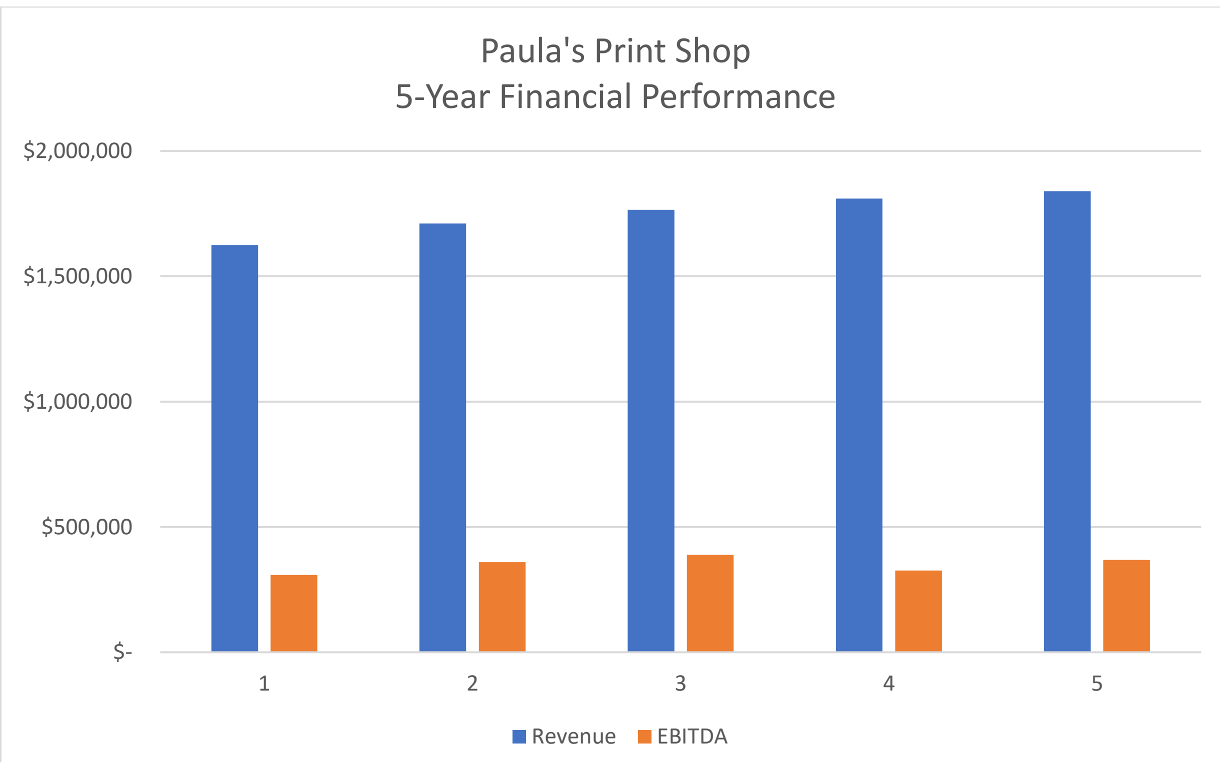
Analyzing the Confidential Memorandum

Summary of the Opportunity

Now that we have explored profitability, consider the two examples below. Let's start with Paula's Print Shop.

Paula's Print Shop

	Year 1	2	3	4	5	Average	AAGR	CAGR
Revenue	$ 1,625,000	$ 1,710,000	$ 1,765,000	$ 1,810,000	$ 1,840,000	$ 1,750,000		
Revenue Growth		*5.2%*	*3.2%*	*2.5%*	*1.7%*		*3.2%*	*3.2%*
EBITDA	$ 308,750	$ 359,100	$ 388,300	$ 325,800	$ 368,050	$ 350,000		
EBITDA Growth		*16.3%*	*8.1%*	*-16.1%*	*13.0%*		*5.3%*	*4.5%*
EBITDA Margin	19%	21%	22%	18%	20%			



At first glance, these financials look good. Paula's Print Shop has grown revenue each year over the 5-year period. This indicates that the business is steadily increasing sales by selling more to its customer base, consistently adding new customers, or both.

But does revenue growth matter? Shouldn't we be focused on what profit is doing year over year? After all, it is the earnings of the business that put money in your pocket. True – and we'll assess profits in just a moment – but do not underestimate what revenue growth can tell you about a business. Revenue growth is an indicator of sales activity. Growing revenue indicates that either the business has a viable sales engine (i.e. a successful internal sales force) or the business is growing organically (i.e. new customers are flocking to the business via positive word of mouth). Either indicates a company poised for future success. Stable revenues usually indicate a loyal customer base, but a lack of sales activity necessary for growth. Declining revenues indicate that the business is fundamentally unhealthy and will take dedicated action to correct its course. Revenue declines may indicate a fickle customer base or a lack of needed sales activities, but could also indicate that the business is in a declining industry or is failing to execute for its customers. Buying a business with declining revenues at the right price could end up being very profitable, but you better have a plan change the status quo.

Though revenue has grown each year over the 5-year period, earnings growth has been a bit more erratic. Year 4 even shows earnings decrease from Year 3. This is not unexpected, nor is it cause for alarm. Remember that as sales grow, different product or service lines, which will have varying profit margins, will grow at different times. In addition, all customers are not equally profitable. Adding customers by offering steep introductory discounts can be a great way to grow revenues and profits in the long-term, but reduce profits in the year they are offered. Reduced earnings can sometimes be attributed to additional expense from reinvestment in the business, though a good business broker will usually see those expenses added back to the bottom line. Paula's Print Shop expresses profits as EBITDA, which almost certainly means adjusted EBITDA in our established lexicon. This should be confirmed with the seller or the seller's broker, but marketing materials always seek to express the highest plausible level of profitability.

Since the revenue and earnings of businesses for sale are generally assessed over a 5-year period, it is useful to consolidate growth into metrics that cover that period. Average annual growth rate (AAGR) and compound annual growth rate (CAGR) are two such metrics.

The AAGR is the average increase in the value of the cash stream over the period of a year. It is calculated in accordance with the following formula:

$$AAGR = \frac{GR_A + GR_B + \cdots + GR_n}{N}$$

where:
GR_A = Growth rate in period A
GR_B = Growth rate in period B
GR_n = Growth rate in period n
N = Number of payments[i]

The CAGR is the rate of return that would be required for an investment to grow from its beginning balance to its ending balance, assuming the profits were reinvested at the end of the year of the investment's lifespan. It is calculated in accordance with the following formula:

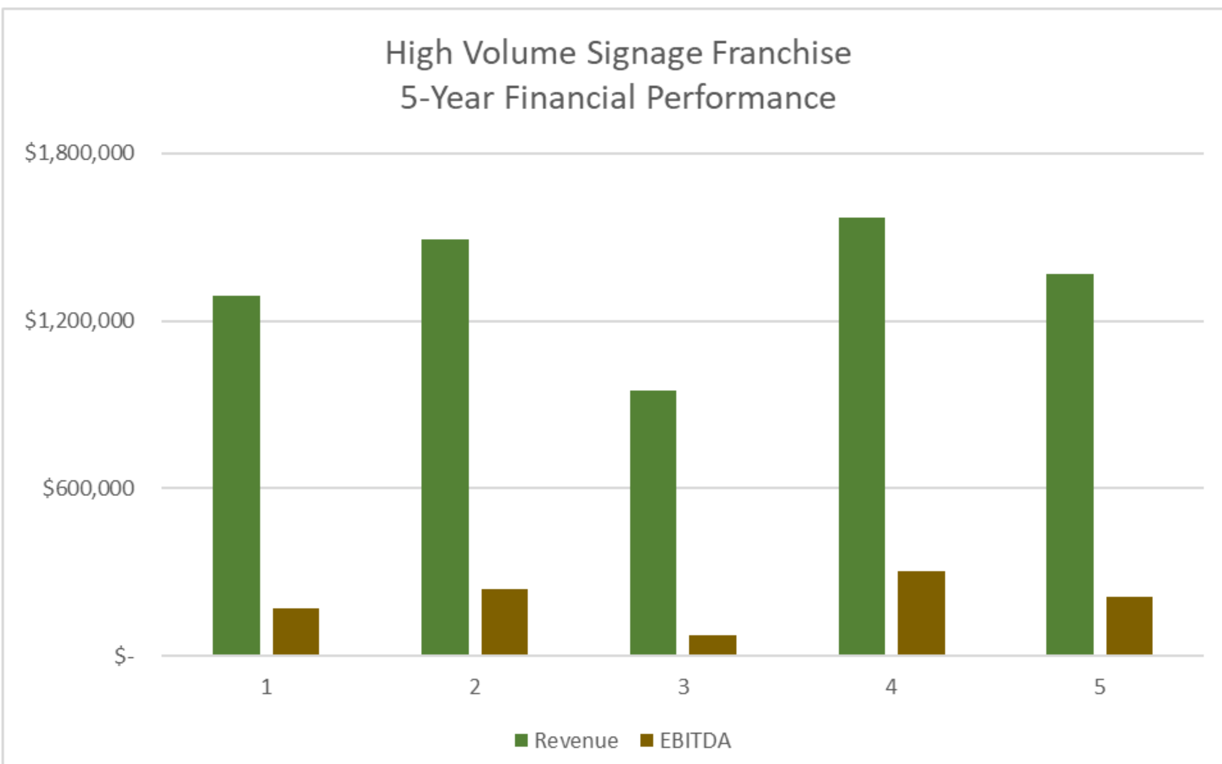
$$CAGR = \left(\frac{EV}{BV}\right)^{\frac{1}{n}} - 1$$

Where:
EV = Ending value
BV = Beginning value
n = Number of years[ii]

Now let's look at an example of a more troubled business.

High Volume Signage Franchise

	Year					Average	AAGR	CAGR
	1	2	3	4	5			
Revenue	$ 1,290,000	$ 1,490,000	$ 950,000	$ 1,570,000	$ 1,366,667	$ 1,333,333		
Revenue Growth		*15.5%*	*-36.2%*	*65.3%*	*-13.0%*		*7.9%*	*1.5%*
EBITDA	$ 170,000	$ 240,000	$ 75,000	$ 302,000	$ 213,000	$ 200,000		
EBITDA Growth		*41.2%*	*-68.8%*	*302.7%*	*-29.5%*		*61.4%*	*5.8%*
EBITDA Margin	13%	16%	8%	19%	16%			



The first thing we notice about the High-Volume Signage Franchise is erratic revenues. Earnings also fluctuate a great deal. These erratic year-over-year growth rates render the EBITDA AAGR meaninglessly high, such that it is a poor indicator of the growth.

Such financials make it difficult to value the business and to construct a financial plan to run it after close. You simply can't be confident as to what the cash flow will be under your ownership. If acquiring such a business, you must be sure you understand the reasons behind the inconsistent performance and that you are prepared to cope.

Sea Story

Pipe Dreams

I opened my Outlook calendar and pulled up the scheduled meeting. I clicked a link to join the Zoom conference call. These were the early days of the COVID-19 pandemic, Zoom, previously a little-known computer-based meeting platform, had become a mainstay of the newly required *work from home* lifestyle. The meeting was with our latest acquisition prospect – an east coast envelope manufacturer. Matt had braved the mask-clad, socially distanced flight from Chicago to meet with John, the owner, and tour his plant. After discussing the details of the business' financial statements and reviewing the competitive landscape, we turned our attention to growth opportunities.

"You could do a lot with this business!" John said through the internet connection. "We've had a lot of competitors go out of business in recent years. Those closures have brought increased volume our way. You could easily move this business to a larger facility, invest in some additional equipment, and scale this thing up. I think the business could double its revenue! There would be margin expansion too since you'd have much higher revenues relative to your overhead costs. I never did it because I didn't want the hassle of moving, but if I were younger…" he trailed off, hoping our imaginations would run wild.

I leaned back in my chair and sighed. As I closed my eyes in contemplation, I was mentally transported to a snowy January day in Michigan about a year and a half earlier. *A similar business. A similar conversation. The same empty promises.*

We were serious about acquiring the Michigan print shop, though still green. It would be our second acquisition. The average annual revenue was about three times that of our first business and the margins were much higher. We had just finished touring the facility and were impressed. The production floor was well organized, suggesting operational excellence that we lacked in our current business.

I stood shoulder to should with Rob, one of the two selling owners, admiring the large Heidelberg printing press positioned against the far wall. Rob was what a business owner hopes to be at retirement age – successful with a confident demeanor. Though his hair had greyed, he was energetic and exuded optimism.

"There's so much you can do with this business…" Rob had said, "Our customers print all sorts of things in which we don't currently specialize. With the right sales pitch, growth will come easy! I'm sure you could also cross-sell the products from you Illinois business. There's a lot of value here."

That had seemed reasonable to me. Upon acquiring the Michigan printer, we would immediately press its customers to buy other supplies from our Illinois company. There were clear cross-selling synergies to be had by combining these two businesses. Cross-selling would be low hanging fruit, providing a short-term boost to cash flow while we strategically grew into new business lines.

After a year and a half of entrepreneurial experience, I now understood that it is never that easy. Buying habits are just that - *habits*. Customers receiving acceptable products and services from their current vendors are hesitant to switch. Even when offering a superior product or a better price, many customers will not wish to expend brain power analyzing the opportunity or incur the risk posed by an unproven partner. Growth rarely comes easy and I am extremely skeptical of those who claim they forewent the financial windfall available to them because they were simple folk just happy with what they had.

I continued to politely listen to John's presentation. I did not, however, modify my financial models to reflect his optimism.

Profit and Loss Statement (P&L)

After explaining the business and tantalizing the prospective buyer with historical financials and tales of inevitable growth, the marketing memorandum is likely to provide a detailed P&L. Let's go back to Paula's Print Shop to see what a marketing deck P&L might look like.

Paula's Print Shop

	Year				
(In US Dollars)	**1**	**2**	**3**	**4**	**5**
Net Sales	$ 1,625,000	$ 1,710,000	$ 1,765,000	$ 1,810,000	$ 1,840,000
Cost of Goods Sold	698,750	666,900	723,650	724,000	680,800
Gross Profit	$ 926,250	$ 1,043,100	$ 1,041,350	$ 1,086,000	$ 1,159,200
Gross Profit Margin	*57%*	*61%*	*59%*	*60%*	*63%*
SG&A Exprenses	$ 855,144	$ 925,284	$ 877,065	$ 977,965	$ 1,007,605
Net Operating Income	**$ 71,106**	**$ 117,816**	**$ 164,285**	**$ 108,035**	**$ 151,595**
Other Income / (Expenses)	0	0	0	0	0
Net Income	**$ 71,106**	**$ 117,816**	**$ 164,285**	**$ 108,035**	**$ 151,595**
Plus: Depreciation / Amortizaton	10,000	10,000	10,000	10,000	10,000
Plus: Interest Expense	66,644	55,284	43,015	29,765	15,455
EBITDA	**147,750**	**183,100**	**217,300**	**147,800**	**177,050**
Add-Backs:					
Seller's Salary	100,000	100,000	100,000	100,000	100,000
Above Market Rent	6,000	6,000	6,000	6,000	6,000
Total Discretionary Expenses	55,000	70,000	65,000	72,000	85,000
Adjusted EBITDA	**$ 308,750**	**$ 359,100**	**$ 388,300**	**$ 325,800**	**$ 368,050**
Adjusted EBITDA Margin	***19%***	***21%***	***22%***	***18%***	***20%***

As we would expect, this P&L builds to net income. However, there is no line item detail provided for costs of goods sold and SG&A expenses. That is acceptable for a pre-due diligence marketing deck designed to provide a high-level overview of the business. However, it is imperative that a prospective buyer fully understand these expenses before finalizing the purchase.

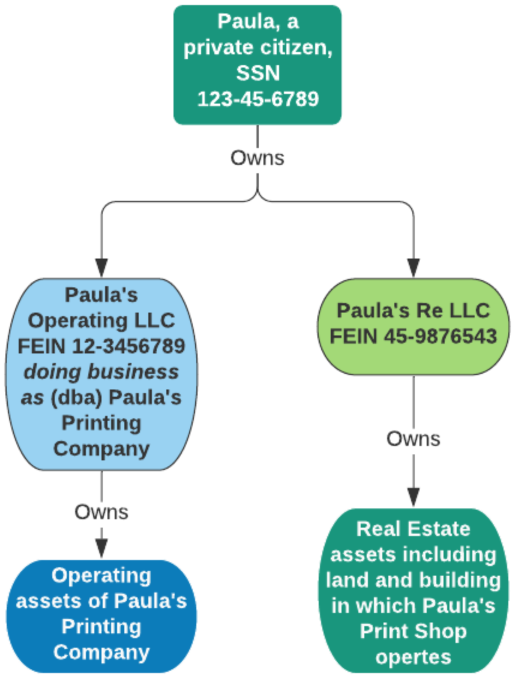
In the build from net income to EBITDA, we see that Paula's Print Shop has depreciation/amortization expenses of $10k per year. The equal amount expensed each year indicates *straight-line* depreciation or amortization, in which the asset decreasing in value does so by the same amount (or *linearly*) each year. When we examine the balance sheet, we will be interested in which asset is creating this expense and how that asset impacts the business. Remember, depreciation and amortization are non-cash expenses. They lower the business' net income and, thus, tax burden, but they do not represent a cash outflow in the period to which they are applied. Because they are non-cash expenses, they are added back to net income.

Interest is different. The interest expense recognized by Paula's Print Shop represents cash paid by the business for the interest portion of the company's debts. However, this is the seller's debt and will be settled before close. Thus, it is added back to net income since it is an expense the buyer will not inherent. Nevertheless, there are two important points to make with respect to interest. The first is that the principal portion of the debt payment is not reflected on the P&L. Instead, principal payments *hit the balance sheet*, meaning they reduce the debt liability. When we review the balance sheet, we will be interested to see what the business' debt liabilities are and how much the principle is reduced each period. The interest expense plus the principal reduction is the total debt payment (usually called *debt service*) the seller bears in a given period. The second, is that adding back interest expense when adjusting from net income to EBITDA creates an earnings metric independent of financing. This means that EBITDA describes the company's earnings as though it were debt free. However, when you acquire the business, that will almost certainly not be the case. At a minimum, you are likely to have taken a loan to buy the business. You must remember that a portion of the cash created by earnings will be consumed by principal and interest payments on your loans.

Having added back depreciation, amortization, and interest expenses to arrive at EBITDA, the seller will now assert what are commonly called "add-backs". These are expenses of an extraordinary or discretionary nature that, from the seller's perspective, unfairly reduce the business' profitability. Add-backs can be legitimate, but must be scrutinized. It is in the seller's interest to drive the profit metric (and thus the valuation of the company) as high as possible.

The first proposed add-back is the seller's salary. Paula is paying herself $100k each year. This should cause pause. Seller's salary is an add-back we would reluctantly accept if we were using seller's discretionary earnings (SDE) as the profitability metric for valuation. However, the P&L presented uses adjusted EBITDA. Because adjusted EBITDA is a metric best suited to describe the profits of a fully manned business, I would not give the seller full credit for this add-back. Let's say I thought I could replace the current owner's business functions with a $60k per year employee. This would cause me to reduce the annual add-back, and thus adjusted EBITDA, by $60k.

Next, we see that the seller is claiming that the business pays "above market rent" in the amount of $6k per year. Once in due diligence, the seller will have to explain why this is the case. However, from my experience, I would guess that the seller also owns the real estate upon which the business operates. When this is the case, the real estate is usually owned by a separate legal entity (usually an LLC) that is, in turn, owned by the business owner.



In this arrangement, the business would make rent payments to the real estate entity, which the real estate entity would book as rental income. Since the business owner also owns the real estate, this may seem like moving money from the preverbal right hand to the left hand. Even so, this arrangement is an effective means of keeping the business and real estate ownership separate. While the above market rent add-back must be scrutinized, for our initial valuation, we will allow it to stand.

The final add-back claimed by the seller is a general category named “total discretionary expenses”. While this high-level treatment is expected in a marketing deck, the discretionary nature of these expenses will have to be thoroughly explained during the due diligence process. Nevertheless, for the purposes of initial valuation, we will allow it.

With only one adjustment to the presented P&L, we are ready to establish an adjusted EBITDA-based valuation that will constitute our initial offer.

Paula's Print Shop

(In US Dollars)	Year 1	2	3	4	5
Net Sales	$ 1,625,000	$ 1,710,000	$ 1,765,000	$ 1,810,000	$ 1,840,000
Cost of Goods Sold	698,750	666,900	723,650	724,000	680,800
Gross Profit	$ 926,250	$ 1,043,100	$ 1,041,350	$ 1,086,000	$ 1,159,200
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Net Operating Income	**$ 71,106**	**$ 117,816**	**$ 164,285**	**$ 108,035**	**$ 151,595**
Other Income / (Expenses)	0	0	0	0	0
Net Income	**$ 71,106**	**$ 117,816**	**$ 164,285**	**$ 108,035**	**$ 151,595**
Plus: Depreciation / Amortizaton	10,000	10,000	10,000	10,000	10,000
Plus: Interest Expense	66,644	55,284	43,015	29,765	15,455
EBITDA	**147,750**	**183,100**	**217,300**	**147,800**	**177,050**
Add-Backs:					
Seller's Salary	100,000	100,000	100,000	100,000	100,000
Manager Hired to Replace Seller	(60,000)	(60,000)	(60,000)	(60,000)	(60,000)
Above Market Rent	6,000	6,000	6,000	6,000	6,000
Total Discretionary Expenses	55,000	70,000	65,000	72,000	85,000
Adjusted EBITDA	**$ 248,750**	**$ 299,100**	**$ 328,300**	**$ 265,800**	**$ 308,050**
Adjusted EBITDA Margin	***15%***	***17%***	***19%***	***15%***	***17%***

This average adjusted EBITDA over the previous 5-year period comes to $290k. To turn this into a valuation, we must apply a *multiple*. This means that we will multiply the adjusted EBITDA by some number that is a) reasonable for the business' industry and b) reflects the strength of the business within the industry. The range of reasonable multiples will vary by industry. Print shops such as Paula's typically command between a 3x and 5x multiple. That would place a proper valuation somewhere between $870k and $1.45mm.

Choosing an offer price based on this range can be tricky. As the world continues to move toward digital content, commercial print has become a declining industry. Thus, to command a 5x multiple, the business must occupy a highly profitable industry niche and have highly modernized manufacturing equipment. However, the business for sale often represents the seller's life work, meaning a 3x multiple might be viewed as an insult. Applying the correct multiple is always dependent on subjective analysis of the business' strength and future prospects. For the purpose of this example, let's assume that we will move forward with a 4x multiple offer of $1.16mm.

Balance Sheet

While the P&L expresses the business' profitability and is thus the primary basis for valuation, the balance sheet provides important insight into the health of the business. See below for Paula's Print Shop's balance sheet.

Paula's Print Shop

	December 31 of Year				
(In US Dollars)	1	2	3	4	5
Assets					
Operating Checking Account (Cash)	$ 154,212	$ 147,816	$ 165,119	$ 163,216	$ 161,113
Payroll Checking Account (Cash)	115,000	115,000	112,824	114,112	115,101
Accounts Receivable	202,559	199,633	220,536	215,895	238,526
Inventories	161,259	170,125	166,949	172,853	171,889
Other Current Assets	210,126	212,589	209,875	211,489	209,636
Total Current Assets	**843,155**	**845,163**	**875,304**	**877,564**	**896,265**
PP&E	100,000	100,000	100,000	100,000	100,000
Accumulated Depreciation	(10,000)	(20,000)	(30,000)	(40,000)	(50,000)
PP&E, net	90,000	80,000	70,000	60,000	50,000
Other assets	61,563	59,874	45,698	41,852	51,897
Total assets	**$ 994,719**	**$ 985,037**	**$ 991,002**	**$ 979,417**	**$ 998,162**
Liabilities & Equity					
Accounts Payable	$ 182,303	$ 179,669	$ 198,483	$ 194,305	$ 214,673
Accrued Expenses	11,012	11,452	11,911	11,672	12,840
Income Tax Payables	28,443	47,127	65,714	43,214	60,638
Line of Credit	50,000	60,000	30,000	10,000	-
Total Current Liabilities	**271,757**	**298,248**	**306,107**	**259,192**	**288,151**
Notes Payable - SBA 7a Loan	691,046	537,689	372,063	193,186	0
Deferred Taxes	-	-	-	-	-
Total Liabilities	**962,804**	**835,937**	**678,170**	**452,378**	**288,151**
Retained Earnings	31,915	149,100	312,832	527,039	710,011
Total Stockholders' Equity	**31,915**	**149,100**	**312,832**	**527,039**	**710,011**
Total Liabiities and Stockholders' Equity	**$ 994,719**	**$ 985,037**	**$ 991,002**	**$ 979,417**	**$ 998,162**

For those less familiar with financial statements, there is an important difference between the P&L and balance sheet with respect to the *reported period*. The P&L reports financial activity within a defined time interval. For instance, the P&L tells us that Paula's Print Shop had $1.71mm in revenue in Year 2. This is the total amount of sales in that 12-month interval. In contrast, the balance sheet tells us the value of some financial category *at a given moment in time*. For instance, the balance sheet indicates that inventories were worth $166,949 at the end of the day on December 31 of Year 3.

When reviewing the balance sheet, it is best to start with those items affecting *working capital*. Working capital is defined as the difference between *current assets* and *current liabilities*. Current assets are all the assets of a company that are expected to be sold, consumed, or exhausted through standard business operations within one year.[iii] Current liabilities are, likewise, liabilities to be settled within one year. Though this definition is important to financial analysts, I recommend that, for the purposes of understanding the business, you focus on the *cash flow* related items of current assets and current liabilities.

Let's start with current liabilities. Accounts payable (bills to be paid), accrued expenses, and the principal portion of the line of credit all represent cash demands on the business. These cash burdens are most likely paid in monthly installments. Income tax payables is an annual payment based on the company's performance. At Paula's Print Shop, somewhere between $250k and $300k will be needed annually to cover these current liabilities. The principal portion of the SBA 7a loan is an additional cash demand on the business. While the total monthly loan payment stays the same for a given interest rate, the amount of principle paid down in each payment increases over time, while the interest portion decreases. In Year 5, Paula paid $193,186 to reduce her 7a loan balance to zero. These, combined with the SG&A expenses from the P&L, gives us an understanding of how much cash is needed to run this business.

On the current assets side of things, we can see that Paula is running her business conservatively, maintaining high cash balances in both business checking accounts and large amounts of accounts receivable, most of which converts to cash in about 30 days.

Now that we understand the cash demands on the business, we can use the balance sheet to understand the company's equipment assets, which are of key importance to a manufacturing business. These are listed on the balance sheet as *PP&E, net*. This stands for Property, Plant, and Equipment and consists of tangible assets with clear resale value. At a business-like Paula's Print Shop, the manufacturing equipment is likely to be the bulk of PP&E. From the balance sheet, we can see that the value of PP&E at the end of Year 1 was $90k and that this value decreases by $10k each year. This matches the depreciation expense on the P&L.

Capital Expenditures (CAPEX)

In addition to the financial statements, the marketing materials will often include a proclamation on recent capital expenditures or *CAPEX*. Let's consider the following statement pertaining to Paula's Print Shop.

Capital Expenditures - At the beginning of Year 1, Paula's Print Shop acquired four Heidelberg offset printing press at a price of $25k per press for a total of $100k. The purpose of this acquisition was to expand manufacturing capacity with respect to the printing of booklets for government customers.

This is encouraging news. Paula's Print Shop is actively investing in additional equipment to ensure it plant stays competitive. Too often, owners who are looking to sell stop investing in the business, allowing it to atrophy.

This statement also clarifies the financial statements. According to the balance sheet, the value of this equipment decreases by $10k each year. This corresponds to the $10k depreciation expense on the P&L. *Now we know where that come from*. At the beginning of Year 1, Paula purchased $100k worth of equipment. That equipment is being depreciated using the straight-line methodology over ten years.

Sea Story

LOI or Die

I sighed in disbelief as I read the email. The business broker had yet another round of changes to our proposed letter of intent. *What was it going to take to get this LOI signed?!* The seller was negotiating hard on the terms of the earnout portion of the purchase price.

That, in and of itself, was not surprising – after all, the earnout was worth $3 million over 6 years. We had initially proposed earnout terms based on revenue performance. Over the 6-year term, the $500k annual earnout payment would be reduced dollar-for-dollar with any shortfall to an agreed upon target revenue. This business was expected to do $2 million in annual revenue, so, if revenue in a given year came in at $1.9 million, the seller would only receive $400k in earnout instead of the $500k potential.

For the seller, reducing the earnout payment based on shortfall to a revenue target was a *no-go*. He reasoned that his earnout should be reduced based on *profit shortfall*; after all, reduced profits directly affect the business' cash position. His position was rational, but his modifications to the draft LOI just wouldn't work. He proposed we reduce the earnout payments relative to an adjusted EBITDA target. This, of course, induces the obvious question – *who determines adjusted EBITDA*?

Determining (true) EBITDA is easy - start with net income and simply add back interest, tax, depreciation, and amortization expenses. *Adjusted* EBITDA, however, isn't cut and dry. Adjusted EBITDA also adds back extraordinary and discretionary expenses to increase profitability. *But who decides what is extraordinary or discretionary?* The seller will insist that nearly every new expense incurred by the buyer should be added back to achieve the highest possible adjusted EBITDA. After all, the seller ran the business without those expenses, so how could they be necessary? The new owner will disagree, contending that the previous owner had neglected to invest in the business and that the new expenses are essential to running the business properly. Such disagreements will destroy the relationship between the two parties and may lead to litigation. To head off this unpleasant outcome, an extensive contract would have to be established that clearly delineated the manner in which adjusted EBITDA would be calculated. Furthermore, official determination of adjusted EBITDA would have to be outsourced to a neutral party - comprised of lawyers and accountants – to ensure a fair treatment. This approach to earnout is overwhelmingly complicated, potentially subjective, and would cost a fortune in legal and accounting fees. *It just isn't practical*.

I rocked back in my leather office chair as my cell phone rang Matt. "Hello," he answered.

"Hey… another round of changes to the LOI…" I replied.

"I saw," Matt said with a chuckle, "What are your thoughts?"

"Too complicated… The earnout provisions can't stand." I continued to explain my reasoning regarding adjusted EBITDA targets.

"I agree completely. *However*, I think I have something that will work. He won't accept a revenue target and we can't manage adjusted EBITDA, but an earnout measured against *gross profit contribution* might just work for both us!"

Gross profit contribution is revenue earned less material costs incurred. This treatment preserves the margin of the work being sold while separating it from overhead expenses. A revenue target does not distinguish between high and low margin work, but a gross profit contribution target does.

Matt's suggestion worked. After one final round of revisions, the seller signed the LOI and we were cleared to start due diligence.

<u>Letter of Intent (LOI)</u>

With the information available in the marketing deck, we have enough information to understand the basics of the business and to arrive at an initial valuation. *Now we can get the ball rolling!*

The next step is to present the seller with a *letter of intent* (LOI). The purpose of an LOI is (at a minimum) to state your desire to acquire the business at a given price, provide an overview of how the acquisition will be financed, and outline the due diligence process that will follow once the LOI is signed by both parties.

An LOI is a non-binding document. Should problems with the business become apparent during the due diligence process, the prospective buyer is within his or her rights to propose a reduced purchase price or to walk away all together.

Rather than provide an example LOI, I recommend an essential handbook when buying a small business – *HBR Guide to Buying a Small Business by Richard S. Ruback and Royce Yudkoff*. Appendix A of that book provides an excellent LOI template.

Chapter Summary

The Essential Process

1. Start by developing a spreadsheet to collect vital business information, including business name or description, location, business type, asking price, revenue, earnings, margin, and asking price multiple.

2. Utilize public websites and business brokers to learn about businesses listed for sale. Industry insiders and cold approaches can open up opportunities not on the market.

3. Receive and sign an NDA for any business in which you are interested. This will usually be followed by marketing deck explaining the opportunity.

4. Use presented financial data to understand the business' profitability. SDE is fine if you intend to be an owner-operator. For larger businesses in which you intend to provide executive oversight, adjusted EBITDA is a more appropriate metric.

5. Multiply profitability by some number appropriate for the industry to achieve an initial valuation.

6. Present your intention to buy the business to the seller in a letter of intent (LOI). The LOI includes this initial valuation as an intended purchase price subject to due diligence.

7. When the seller accepts and signs a proposed LOI, the due diligence process may commence.

The Essential Partners

- BizBuySell.com – find businesses for sale
- Axial.net – aggregates businesses for sale and tracks deal progress

The Essential Library

- HBR Guide to Buying a Small Business by Richard S. Ruback and Royce Yudkoff

[i] https://www.investopedia.com/terms/a/aagr.asp
[ii] https://www.investopedia.com/terms/c/cagr.asp
[iii] https://www.investopedia.com/terms/c/currentassets.asp