Chapter 2

Due Diligence

Sea Story

The Numbers Don't Add Up

"You think we should walk away from this one…?" Matt asked incredulously through a spotty iPhone connection.

I gripped my Dunkin' Donuts coffee with both hands to ward off the mid-December chill, "Not walk away – *run*!"

From the start, Superior Care Imaging (SCi) had been a difficult prospect. The company operated eight MRI centers across Ohio, but only its Dayton and Toledo locations were for sale. There were reasons to be excited about SCi – new medical technology was unlikely to replace the MRI anytime soon and profit margins were stated at about 35%. *But* there were also reasons to be cautious. Patient acquisition was completely dependent on doctor referrals – if doctors stopped referring their patients to SCi, those ample profits would dry up.

The greatest due diligence challenge, however, was properly understanding the financials of the Toledo and Dayton sites as stand-alone business units. The owner hadn't administered the business with individual sites in mind, meaning we had to extract the Toledo and Dayton financial data from the whole.

We knew this was dangerous. It would be easy to make Toledo and Dayton look more profitable than they really were by shifting shared administrative costs to other sites. We had asked Sam, the owner, to provide a break out. What he submitted made no sense.

He had started with SCi's last three tax returns, each of which showed a very small profit. No surprise there – depreciation and amortization reduce taxable profit and business owners wisely make extraordinary and discretionary spends to reduce their end-of-year tax burden. We weren't expecting Sam to show the IRS his advertised 35% profits.

We *were* expecting financials that started at taxable net income and added back the appropriate expenses to reach adjusted EBITDA. That adjusted EBITDA should have resulted in a roughly 35% profit margin as advertised in the introductory marketing materials. Those financials should then have been broken down by site, showing the performance of each site as a stand-alone business unit. Only then would we have the insight to properly understand Toledo and Dayton.

But that's not what we got. Instead, Sam had provided financials by site that showed spectacular profits at Toledo and Dayton and losses at the other six sites, all netting to taxable income shown on the tax returns. It was as though he was saying, "My business is barely profitable, the bright side of which is that I don't pay much tax. I'd like to sell you the two profitable business units and I'll hold on to the six duds." Obviously, that is an absurd proposition.

The inability of a seller to present an accurate and detailed account of the business financial statements constitutes grounds for a *walk-away* in and of itself. It is also likely indicative of deeper problems in business. Fortunately, Matt agreed and we moved on to the next opportunity.

The Process

Intense Scrutiny Follows the LOI

Due diligence is a collaborative process between buyer and seller. The buyer asks probing questions to gain insight into the business. The seller responds with answers supported by documentation. The buyer scrutinizes those answers, hoping to determine if the target really is an attractive asset and whether detailed company financials justify the proposed purchase price.

I have found success organizing due diligence efforts into five distinct phases: quantitative financial analysis, qualitative business analysis, legal compliance, tax compliance, and environmental compliance. Approached properly, these phases constitute a formal process advisable when acquiring any business. In this chapter, we will develop a playbook that will help you work through rigorous due diligence.

Quantitative financial analysis and qualitative business analysis should be conducted internally. You and your team members should dive deep into the details of the balance sheet and P&L in order to decipher the cash flow dynamics of the business. Once fully understood, you can move forward with confidence in the LOI proposed purchase price or, if the financials held unpleasant surprises, you can negotiate a new purchase price. After digging through every financial detail, take a step back and assess the business qualitatively. You need to understand the business' story. *Is the business in a growing or declining industry? What are the barriers to entry for potential competitors? Are the current profit margins defensible? What is the likelihood that technology will render company's products or service offerings obsolete?*

Legal, tax, and environmental due diligence should be provided by third-party professional partners. A strong relationship with an attorney and tax CPA is crucial to proper business operations. It is best to start those relationships before the business is acquired. Their expert review in these areas can protect you, the buyer, from unforeseen liability. Additionally, environmental compliance is an often-overlooked area that can have dire consequences if mishandled. Even if you are not buying the real estate upon which the business operates, newly discovered environmental issues can cause costly disruptions to business operations.

We will review each of these due diligence areas in detail.

The Process

Quantitative Financial Analysis

A thorough review of the target's financials will include all of the company's financial statements. However, you should start by building a detailed financial model based on the target's monthly P&L results for as many years as you choose to analyze – I recommend five years.

<u>P&L Format Cash Flow Model</u>

Our goal will be to take the seller's P&L and use it to create a model that predicts the business' cash flow under your management. Consider the monthly P&L below for Paula's Print Shop. While a full model would include up to five years of monthly data, to preserve space in this book, I will show the process with only one year of data. Reducing the timeframe won't alter any of the underlining principles.

Paula's Print Shop

	Year 5												
	January	February	March	April	May	June	July	August	September	October	November	December	Total
Income													
410000 Sales of Product Income	$ 159,859	$ 87,370	$ 187,021	$ 64,207	$ 73,658	$ 163,177	$ 203,493	$ 165,124	$ 122,410	$ 160,203	$ 197,694	$ 218,986	$ 1,803,200
411000 Shipping and Delivery Income	6,033	3,374	2,730	2,063	1,567	597	4,702	2,073	2,905	4,483	5,601	674	36,800
Total Income	**$ 165,891**	**$ 90,744**	**$ 189,751**	**$ 66,270**	**$ 75,225**	**$ 163,774**	**$ 208,195**	**$ 167,196**	**$ 125,315**	**$ 164,686**	**$ 203,294**	**$ 219,659**	**$ 1,840,000**
Cost of Goods Sold													
510000 Supplies & Materials - COGS	$ 21,102	$ 11,434	$ 23,709	$ 7,850	$ 9,478	$ 20,636	$ 26,733	$ 21,067	$ 15,190	$ 20,950	$ 25,615	$ 28,077	$ 231,840
511000 Shipping, Freight & Delivery - COGS	1,147	638	1,353	513	529	1,151	1,416	1,175	938	1,139	1,429	1,506	12,935
511500 Other Costs of Services - COGS	1,902	1,358	3,422	2,445	1,126	2,452	1,664	2,503	3,619	1,884	3,043	2,126	27,545
512000 Cost of labor - COGS	36,228	20,145	42,725	16,212	16,700	36,358	44,719	37,118	29,620	35,960	45,131	47,564	408,480
Total Cost of Goods Sold	**$ 60,380**	**$ 33,575**	**$ 71,208**	**$ 27,020**	**$ 27,833**	**$ 60,597**	**$ 74,532**	**$ 61,863**	**$ 49,366**	**$ 59,934**	**$ 75,219**	**$ 79,274**	**$ 680,800**
Gross Profit	**$ 105,512**	**$ 57,169**	**$ 118,543**	**$ 39,250**	**$ 47,391**	**$ 103,178**	**$ 133,663**	**$ 105,333**	**$ 75,948**	**$ 104,752**	**$ 128,075**	**$ 140,385**	**$ 1,159,200**
	64%	***63%***	***62%***	***59%***	***63%***	***63%***	***64%***	***63%***	***61%***	***64%***	***63%***	***64%***	***63%***
Expenses													
610000 Advertising & Marketing	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ 566	$ -	$ -	$ -	$ 566
610500 Automobile Expense	264	310	221	201	201	249	68	269	350	198	199	228	2,759
611000 Bank Charges & Fees	16	17	16	16	16	16	97	17	16	81	57	87	452
611100 Building Maintenance	268	-	145	240	65	789	-	545	240	-	245	-	2,536
611110 Conferences	550	-	-	-	-	-	-	-	-	-	-	-	550
611111 Contractors	-	-	-	173	-	-	-	-	-	-	-	-	173
611400 Depreciation & Amortization	833	833	833	833	833	833	833	833	833	833	833	833	10,000
611500 Dues & subscriptions	-	-	-	-	-	-	-	-	300	-	-	-	300
611510 Equipment Lease Expense	1,044	1,044	1,241	1,384	2,576	2,950	2,376	1,455	1,610	1,927	2,252	1,345	21,205
613100 Insurance - Employee Healthcare	2,903	2,956	3,009	(1,109)	3,978	7,610	2,877	8,226	4,606	1,753	1,256	2,698	40,763
614100 Insurance - Other													
613500 Business Insurance	$ 352	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 4,209
613510 Owner's Life Insurance	45	45	45	45	45	45	45	45	45	45	45	-	493
641010 Workers Comp Insurance	318	335	324	277	261	288	348	336	320	362	334	385	3,888
Total 614100 Insurance - Other	**$ 716**	**$ 730**	**$ 720**	**$ 673**	**$ 656**	**$ 683**	**$ 744**	**$ 732**	**$ 715**	**$ 757**	**$ 730**	**$ 735**	**$ 8,589**
614110 Janitorial Expense	$ 163	$ 118	$ 123	$ 123	$ 123	$ 124	$ 168	$ 123	$ 123	$ 155	$ 123	$ -	$ 1,465
614121 Promotional Materials	19	-	9	-	35	-	-	-	-	-	-	-	63
615000 Repairs & Maintenance	-	-	-	-	35	-	865	-	-	1,540	4,623	-	7,062
615500 Office Supplies and Software	1,014	2,968	1,912	2,043	1,110	613	989	5,539	952	1,191	583	979	19,894
616500 Utilities	1,410	1,299	923	539	1,193	926	971	308	1,559	1,065	969	372	11,535
617000 Postage and Delivery	-	-	-	200	-	29	-	3,684	-	200	-	-	4,112
617100 Production Tools and Equipment	5	-	22	40	-	-	38	4,330	702	146	3	221	5,507
617500 Rent	4,080	4,243	4,162	4,162	4,162	15,481	4,162	4,162	4,162	4,162	4,162	4,162	61,259
618000 Salesperson Expenses	-	-	-	-	-	246	100	236	-	139	127	130	979
620000 Legal & Professional Services	-	-	-	-	-	-	4,800	1,085	-	-	-	-	5,885
640000 Guaranteed Payments - Owner's Salary	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	100,000
640001 Payroll Expenses - Wages	35,123	34,792	36,431	35,398	32,059	32,359	32,663	32,969	32,350	31,743	31,148	33,539	400,575
640011 Payroll Expenses - Management Salaries	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	75,000
640033 Payroll Expenses - Commissions	16,589	9,074	18,975	6,627	7,522	16,377	20,819	16,720	12,531	16,469	20,329	21,966	184,000
649000 Payroll Expenses - Fees	674	759	292	401	512	292	529	418	362	593	473	178	5,485
649500 Payroll Expenses - Taxes	-	-	-	-	-	-	-	-	-	-	-	-	-
690000 Interest Expense	2,388	2,188	1,988	1,788	1,588	1,388	1,188	988	788	588	388	188	15,455
Total Expenses	**$ 82,642**	**$ 75,916**	**$ 85,605**	**$ 68,315**	**$ 71,247**	**$ 95,549**	**$ 88,870**	**$ 97,221**	**$ 77,348**	**$ 78,125**	**$ 83,084**	**$ 82,246**	**$ 1,007,605**
Net Operating Income	**$ 22,870**	**$ (18,748)**	**$ 32,938**	**$ (29,065)**	**$ (23,855)**	**$ 7,629**	**$ 44,792**	**$ 8,112**	**$ (1,400)**	**$ 26,627**	**$ 44,991**	**$ 58,140**	**$ 151,595**
Net Income	**$ 22,870**	**$ (18,748)**	**$ 32,938**	**$ (29,065)**	**$ (23,855)**	**$ 7,629**	**$ 44,792**	**$ 8,112**	**$ (1,400)**	**$ 26,627**	**$ 44,991**	**$ 58,140**	**$ 151,595**
Add-Backs:													
611400 Depreciation & Amortization	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 10,000
690000 Interest Expense	2,388	2,188	1,988	1,788	1,588	1,388	1,188	988	788	588	388	188	15,455
EBITDA	**$ 26,091**	**$ (15,726)**	**$ 35,759**	**$ (26,444)**	**$ (21,434)**	**$ 9,850**	**$ 46,814**	**$ 9,933**	**$ 222**	**$ 28,048**	**$ 46,213**	**$ 59,161**	**$ 177,050**
Seller's Salary	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 100,000
Manager Hired to Replace Seller	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(60,000)
Above Market Rent	500	500	500	500	500	500	500	500	500	500	500	500	6,000
Total Discretionary Expenses	-	-	15,000	-	-	-	25,000	-	-	45,000	-	-	85,000
Adjusted EBITDA	**$ 29,924**	**$ (11,893)**	**$ 54,592**	**$ (22,610)**	**$ (17,601)**	**$ 13,683**	**$ 75,647**	**$ 13,767**	**$ 4,055**	**$ 76,881**	**$ 50,046**	**$ 62,994**	**$ 308,050**

Now that we have a monthly P&L, we will begin a step-by-step process of both scrutinizing it and building upon it in order to understand how the business would perform under your ownership.

COGS Supplies and Materials Accounting – Purchasing vs. Matching Principle

Our first step in converting the monthly P&L to a model that mimics cash flow is to understand and, if necessary, adjust cost of goods sold as it relates to inventory items.

The Financial Accounting Standards Board (FASB) is an independent nonprofit organization that establishes standards for accounting and financial reporting in the United States. FASB issues a common set of accounting principles, standards, and procedures referred to as *generally accepted accounting principles* (GAAP).[i]

If the P&L you are working with was prepared in accordance with GAAP – *and most are* – inventory-related cost of goods sold expenses are likely disassociated from cash flow due to the *matching principle*.

The matching principle causes inventory costs to be expensed when they are sold rather than when they are purchased. Let's consider an example…

Paula's Print Shop sells *Item #100 – Folder Paper Composite*, which consists of 1 folder and 1 piece of paper. Paula wants to have ten of these in stock in order to meet her anticipated demand during the upcoming summer months. In May, she purchases ten folders at a rate of $10 per folder and ten pieces of paper at a rate of $5 per sheet - for a total of $150. However, she does not record this $150 purchase on her P&L. Rather, she increases the value of inventory (an asset) on the balance sheet by $150. She also receives a bill for these raw materials, which she enters into her accounting system, increasing her *accounts payable* by $150. In June, Paula sells 5 of *Item #100*. In July, she sells 3 and in August she sells 2. As a result, in June, she reduces her inventory value and increases her *supplies and materials cost of goods sold P&L expense* by $75 (five of Item #100 equates to 5 folders at $10 per folder plus 5 sheets of paper at $5 per sheet – for a total of $75). This process is repeated in July for the amount of $45 and in August for $30. As a result, the matching principle causes cost of goods sold to be recognized as a P&L expense when the product is sold rather than when the materials are ordered or when you send the vendor payment. This means that cost of goods sold expense is often not a good proxy of cash flow for raw materials purchases.

	May	**June**	**July**	**August**
Inventory (B/S Asset)	Increase by $150	Decrease by $75	Decrease by $45	Decrease by $30
A/P (B/S Liability)	Increase by $150			
COGS (P&L Expense)		Increase by $75	Increase by $45	Increase by $30

Since our goal is a P&L formatted model that predicts cash flow, we should replace *510000 Supplies & Materials – COGS* with an inventory *purchasing schedule*. Using the example above, Paula received her inventory materials in May. Her vendor also billed her in May, expecting payment within 30 days. Thus, for the purposes of a P&L formatted cash flow model, we would replace the matching principle-based *Supplies & Materials – COGS* with a line-item based on billing for inventory items. Whereas *Supplies & Materials – COGS* recognized expenses in June, July and August (when Item #100 was sold), *Purchasing – COGS* would recognize the full $150 expense in May (when Item #100 components were billed to Paula's Print Shop). This effectively adjusts raw materials cost of goods sold expense recognition to be the same as all other expenses, making it more directly related to cash flow.

Let's consider a full-year purchasing schedule for Paula's Print Shop.

Month	**Items**	**Cost**
January	Paper	$50,000.00
February	Laminating Materials	$10,000.00
March	Folders	$40,000.00
April	Manila Stock	$15,000.00
May	Laminating Materials	$5,000.00
June	Paper	$20,000.00
July	Paper	$25,000.00
August	Manila Stock	$10,000.00
September	Binding Materials	$5,000.00
October	Manila Stock	$20,000.00
November	Paper	$30,000.00
December	Binding Materials	$5,000.00
Total		**$235,000.00**

This purchasing schedule will replace *510000 Supplies & Materials – COGS*, which uses the GAAP matching principle, in our P&L format cash flow model.

Paula's Print Shop

	Year 5												
	January	February	March	April	May	June	July	August	September	October	November	December	Total
Income													
410000 Sales of Product Income	$ 159,859	$ 87,370	$ 187,021	$ 64,207	$ 73,658	$ 163,177	$ 203,493	$ 165,124	$ 122,410	$ 160,203	$ 197,694	$ 218,986	$ 1,803,200
411000 Shipping and Delivery Income	6,033	3,374	2,730	2,063	1,567	597	4,702	2,073	2,905	4,483	5,601	674	36,800
Total Income	**$ 165,891**	**$ 90,744**	**$ 189,751**	**$ 66,270**	**$ 75,225**	**$ 163,774**	**$ 208,195**	**$ 167,196**	**$ 125,315**	**$ 164,686**	**$ 203,294**	**$ 219,659**	**$ 1,840,000**
Cost of Goods Sold													
510001 Purchasing - COGS	**$ 50,000**	**$ 10,000**	**$ 40,000**	**$ 15,000**	**$ 5,000**	**$ 20,000**	**$ 25,000**	**$ 10,000**	**$ 5,000**	**$ 20,000**	**$ 30,000**	**$ 5,000**	**$ 235,000**
511000 Shipping, Freight & Delivery - COGS	1,147	638	1,353	513	529	1,151	1,416	1,175	938	1,139	1,429	1,506	12,935
511500 Other Costs of Services - COGS	(26,995)	2,792	(12,870)	(4,705)	5,604	3,087	3,397	13,570	13,809	2,835	(1,342)	25,203	24,385
512000 Cost of labor - COGS	36,228	20,145	42,725	16,212	16,700	36,358	44,719	37,118	29,620	35,960	45,131	47,564	408,480
Total Cost of Goods Sold	**$ 60,380**	**$ 33,575**	**$ 71,208**	**$ 27,020**	**$ 27,833**	**$ 60,597**	**$ 74,532**	**$ 61,863**	**$ 49,366**	**$ 59,934**	**$ 75,219**	**$ 79,274**	**$ 680,800**
Gross Profit	**$ 105,512**	**$ 57,169**	**$ 118,543**	**$ 39,250**	**$ 47,391**	**$ 103,178**	**$ 133,663**	**$ 105,333**	**$ 75,948**	**$ 104,752**	**$ 128,075**	**$ 140,385**	**$ 1,159,200**
	64%	***63%***	***62%***	***59%***	***63%***	***63%***	***64%***	***63%***	***61%***	***64%***	***63%***	***64%***	***63%***
Expenses													
610000 Advertising & Marketing	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ 566	$ -	$ -	$ -	$ 566
610500 Automobile Expense	264	310	221	201	201	249	68	269	350	198	199	228	2,759
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611110 Conferences	550	-	-	-	-	-	-	-	-	-	-	-	550
611111 Contractors	-	-	-	173	-	-	-	-	-	-	-	-	173
611400 Depreciation & Amortization	833	833	833	833	833	833	833	833	833	833	833	833	10,000
611500 Dues & subscriptions	-	-	-	-	-	-	-	-	300	-	-	-	300
611510 Equipment Lease Expense	1,044	1,044	1,241	1,384	2,576	2,950	2,376	1,455	1,610	1,927	2,252	1,345	21,205
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613500 Business Insurance	$ 352	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 4,209
613510 Owner's Life Insurance	45	45	45	45	45	45	45	45	45	45	45	-	493
641010 Workers Comp Insurance	318	335	324	277	261	288	348	336	320	362	334	385	3,888
Total 614100 Insurance - Other	**$ 716**	**$ 730**	**$ 720**	**$ 673**	**$ 656**	**$ 683**	**$ 744**	**$ 732**	**$ 715**	**$ 757**	**$ 730**	**$ 735**	**$ 8,589**
614110 Janitorial Expense	$ 163	$ 118	$ 123	$ 123	$ 123	$ 124	$ 168	$ 123	$ 123	$ 155	$ 123	$ -	$ 1,465
614121 Promotional Materials	19	-	9	-	35	-	-	-	-	-	-	-	63
615000 Repairs & Maintenance	-	-	-	-	35	-	865	-	-	1,540	4,623	-	7,062
615500 Office Supplies and Software	1,014	2,968	1,912	2,043	1,110	613	989	5,539	952	1,191	583	979	19,894
616500 Utilities	1,410	1,299	923	539	1,193	926	971	308	1,559	1,065	969	372	11,535
617000 Postage and Delivery	-	-	-	200	-	29	-	3,684	-	200	-	-	4,112
617100 Production Tools and Equipment	5	-	22	40	-	-	38	4,330	702	146	3	221	5,507
617500 Rent	4,080	4,243	4,162	4,162	4,162	15,481	4,162	4,162	4,162	4,162	4,162	4,162	61,259
618000 Salesperson Expenses	-	-	-	-	-	246	100	236	-	139	127	130	979
620000 Legal & Professional Services	-	-	-	-	-	-	4,800	1,085	-	-	-	-	5,885
640000 Guaranteed Payments - Owner's Salary	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	100,000
640001 Payroll Expenses - Wages	35,123	34,792	36,431	35,398	32,059	32,359	32,663	32,969	32,350	31,743	31,148	33,539	400,575
640011 Payroll Expenses - Management Salaries	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	75,000
640033 Payroll Expenses - Commissions	16,589	9,074	18,975	6,627	7,522	16,377	20,819	16,720	12,531	16,469	20,329	21,966	184,000
649000 Payroll Expenses - Fees	674	759	292	401	512	292	529	418	362	593	473	178	5,485
649500 Payroll Expenses - Taxes	-	-	-	-	-	-	-	-	-	-	-	-	-
690000 Interest Expense	2,388	2,188	1,988	1,788	1,588	1,388	1,188	988	788	588	388	188	15,455
Total Expenses	**$ 82,642**	**$ 75,916**	**$ 85,605**	**$ 68,315**	**$ 71,247**	**$ 95,549**	**$ 88,870**	**$ 97,221**	**$ 77,348**	**$ 78,125**	**$ 83,084**	**$ 82,246**	**$ 1,007,605**
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Add-Backs:													
611400 Depreciation & Amortization	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 10,000
690000 Interest Expense	2,388	2,188	1,988	1,788	1,588	1,388	1,188	988	788	588	388	188	15,455
EBITDA	**$ 26,091**	**$ (15,726)**	**$ 35,759**	**$ (26,444)**	**$ (21,434)**	**$ 9,850**	**$ 46,814**	**$ 9,933**	**$ 222**	**$ 28,048**	**$ 46,213**	**$ 59,161**	**$ 177,050**
Seller's Salary	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 100,000
Manager Hired to Replace Seller	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(60,000)
Above Market Rent	500	500	500	500	500	500	500	500	500	500	500	500	6,000
Total Discretionary Expenses	-	-	15,000	-	-	-	25,000	-	-	45,000	-	-	85,000
Adjusted EBITDA	**$ 29,924**	**$ (11,893)**	**$ 54,592**	**$ (22,610)**	**$ (17,601)**	**$ 13,683**	**$ 75,647**	**$ 13,767**	**$ 4,055**	**$ 76,881**	**$ 50,046**	**$ 62,994**	**$ 308,050**

There is only one way around this process. If the year-end inventory balance remains roughly constant, you know that the business sells off inventory items at about the same rate it purchases them. There may be cash flow timing issues on a month-to-month basis, but the COGS expense for the year will closely match the purchasing schedule.

Trend Analysis – Understanding the Ebbs and Flows of Business Expenses

Having adjusted COGS to represent the purchasing schedule for inventory items, we are now in a position to review the P&L for trends in business income and expenses. Trend analysis is tedious. The purpose is to review each line item of the P&L with the goal of understanding the ebbs and flows of financial performance.

With respect to revenue, April and May show a dip in sales. This should be compared to other years to determine whether these months constitute a consistent slow period. The reasons for periods with lower sales should be provided by the seller.

COGS shows large inventory purchases made in January and March. Labor costs are lowest in April and May, corresponding to the dip in sales. *Other Cost of Services – COGS* will require further explanation. My experience in manufacturing leads me to suspect this is cost incurred from outsourcing certain production functions, but Paula would need to confirm.

A number of SG&A items require explanation as well. Advertising & Marketing incurs its only cost in September. Bank Charges & Fees are appreciably higher in July and October through December. There is a conference expense in January. Employee healthcare insurance is significantly higher in June and August. Repairs & Maintenance incurred high costs in February, March, October, and November. August incurred high costs in both Postage and Delivery and Production Tools and Equipment. Rent expense was more than $11k higher in June than in other months.

Paula's explanation of these items will not only help you know what to expect financially, but also provide a qualitative understanding of the nature of the business. For instance, when you ask Paula about the January conference expense, she is likely to explain – in detail – what happens at the conference and how it affects business for the remainder of the year. Such insights are invaluable.

Paula's Print Shop

	Year 5												
	January	**February**	**March**	**April**	**May**	**June**	**July**	**August**	**September**	**October**	**November**	**December**	**Total**
Income													
410000 Sales of Product Income	$ 159,859	$ 87,370	$ 187,021	$ 64,207	$ 73,658	$ 163,177	$ 203,493	$ 165,124	$ 122,410	$ 160,203	$ 197,694	$ 218,986	$ 1,803,200
411000 Shipping and Delivery Income	6,033	3,374	2,730	2,063	1,567	597	4,702	2,073	2,905	4,483	5,601	674	36,800
Total Income	**$ 165,891**	**$ 90,744**	**$ 189,751**	**$ 66,270**	**$ 75,225**	**$ 163,774**	**$ 208,195**	**$ 167,196**	**$ 125,315**	**$ 164,686**	**$ 203,294**	**$ 219,659**	**$ 1,840,000**
Cost of Goods Sold													
510000 Supplies & Materials - COGS	**$ 50,000**	**$ 10,000**	**$ 40,000**	**$ 15,000**	**$ 5,000**	**$ 20,000**	**$ 25,000**	**$ 10,000**	**$ 5,000**	**$ 20,000**	**$ 30,000**	**$ 5,000**	**$ 235,000**
511000 Shipping, Freight & Delivery - COGS	1,147	638	1,353	513	529	1,151	1,416	1,175	938	1,139	1,429	1,506	12,935
511500 Other Costs of Services - COGS	1,902	1,358	3,422	2,445	1,126	2,452	1,664	2,503	3,619	1,884	3,043	2,126	27,545
512000 Cost of labor - COGS	36,228	20,145	42,725	16,212	16,700	36,358	44,719	37,118	29,620	35,960	45,131	47,564	408,480
Total Cost of Goods Sold	**$ 89,278**	**$ 32,142**	**$ 87,499**	**$ 34,170**	**$ 23,355**	**$ 59,961**	**$ 72,800**	**$ 50,796**	**$ 39,177**	**$ 58,983**	**$ 79,604**	**$ 56,197**	**$ 680,800**
Gross Profit	**$ 76,614**	**$ 58,602**	**$ 102,252**	**$ 32,100**	**$ 51,870**	**$ 103,813**	**$ 135,395**	**$ 116,400**	**$ 86,138**	**$ 105,703**	**$ 123,690**	**$ 163,462**	**$ 1,159,200**
	46%	***65%***	***54%***	***48%***	***69%***	***63%***	***65%***	***70%***	***69%***	***64%***	***61%***	***74%***	***63%***
Expenses													
610000 Advertising & Marketing	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ 566	$ -	$ -	$ -	$ 566
610500 Automobile Expense	264	310	221	201	201	249	68	269	350	198	199	228	2,759
611000 Bank Charges & Fees	16	17	16	16	16	16	97	17	16	81	57	87	452
611100 Building Maintenance	268	-	145	240	65	789	-	545	240	-	245	-	2,536
611110 Conferences	550	-	-	-	-	-	-	-	-	-	-	-	550
611111 Contractors	-	-	-	173	-	-	-	-	-	-	-	-	173
611400 Depreciation & Amortization	833	833	833	833	833	833	833	833	833	833	833	833	10,000
611500 Dues & subscriptions	-	-	-	-	-	-	-	-	300	-	-	-	300
611510 Equipment Lease Expense	1,044	1,044	1,241	1,384	2,576	2,950	2,376	1,455	1,610	1,927	2,252	1,345	21,205
613100 Insurance - Employee Healthcare	2,903	2,956	1,900	1,109	2,869	7,610	2,877	8,226	4,606	1,753	1,256	2,698	40,763
614100 Insurance - Other													
613500 Business Insurance	$ 352	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 4,209
613510 Owner's Life Insurance	45	45	45	45	45	45	45	45	45	45	45	-	493
641010 Workers Comp Insurance	318	335	324	277	261	288	348	336	320	362	334	385	3,888
Total 614100 Insurance - Other	**$ 716**	**$ 730**	**$ 720**	**$ 673**	**$ 656**	**$ 683**	**$ 744**	**$ 732**	**$ 715**	**$ 757**	**$ 730**	**$ 735**	**$ 8,589**
614110 Janitorial Expense	$ 163	$ 118	$ 123	$ 123	$ 123	$ 124	$ 168	$ 123	$ 123	$ 155	$ 123	$ -	$ 1,465
614121 Promotional Materials	19	-	9	-	35	-	-	-	-	-	-	-	63
615000 Repairs & Maintenance	-	10,000	11,436	-	35	-	865	-	-	1,540	4,623	-	28,498
615500 Office Supplies and Software	1,014	2,968	1,912	2,043	1,110	613	989	5,539	952	1,191	583	979	19,894
616500 Utilities	1,410	1,299	923	539	1,193	926	971	308	1,559	1,065	969	372	11,535
617000 Postage and Delivery	-	-	-	200	-	29	-	3,684	-	200	-	-	4,112
617100 Production Tools and Equipment	5	-	22	40	-	-	38	4,330	702	146	3	221	5,507
617500 Rent	4,080	4,243	4,162	4,162	4,162	15,481	4,162	4,162	4,162	4,162	4,162	4,162	61,259
618000 Salesperson Expenses	-	-	-	-	-	246	100	236	-	139	127	130	979
620000 Legal & Professional Services	-	-	-	-	-	-	4,800	1,085	-	-	-	-	5,885
640000 Guaranteed Payments - Owner's Salary	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	100,000
640001 Payroll Expenses - Wages	35,123	34,792	36,431	35,398	32,059	32,359	32,663	32,969	32,350	31,743	31,148	33,539	400,575
640011 Payroll Expenses - Management Salaries	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	75,000
640033 Payroll Expenses - Commissions	16,589	9,074	18,975	6,627	7,522	16,377	20,819	16,720	12,531	16,469	20,329	21,966	184,000
649000 Payroll Expenses - Fees	674	759	292	401	512	292	529	418	362	593	473	178	5,485
649500 Payroll Expenses - Taxes	-	-	-	-	-	-	-	-	-	-	-	-	-
690000 Interest Expense	2,388	2,188	1,988	1,788	1,588	1,388	1,188	988	788	588	388	188	15,455
Total Expenses	**$ 82,642**	**$ 85,916**	**$ 95,933**	**$ 70,532**	**$ 70,138**	**$ 95,549**	**$ 88,870**	**$ 97,221**	**$ 77,348**	**$ 78,125**	**$ 83,084**	**$ 82,246**	**$ 1,007,605**
Net Operating Income	**$ (6,028)**	**$ (27,314)**	**$ 6,319**	**$ (38,432)**	**$ (18,268)**	**$ 8,264**	**$ 46,525**	**$ 19,179**	**$ 8,790**	**$ 27,577**	**$ 40,607**	**$ 81,217**	**$ 151,595**
Net Income	**$ (6,028)**	**$ (27,314)**	**$ 6,319**	**$ (38,432)**	**$ (18,268)**	**$ 8,264**	**$ 46,525**	**$ 19,179**	**$ 8,790**	**$ 27,577**	**$ 40,607**	**$ 81,217**	**$ 151,595**
Add-Backs:													
611400 Depreciation & Amortization	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 10,000
690000 Interest Expense	2,388	2,188	1,988	1,788	1,588	1,388	1,188	988	788	588	388	188	15,455
EBITDA	**$ (2,807)**	**$ (24,293)**	**$ 9,140**	**$ (35,811)**	**$ (15,847)**	**$ 10,486**	**$ 48,546**	**$ 21,000**	**$ 10,411**	**$ 28,998**	**$ 41,828**	**$ 82,238**	**$ 177,050**
Seller's Salary	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 100,000
Manager Hired to Replace Seller	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(60,000)
Above Market Rent	500	500	500	500	500	500	500	500	500	500	500	500	6,000
Total Discretionary Expenses	-	-	15,000	-	-	-	25,000	-	-	45,000	-	-	85,000
Adjusted EBITDA	**$ 1,026**	**$ (20,459)**	**$ 27,974**	**$ (31,977)**	**$ (12,014)**	**$ 14,319**	**$ 77,379**	**$ 24,833**	**$ 14,245**	**$ 77,832**	**$ 45,661**	**$ 86,071**	**$ 308,050**

Sea Story

Business or Pleasure – The Tale of the Diamond Ring

"Personal expenses on his *business* credit card?!" I asked with equal measures of disgust and disbelief.

"That's what he said…" Matt trailed off. "Says he bought a diamond ring for his wife and that's mixed up in his business financials. I assume that he pulled that expense out on his tax return, but we're working off internal financial statements."

The acquisition target on which we were conducting due diligence was a small, niche player in the print industry. Unfortunately, many of these mom-and-pop operations fail to keep clean financials. This particular owner had an expense category for credit card purchases. He swore most of those expenses were "discretionary," which in his case meant personal.

"Ok…" I replied with a sigh, "but he'll need to provide all of the corresponding credit card statements so we can verify."

Matt nodded, "I've already requested them."

"Great," I said, "but if he's willing to charge a diamond ring to a business credit card, what else is he doing wrong?"

Add-Backs– Make Sure They Are Real

Adding back certain eligible expenses to net operating income is an essential step in achieving adjusted EBITDA, the metric best suited for representing the business' financial engine. It is also fraught with dangers for the buyer. A seller will be tempted to exaggerate add-backs to achieve the highest possible representation of profitability.

The first set of add-backs is not controversial. These are the *ITDA* of *EBITDA*. Since, in most cases, the business is sold debt free, interest expense should be added back to profitability. Taxes are almost never included in a P&L presented to a potential buyer, but add them back if they are there. Depreciation and amortization are non-cash expenses, so don't think twice about adding those back. Remember, our goal is to adjust profitability so that it is a good representation of the economic engine you are buying.

That brings us to extraordinary and discretionary expenses. These add-backs can be very dangerous. The seller will seek to claim as many expenses as possible fall into these categories. There will be the temptation exaggerate in order to achieve a higher adjusted EBITDA.

First, let's examine extraordinary expenses. Extraordinary expenses are the less contentious of the two. These are necessary business expenses that are not recurring. Consider the implementation of an enterprise resource planning (ERP) system. ERPs are used by businesses to manage and track workflow – from inventory purchasing to financial accounting. They position the business for growth and usual incur monthly subscription costs. They also, however, incur large upfront implementation fees. A business might spend $50k for the initial setup of the ERP system SAP Business One. This is a one-time fee for which the business benefits as long as the ERP is in use. As a result, this cost is considered extraordinary and is a legitimate add-back. If you were to buy such a business, this one-time expense would distort how historical performance corresponds to your future ownership.

Next, let's consider discretionary expenses. This is where things really get dicey. When a seller claims that an expense on the business was not really necessary for business operations, a potential buyer should ask a simple question: *"Why then was the expense incurred?"* Mixing personal and business expenses suggests impropriety. This inadvisable practice can also sully the business financials to the point that good analysis becomes impossible. Discretionary reinvestment in the business should be viewed with suspicion. A seller who claims that operational equipment was replaced despite the original equipment still working adequately should be met with incredulity. A seller who claims a conference trip to Hawaii was not really necessary might have a case, but the buyer should be sure that skipping that conference would not damage the business' sales engine.

Finally, there is the issue of the current owner's salary. Often, a seller will claim their compensation as an add-back. In the previous chapter, this is how we differentiated *seller's discretionary earnings* from *adjusted EBITDA*. I advise against this as a complete add-back. It is, however, fair to adjust the seller's salary to market rate for a replacement who will assume the current owner's vital functions.

When these scrutinized add-backs are applied to net operating income they result in adjusted EBITDA. This crucial metric is likely to be the basis of the business' valuation. Buying a business at the right price is the first step to acquisition success. In order to do so, you must avoid invalid add-backs that lead to an inflated EBITDA assessment.

Getting to Free Cash Flow – How You Use Your EBITDA

If adjusted EBITDA is a representation of the business' financial engine, we must think through how *we* – as the new owners – will use the cash produced. After reducing adjusted EBITDA by these necessary uses, what's left over is *free cash flow (FCF)*. The cash obligations to be accounted for will vary by industry and with each particular business. However, at a minimum, your debt service (principal and interest), expected capital expenditures (CAPEX), seller earnout (if applicable), and business taxes must be applied as reductions to adjusted EBITDA.

EBITDA excludes debt service so the business' economic engine can be examined independently of financing used to acquire the business or its key assets. Nevertheless, debt payments are a real demand on the business' cash. Thus, you must reduce adjusted EBITDA by the principal and interest payments associated with acquiring the business. Because the business' tax burden, which we will discuss shortly, is reduced by interest expense but not principal payments, I recommend separating the two in your model. Fortunately, Excel makes this easy.

There is an Excel formula that calculates the entire debt payment (principal and interest):

$$= pmt(rate, nper, pv)$$

where *rate* is the interest rate, *nper* is the number of periods in the loan term, and *pv* is the present value of the loan (the initial principal amount).

But we're actually interested in separating the debt payments into their principal and interest components. Excel makes this easy as well. Principal payment can be determined using the following formula:

$$= ppmt(rate, per, nper, pv)$$

where *per* is the number of the specific period. For interest, if you were calculating the second of five annual payments, *per* would be 2 and *nper* would be 5.

The associated interest payment is the difference between the total payment and the interest:

$$= pmt(rate, nper, pv) - ppmt(rate, per, nper, pv)$$

Each of these formulas outputs the result as a negative number, so be sure to add a *minus* sign when a positive number result is desired.

CAPEX – Investing in the Business

Capital expenditures (CAPEX) are an additional cash burden. CAPEX shows up on the balance sheet rather the P&L. Instead of being treated as an expense, CAPEX is recorded as an asset offset by a liability. When CAPEX is paid, a reduction in cash reduces the liability. Meanwhile, over time, the asset is reduced by accumulating depreciation on the balance sheet matched by a depreciation expense on the P&L.

At the highest level, there is some baseline CAPEX that a business is expected to incur. This amount varies by industry. In the print industry, 3% of revenue is standard. This accounts for unforeseen CAPEX requirements that become apparent after the acquisition.

In addition to the CAPEX baseline, a buyer should also reduce adjusted EBITDA by the cost of intended investments. If a buyer believes a $15k printing press is required at Paula's Print Shop, the buyers should account for the associated payments.

Other Obligations on Free Cash Flow

Before estimating the tax burden on FCF, you should be sure to add any other expenses to the model. For instance, if you must hire additional employees or embark on an internet marketing campaign to achieve your vision, the resulting costs should reduce adjusted EBITDA.

Tax Burden

Finally, we must reduce adjusted EBITDA by the end-of-year tax burden. To estimate taxable profit, reduce adjusted EBITDA by interest (not principal), depreciation, and amortization; then by other obligations on FCF; finally, apply the appropriate tax rate to this amount.

The appropriate tax rate is determined by the business' legal structure.

LLCs and S-Corps are "pass through entities" – meaning that business profits are passed through to the owners and taxed as income. At the time of this writing, the top federal income tax bracket sits at 37%. If we assume that state taxes average to about 3%, 40% is a fair estimation of the business tax rate.

C-Corps are taxed directly. At the time of this writing, the corporate tax rate is 21%. However, a new administration has stated its intention to raise this to 28%. After adding an estimate for state taxes, 30% is a fair estimation for the C-Corp tax rate.

The modifications listed above, from debt service to taxes, adjust the EBITDA you acquire to FCF under your ownership.

Paula's Print Shop

	Year 5 January	February	March	April	May	June	July	August	September	October	November	December	Total
Income													
410000 Sales of Product Income	$ 159,859	$ 87,370	$ 187,021	$ 64,207	$ 73,658	$ 163,177	$ 203,493	$ 165,124	$ 122,410	$ 160,203	$ 197,694	$ 218,986	$ 1,803,200
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Cost of Goods Sold													
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611110 Conferences	550	-	-	-	-	-	-	-	-	-	-	-	550
611111 Contractors	-	-	-	173	-	-	-	-	-	-	-	-	173
611400 Depreciation & Amortization	833	833	833	833	833	833	833	833	833	833	833	833	10,000
611500 Dues & subscriptions	-	-	-	-	-	-	-	-	300	-	-	-	300
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616500 Utilities	1,410	1,299	923	539	1,193	926	971	308	1,559	1,065	969	372	11,535
617000 Postage and Delivery	-	-	-	200	-	29	-	3,684	-	200	-	-	4,112
617100 Production Tools and Equipment	5	-	22	40	-	-	38	4,330	702	146	3	221	5,507
617500 Rent	4,080	4,243	4,162	4,162	4,162	15,481	4,162	4,162	4,162	4,162	4,162	4,162	61,259
618000 Salesperson Expenses	-	-	-	-	-	246	100	236	-	139	127	130	979
620000 Legal & Professional Services	-	-	-	-	-	-	4,800	1,085	-	-	-	-	5,885
640000 Guaranteed Payments - Owner's Salary	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	100,000
640001 Payroll Expenses - Wages	35,123	34,792	36,431	35,398	32,059	32,359	32,663	32,969	32,350	31,743	31,148	33,539	400,575
640011 Payroll Expenses - Management Salaries	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	75,000
640033 Payroll Expenses - Commissions	16,589	9,074	18,975	6,627	7,522	16,377	20,819	16,720	12,531	16,469	20,329	21,966	184,000
649000 Payroll Expenses - Fees	674	759	292	401	512	292	529	418	362	593	473	178	5,485
649500 Payroll Expenses - Taxes	-	-	-	-	-	-	-	-	-	-	-	-	-
690000 Interest Expense	2,388	2,188	1,988	1,788	1,588	1,388	1,188	988	788	588	388	188	15,455
Total Expenses	**$ 82,642**	**$ 85,916**	**$ 95,933**	**$ 70,532**	**$ 70,138**	**$ 95,549**	**$ 88,870**	**$ 97,221**	**$ 77,348**	**$ 78,125**	**$ 83,084**	**$ 82,246**	**$ 1,007,605**
Net Operating Income	**$ (6,028)**	**$ (27,314)**	**$ 6,319**	**$ (38,432)**	**$ (18,268)**	**$ 8,264**	**$ 46,525**	**$ 19,179**	**$ 8,790**	**$ 27,577**	**$ 40,607**	**$ 81,217**	**$ 148,435**
Net Income	**$ (6,028)**	**$ (27,314)**	**$ 6,319**	**$ (38,432)**	**$ (18,268)**	**$ 8,264**	**$ 46,525**	**$ 19,179**	**$ 8,790**	**$ 27,577**	**$ 40,607**	**$ 81,217**	**$ 148,435**
Add-Backs:													
611400 Depreciation & Amortization	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 10,000
690000 Interest Expense	2,388	2,188	1,988	1,788	1,588	1,388	1,188	988	788	588	388	188	15,455
EBITDA	**$ (2,807)**	**$ (24,293)**	**$ 9,140**	**$ (35,811)**	**$ (15,847)**	**$ 10,486**	**$ 48,546**	**$ 21,000**	**$ 10,411**	**$ 28,998**	**$ 41,828**	**$ 82,238**	**$ 173,890**
Seller's Salary	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 100,000
Manager Hired to Replace Seller	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(60,000)
Above Market Rent	500	500	500	500	500	500	500	500	500	500	500	500	6,000
Total Discretionary Expenses	-	-	15,000	-	-	-	25,000	-	-	45,000	-	-	85,000
Adjusted EBITDA	**$ 1,026**	**$ (20,459)**	**$ 27,974**	**$ (31,977)**	**$ (12,014)**	**$ 14,319**	**$ 77,379**	**$ 24,833**	**$ 14,245**	**$ 77,832**	**$ 45,661**	**$ 86,071**	**$ 304,890**

Debt Used by Byer for Acquisiton	
Amount Borrowed	$ 500,000
Annual Interest Rate	6%
Term (yrs)	10

	January	February	March	April	May	June	July	August	September	October	November	December	Total
Debt Service - Principal Payments	$ 3,051	$ 3,066	$ 3,082	$ 3,097	$ 3,113	$ 3,128	$ 3,144	$ 3,159	$ 3,175	$ 3,191	$ 3,207	$ 3,223	$ 37,636
Debt Service - Interest Payments	2,500	2,485	2,469	2,454	2,439	2,423	2,407	2,392	2,376	2,360	2,344	2,328	28,976
CAPEX	4,977	2,722	5,693	1,988	2,257	4,913	6,246	5,016	3,759	4,941	6,099	6,590	55,200
Additional CAPEX	-	-	15,000	-	-	-	-	-	-	-	-	-	15,000
Other Obligations on Free Cash Flow	-	-	-	-	-	-	-	-	-	-	-	-	-
Tax Burden / (Benefit)	(2,580)	(10,267)	1,925	(14,568)	(6,684)	2,793	27,491	6,970	3,244	28,212	14,887	30,861	82,286
Free Cash Flow (FCF)	**$ (6,921)**	**$ (18,466)**	**$ (195)**	**$ (24,949)**	**$ (13,138)**	**$ 1,062**	**$ 38,092**	**$ 7,296**	**$ 1,690**	**$ 39,128**	**$ 19,124**	**$ 43,069**	**$ 85,792**

Running Cash Balance

Having calculated the FCF produced each month, the next step is to model the *running cash balance* that results. This is the month end cash balance of the business. This can be modeled by starting with cash on hand plus A/R less A/P plus the FCF generated during the initial month.

Subsequent months can be modeled as the previous month's ending balance plus the FCF generated during the that month. This shows an estimate of the business' cash on hand at the end of each month and shows how the business is expected to accumulate (or draw down) cash.

Paula's Print Shop

	Year 5												
	January	**February**	**March**	**April**	**May**	**June**	**July**	**August**	**September**	**October**	**November**	**December**	**Total**
Income													
410000 Sales of Product Income	$ 159,859	$ 87,370	$ 187,021	$ 64,207	$ 73,658	$ 163,177	$ 203,493	$ 165,124	$ 122,410	$ 160,203	$ 197,694	$ 218,986	$ 1,803,200
411000 Shipping and Delivery Income	6,033	3,374	2,730	2,063	1,567	597	4,702	2,073	2,905	4,483	5,601	674	36,800
Total Income	**$ 165,891**	**$ 90,744**	**$ 189,751**	**$ 66,270**	**$ 75,225**	**$ 163,774**	**$ 208,195**	**$ 167,196**	**$ 125,315**	**$ 164,686**	**$ 203,294**	**$ 219,659**	**$ 1,840,000**
Cost of Goods Sold													
510000 Supplies & Materials - COGS	$ 50,000	$ 10,000	$ 40,000	$ 15,000	$ 5,000	$ 20,000	$ 25,000	$ 10,000	$ 5,000	$ 20,000	$ 30,000	$ 5,000	$ 235,000
511000 Shipping, Freight & Delivery - COGS	1,147	638	1,353	513	529	1,151	1,416	1,175	938	1,139	1,429	1,506	12,935
511500 Other Costs of Services - COGS	1,902	1,358	3,422	2,445	1,126	2,452	1,664	2,503	3,619	1,884	3,043	2,126	27,545
512000 Cost of labor - COGS	36,228	20,145	42,725	16,212	16,700	36,358	44,719	37,118	29,620	35,960	45,131	47,564	408,480
Total Cost of Goods Sold	**$ 89,278**	**$ 32,142**	**$ 87,499**	**$ 34,170**	**$ 23,355**	**$ 59,961**	**$ 72,800**	**$ 50,796**	**$ 39,177**	**$ 58,983**	**$ 79,604**	**$ 56,197**	**$ 683,960**
Gross Profit	**$ 76,614**	**$ 58,602**	**$ 102,252**	**$ 32,100**	**$ 51,870**	**$ 103,813**	**$ 135,395**	**$ 116,400**	**$ 86,138**	**$ 105,703**	**$ 123,690**	**$ 163,462**	**$ 1,156,040**
	46%	***65%***	***54%***	***48%***	***69%***	***63%***	***65%***	***70%***	***69%***	***64%***	***61%***	***74%***	***63%***
Expenses													
610000 Advertising & Marketing	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ 566	$ -	$ -	$ -	$ 566
610500 Automobile Expense	264	310	221	201	201	249	68	269	350	198	199	228	2,759
611000 Bank Charges & Fees	16	17	16	16	16	16	97	17	16	81	57	87	452
611100 Building Maintenance	268	-	145	240	65	789	-	545	240	-	245	-	2,536
611110 Conferences	550	-	-	-	-	-	-	-	-	-	-	-	550
611111 Contractors	-	-	-	173	-	-	-	-	-	-	-	-	173
611400 Depreciation & Amortization	833	833	833	833	833	833	833	833	833	833	833	833	10,000
611500 Dues & subscriptions	-	-	-	-	-	-	-	-	300	-	-	-	300
611510 Equipment Lease Expense	1,044	1,044	1,241	1,384	2,576	2,950	2,376	1,455	1,610	1,927	2,252	1,345	21,205
613100 Insurance - Employee Healthcare	2,903	2,956	1,900	1,109	2,869	7,610	2,877	8,226	4,606	1,753	1,256	2,698	40,763
614100 Insurance - Other													
613500 Business Insurance	$ 352	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 351	$ 4,209
613510 Owner's Life Insurance	45	45	45	45	45	45	45	45	45	45	45	-	493
641010 Workers Comp Insurance	318	335	324	277	261	288	348	336	320	362	334	385	3,888
Total 614100 Insurance - Other	**$ 716**	**$ 730**	**$ 720**	**$ 673**	**$ 656**	**$ 683**	**$ 744**	**$ 732**	**$ 715**	**$ 757**	**$ 730**	**$ 735**	**$ 8,589**
614110 Janitorial Expense	$ 163	$ 118	$ 123	$ 123	$ 123	$ 124	$ 168	$ 123	$ 123	$ 155	$ 123	$ -	$ 1,465
614121 Promotional Materials	19	-	9	-	35	-	-	-	-	-	-	-	63
615000 Repairs & Maintenance	-	10,000	11,436	-	35	-	865	-	-	1,540	4,623	-	28,498
615500 Office Supplies and Software	1,014	2,968	1,912	2,043	1,110	613	989	5,539	952	1,191	583	979	19,894
616500 Utilities	1,410	1,299	923	539	1,193	926	971	308	1,559	1,065	969	372	11,535
617000 Postage and Delivery	-	-	-	200	-	29	-	3,684	-	200	-	-	4,112
617100 Production Tools and Equipment	5	-	22	40	-	-	38	4,330	702	146	3	221	5,507
617500 Rent	4,080	4,243	4,162	4,162	4,162	15,481	4,162	4,162	4,162	4,162	4,162	4,162	61,259
618000 Salesperson Expenses	-	-	-	-	-	246	100	236	-	139	127	130	979
620000 Legal & Professional Services	-	-	-	-	-	-	4,800	1,085	-	-	-	-	5,885
640000 Guaranteed Payments - Owner's Salary	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	100,000
640001 Payroll Expenses - Wages	35,123	34,792	36,431	35,398	32,059	32,359	32,663	32,969	32,350	31,743	31,148	33,539	400,575
640011 Payroll Expenses - Management Salaries	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	6,250	75,000
640033 Payroll Expenses - Commissions	16,589	9,074	18,975	6,627	7,522	16,377	20,819	16,720	12,531	16,469	20,329	21,966	184,000
649000 Payroll Expenses - Fees	674	759	292	401	512	292	529	418	362	593	473	178	5,485
649500 Payroll Expenses - Taxes	-	-	-	-	-	-	-	-	-	-	-	-	-
690000 Interest Expense	2,388	2,188	1,988	1,788	1,588	1,388	1,188	988	788	588	388	188	15,455
Total Expenses	**$ 82,642**	**$ 85,916**	**$ 95,933**	**$ 70,532**	**$ 70,138**	**$ 95,549**	**$ 88,870**	**$ 97,221**	**$ 77,348**	**$ 78,125**	**$ 83,084**	**$ 82,246**	**$ 1,007,605**
Net Operating Income	**$ (6,028)**	**$ (27,314)**	**$ 6,319**	**$ (38,432)**	**$ (18,268)**	**$ 8,264**	**$ 46,525**	**$ 19,179**	**$ 8,790**	**$ 27,577**	**$ 40,607**	**$ 81,217**	**$ 148,435**
Net Income	**$ (6,028)**	**$ (27,314)**	**$ 6,319**	**$ (38,432)**	**$ (18,268)**	**$ 8,264**	**$ 46,525**	**$ 19,179**	**$ 8,790**	**$ 27,577**	**$ 40,607**	**$ 81,217**	**$ 148,435**
Add-Backs:													
611400 Depreciation & Amortization	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 10,000
690000 Interest Expense	2,388	2,188	1,988	1,788	1,588	1,388	1,188	988	788	588	388	188	15,455
EBITDA	**$ (2,807)**	**$ (24,293)**	**$ 9,140**	**$ (35,811)**	**$ (15,847)**	**$ 10,486**	**$ 48,546**	**$ 21,000**	**$ 10,411**	**$ 28,998**	**$ 41,828**	**$ 82,238**	**$ 173,890**
Seller's Salary	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 100,000
Manager Hired to Replace Seller	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(60,000)
Above Market Rent	500	500	500	500	500	500	500	500	500	500	500	500	6,000
Total Discretionary Expenses	-	-	15,000	-	-	-	25,000	-	-	45,000	-	-	85,000
Adjusted EBITDA	**$ 1,026**	**$ (20,459)**	**$ 27,974**	**$ (31,977)**	**$ (12,014)**	**$ 14,319**	**$ 77,379**	**$ 24,833**	**$ 14,245**	**$ 77,832**	**$ 45,661**	**$ 86,071**	**$ 304,890**

Debt Used by Byer for Acquisiton	
Amount Borrowed	$ 500,000
Annual Interest Rate	6%
Term (yrs)	10

	January	February	March	April	May	June	July	August	September	October	November	December	Total
Debt Service - Principal Payments	$ 3,051	$ 3,066	$ 3,082	$ 3,097	$ 3,113	$ 3,128	$ 3,144	$ 3,159	$ 3,175	$ 3,191	$ 3,207	$ 3,223	$ 37,636
Debt Service - Interest Payments	2,500	2,485	2,469	2,454	2,439	2,423	2,407	2,392	2,376	2,360	2,344	2,328	28,976
CAPEX	4,977	2,722	5,693	1,988	2,257	4,913	6,246	5,016	3,759	4,941	6,099	6,590	55,200
Additional CAPEX	-	-	15,000	-	-	-	-	-	-	-	-	-	15,000
Other Obligations on Free Cash Flow	-	-	-	-	-	-	-	-	-	-	-	-	-
Tax Burden / (Benefit)	(2,580)	(10,267)	1,925	(14,568)	(6,684)	2,793	27,491	6,970	3,244	28,212	14,887	30,861	82,286
Free Cash Flow (FCF)	**$ (6,921)**	**$ (18,466)**	**$ (195)**	**$ (24,949)**	**$ (13,138)**	**$ 1,062**	**$ 38,092**	**$ 7,296**	**$ 1,690**	**$ 39,128**	**$ 19,124**	**$ 43,069**	**$ 85,792**

Starting Cash	$ 200,000
plus Starting A/R	60,000
less Starting A/P	20,000
Starting Working Capital	**$ 240,000**

	January	February	March	April	May	June	July	August	September	October	November	December
Running Cash Balance (End-of-Month Totals)	**$ 233,079**	**$ 214,613**	**$ 214,418**	**$ 189,469**	**$ 176,331**	**$ 177,393**	**$ 215,485**	**$ 222,781**	**$ 224,472**	**$ 263,599**	**$ 282,723**	**$ 325,792**

Sea Story

It's Not Print!

We were excited… and we had cause to be. Our new acquisition prospect would be a great addition to our growing enterprise. The company had clear synergies with our business units, a great reputation in its industry, *and profit margins over fifty percent*!

The seller had just signed the LOI and we were in the early stages of due diligence. Travis, an industry expert with whom we'd become acquainted, had agreed to meet us for an early Saturday morning discussion over coffee.

Matt and I ordered *Americanos* – black. Travis ordered a *latte* and reached for his wallet. Matt stopped him, "No way! You're doing us a favor… coffee is on us."

We stepped back from the counter as the barista went to work preparing our order. Matt turned excitedly to Travis, "This company looks great to us. We think it would be a perfect fit."

"…and the margins are amazing!" I added.

Travis grimaced and nodded thoughtfully as we stepped forward to claim our coffee, "Yes… and that's what worries me. Let's have a seat and talk."

We sat at a small table by the café's front window and Travis continued, "I've been working in the printing industry for thirty years – buying and selling companies, in some cases managing them… In all that time, I've never seen margins this high."

"Well," Matt replied, "the company prints ballots for elections. We think county governments are willing to pay a premium to a specialty election vendor that can ensure there are no screw ups on election day."

Travis nodded, "There is no doubt that's part of it. I wouldn't want to be a commercial printer playing in the election space. Even so, these margins are outsized for even the most niche segments of the printing market."

"The current owner is an election expert. The customers put a lot of faith in him to navigate the ever-changing election laws and regulations," I said.

"So, is this a printing company or a consulting firm?" Travis asked pointedly.

Matt and I looked at each other pensively. Perhaps we had underestimated the risk of the current owner's departure from the business.

"Listen," Travis said, "I don't know what the specials sauce is for this business. But, whatever they are *really* selling, it's not print!"

Beware High Margins… and Low Ones Too

Profit margins present business buyers with an interesting dilemma. Margins that are too high, say greater than thirty percent, are likely the result of special circumstances enjoyed by the current owner. Often, these special circumstances do not transfer to new ownership. Personal relationships with customers, an owner's industry expertise accompanied by free customer consultation, and, unfortunately, unethical owner-customer arrangements can all drive profits artificially high. When these benefits disappear, so do the highly profitable customers.

Conversely, low margins, say less than ten percent, are undesirable for obvious reasons. *Who wants to do work for so little actual gain?* Low margins can also be an indicator that the product or services being sold are *commodities*. A commodity is a basic good that is interchangeable with other goods of the same type.[ii] This allows competitors to obtain market share by reducing price. Eventually, all the profits are competed away, leaving behind a very undesirable business. Wise business buyers always seek to acquire business that is *defensible*. More on that to follow.

Balance Sheet Review

Having worked extensively with the P&L, you are ready to scrutinize the prospect's balance sheet. The balance sheet has two sides. The left-hand side shows value of the company's assets. The right-hand side shows the company's liabilities and shareholder equity. The term balance sheet comes from the fact that these two sides must be equal, or *balance*, in accordance with the following equation:

$$Assets = Liabilities + Shareholder\ Equity$$

This is known as the *balance sheet equation*.

When reviewing a prospect's balance sheet, the business' assets are your primary interest. Most business acquisitions are asset purchases in which your newly formed legal entity acquires all the business assets, but none of the liabilities. Typically, it is up to the seller to settle their debts in conjunction with the close.

Assets are divided between *current assets* and *fixed assets*. Current assets are short-term assets, which are held for less than a year before being converted to cash.[iii] Cash held in bank accounts, account receivable, and inventory are typical examples of current assets. Fixed assets are assets held for longer than a year. Manufacturing equipment, vehicles, and office fixtures are typical examples of fixed assets.

Previously, we discussed that most business acquisitions are done on a debt-free basis, meaning the seller settles his business debts in conjunctions with the close. Here is it worth mentioning that such acquisitions are also usually *cash-free*, meaning the seller also takes the cash in the business bank account at close. This leaves the new owner to supply cash for working capital in their own, newly formed business bank account. Consequently, cash on the balance sheet is not a current asset of particular concern to a business buyer.

Accounts receivable (A/R) can be a more contentious issue. The owner is likely to feel entitled to all the A/R achieved under their ownership. After all, the product or service was supplied to the customer by them, you had nothing to do with it. However, this reasoning, while logical, is problematic for a buyer seeking *line of credit* financing. It is a common practice for banks to offer businesses a line of credit secured by the business' A/R. These lenders typically allow businesses to borrow an amount up to 80% of their A/R balance. In turn, the lender has a claim (called a *lien*) on those receivables. This financing product usually requires a monthly interest payment. Principal payments are required only if the business' A/R balance decreases such that the outstanding principal balance exceeds 80% of A/R. If a business buyer intends to use this financing product to fund business operations on *Day 1* of their ownership, the buyer and seller must negotiate some amount of A/R to be left in the business.

Inventory is a key current asset for most businesses. After all, you will need something to sell. Even service businesses usually carry some inventory that supports or supplements the service they provide. During the due diligence process, a prospective buyer must ascertain how much inventory is required to run the business without interruption. That amount of inventory must either be supplied by the buyer or, more reasonably, negotiated into the purchase price and left in the business at close.

As discussed previously, small business valuations are usually determined as an appropriate multiple of adjusted EBITDA. If we believe that Paula's Print Shop is a $290k annual adjusted EBITDA company worthy of a 4x multiple, we'll be willing to pay $1.16mm for its cash production capabilities. Unfortunately, unless otherwise negotiated, the seller will expect payment for any A/R or inventory they leave in the business. This can be tricky for a buyer. A/R will take time to convert to cash and some may end up being *bad debt* that is never paid at all. For these reasons, I don't recommend agreeing to pay for A/R on a dollar-for-dollar basis. Rather, I recommend negotiating an arrangement in which the seller receives 80% of the AR value in cash at close. When buying inventory, an outside auditor should be brought in to do a fair market valuation. This will ensure both buyer and seller get a fair deal. The danger to the buyer is that some inventory may no longer be sellable. This could be for many reasons, such as the inventory is past its expiration date or changes in the market make previously useful material obsolete. Accounting for these pitfalls is part of a robust due diligence process.

Fixed assets generally fall under a category called *Property Plant and Equipment (PP&E)*. Typically, the most important fixed assets are manufacturing equipment and delivery vehicles. These assets can have significant market value. Lenders will accept PP&E as loan collateral, usually lending up to 80% of its orderly liquidation value. Understanding a business' PP&E is essential when assessing an acquisition target.

In addition to contributing to the purchase price, tangible assets also constitute a business' *borrowing base*. The borrowing base serves as collateral for lenders and usually consists of A/R, inventory, and PP&E. Creditors prefer to provide acquisition debt capital for businesses with valuable assets. This is true because, should the business fail, the debt can be at least partially recovered through liquidation of those assets. When the acquisition loan is paid off, the borrowing base can be used to secure additional funds. If a business owner desires a loan for working capital or for growth activities, many lenders will fund at some percentage of the value of those assets. I have typically seen loans offered equal to 80% of A/R, 50% of inventory value, and 80% of orderly liquidation value (OLV) of PP&E. Of course, to be used as collateral, these assets must be owned free and clear by the business. If you still owe $400k on a $500k piece of manufacturing equipment, you won't be able to borrow 80% of anywhere near $500k. Even so, there is a distinct advantage in buying a business with valuable assets when it comes to debt financing.

So, does this make asset rich businesses the best acquisition targets? Not necessarily. Businesses with significant assets tend to make and sell things. Manufacturing companies are a prime example. While it is much easier to lend to such businesses, there is a significant amount of additional administration and operational complexity that comes with that advantage. Inventory count and value must be regularly assessed, manufacturing equipment must be maintained and repaired, and custom provisions on orders disrupt the standard work process. Service companies (accounting firms, tree service companies, etc.) have relatively few assets, which means a very limited borrowing base, but also few headaches associated manufacturing or inventory. When service companies do need financing, they typically look for creditors willing to do *cash flow lending*. Cash flow lending provides funds commensurate with the business' historical cash flow performance. The idea being that, should the company's financial success continue, future cash flows will be adequate to service the debt.

Sea Story

You Can't Finance That…

I hadn't seen Jesse in years and was excited to catch up. He swung open the door just as I rang the doorbell. "Jeff!" he exclaimed. After a handshake that turned into a hug, he ushered me into his first-floor study. Jesse had been practicing law for years and his home office showed it. His shelves were overstuffed with leather bound reference books and stacked file folders formed a barricade on his sizable, mahogany executive desk.

I eased myself into a comfortable, oversized leather chair as he plopped down behind his cluttered desk. "Looks like you've been busy," I said taking it all in, my gaze ending up on his impressive collection of law books.

"Those?" Jesse a laughed, gesturing where I was looking, "*Relics*… every one of them. The whole damn world has gone digital. *But, yes.* Business has been good. I'm staying *very* busy. It's great most of the time. The rest of the time clients are screaming at me to do the impossible!"

"Well, that's never fun," I agreed. "We've been busy too - just closed our third acquisition."

"Congrats," Jesse replied with a smile, "Another printing company added to your growing empire. Just out of curiosity, how did you finance that?"

"SBA 7a loan," I answered.

"Good, good," Jesse said thoughtfully, "I've got a client who wants to sell his business to a young woman. They've tentatively agreed to a $1 million purchase price. He takes home about $300k a year."

"Sounds like a good deal for her – that's just over a 3x multiple," I said, excited to hear of a buyer landing on the favorable end of the standard 3-5x range.

"Yeah, but this is a professional services company. Not a print manufacturer with thousand-dollar presses. She'll never get the financing – there's no collateral."

"Oh, I don't know about that," I said, "SBA loans are guaranteed by the government – usually to the tune of 80%. With security like that, there are SBA lenders who will do the deal. Her problem will be trying to finance working capital if she hits a rough patch down the road. That's when a borrowing base comes in handy."

"Hmm…" Jesse said thoughtfully, "You have more experience in this area than I do… I suppose you might be on to something there. I'll pass it along as a suggestion."

In a lender's perfect world, every dollar lent would be secured by business assets, but that doesn't always happen. Small Business Administration (SBA) loans are often used by buyers to finance acquisitions. A lender that makes an SBA loan has the benefit of the government guaranteeing between 75 and 85 percent of the loan. With that security in place, SBA lenders have been known to lend up to $1.5 million above the value of the business assets. This collateral shortfall is sometimes called an *airball*. Be careful though, the SBA requires a personal guarantee. Should the business fail, the SBA will seek to recover from you personally what it can't extract from the business.

The Process

Qualitative Analysis – Does the Story Imply Future Success?

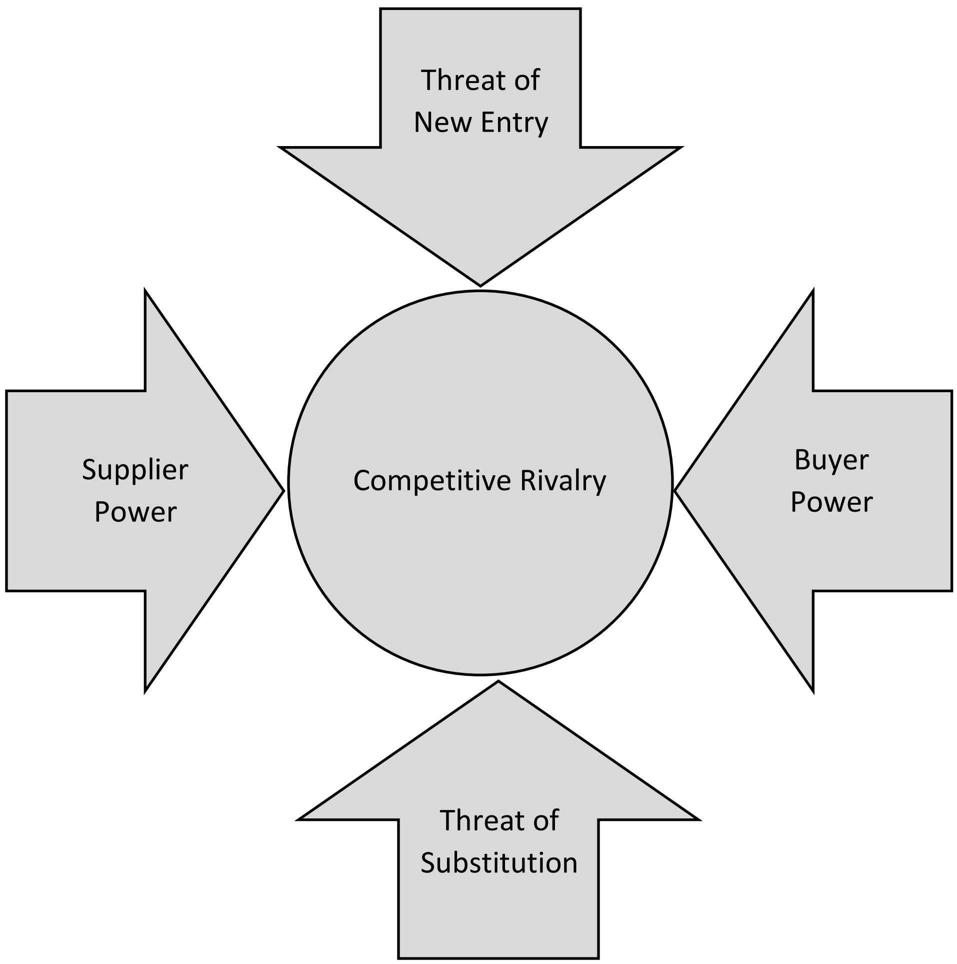
Financial due diligence is the first step in deciding whether a transaction can move forward. At a minimum, past financial performance must be adequate for a new owner's needs. That, however, is not enough. A prospective buyer must understand the industry and the business' position in it. While this book is focused on the financial aspects of acquiring and operating a small business, I would be remiss if I did not provide a high-level overview of the qualitative considerations that must follow the financial number crunching.

Porter's Five Forces

Porter's Five Forces is a framework developed by economist and corporate strategist Michael Porter. It has become the standard methodology for assessing power dynamics in the business' supply chain and threats to its offerings.[iv] These insights are essential in understanding the company's future.

The five forces are: *competitive rivalry, buyer power, supplier power, threat of new entry, and threat of substitution*.

Porter's Five Forces



Let's briefly discuss each.

Competitive Rivalry – How much competition does the prospect have at present? Is the business sufficiently differentiated that it has achieved monopoly in its service area? Is it one of two companies taking part in a fierce rivalry? Are there many similar businesses in direct competition with the prospect? Generally speaking, the less competition the better. Competition often causes rival businesses to reduce prices in order to gain market share. This results in profits being eaten away until the business segment is no longer attractive. Stiff competition also dramatically raises the stakes – and expense – of advertising. When many businesses have similar offerings, effective marketing is often the difference between success and failure.

Buyer Power – How easy is it for your customers to switch to a competitor? Buyer power is at its highest with commodities. If you are selling vegetables, customer choice is nearly unlimited – there is always another grocer down the street. Buyer power is reduced when *switching costs* are high. If switching to a new vendor requires gaining bureaucratic approval, retrieving data from the current vendor, manipulating that data for submission to a new vendor, and a host of setup fees, a customer will be reluctant to switch.

Supplier Power – If your suppliers go out of business, raise prices, or stop selling to you, how easy is it to procure a new supplier? Here commoditized inputs are a benefit to the business. A landscaper can rest easy knowing that there is a plethora of mulch suppliers. Even better, competition amongst them will keep prices in check. Conversely, a car dealership is at the mercy of the auto maker it supports. If that manufacturer makes an exclusive deal with a competitor, the dealership will be left without a business.

Threat of New Entry – If someone wanted to start a competing business, is there anything keeping them out? These *barriers to entry* ensure a stable competitive landscape. Barriers to entry take many forms. Patents are legal barriers that ensure product differentiation. Large capital requirements are financial barriers that keep out most entrepreneurs. Specialized skill sets are practical barriers because they reduce the qualified labor pool. While no business segment is impenetrable, the more barriers to entry, the better.

Threat of Substitution – How likely is it that innovation will render your product or service obsolete? For about 100 years, Eastman Kodak was an industrial behemoth, leading the way in film and camera technology. It took only about a decade for the digital camera to obliterate the market for film and Kodak's prospects with it. In this technological age, it is crucial to understand how vulnerable a company is to new, innovative ways of doing things.

Sea Story

Where's the Moat?

Anticipation, mixed with a bit of anxiety, gripped me as we waited in a hilltop pavilion on an idyllic Kentucky horse farm. The property was owned by Jack, our wealthiest investor, who had texted that he was just minutes out. The purpose of our meeting was to discuss our latest acquisition target. We hoped Jack would provide the equity investment needed to close the deal. The target was a commercial printer, but built for food label and large format printing, two growing verticals in a declining industry.

The scenery, however, made it hard to focus. Off in the distance, a chestnut-colored horse lowered his head for a bite of grass. As he did, a gentle breeze rustled the leaves of the birch tree under which he stood. I smiled to myself, *so this is what it's like to be a millionaire many times over…*

My impressed musings were interrupted by the sound of tires over gravel. I turned to see a white Tesla Model S come to a halt. Jack jumped out the driver side door and greeted us with a wave. Dressed in a white untucked linen shirt, khaki pants, and sandals, he made his way to the breaker panel and turned on the electricity. As the television above the outdoor fireplace flickered on, he walked back towards us, "Welcome guys! Hopefully, you had a pleasant flight."

"Flight was great," Matt said, "Thank you for sending your jet."

"No problem at all," Jack replied, plopping into an oversized chair in front of the fireplace.

Matt and I took seats on a thickly cushioned wicker couch directly across from him. We had both worn suit and tie, which now felt uncomfortably overdressed.

"If you show me where to plug in, I can start our presentation," Matt offered.

Jack leaned back in his chair, "Not just yet… I reviewed the material you sent. Let's just talk for a while… high level stuff."

"Sure," I said, nodding in agreement.

Jack leaned in, "When we invested with you, we did so based on the thesis that elections were moving decidedly to paper ballot. Since then, due to the pandemic, vote-by-mail has also increased dramatically. It seems like we should be entirely focused on elections, but you're looking to acquire another commercial printer…"

"Well, there is good reason for that," Matt said, trying not to sound defensive, "food label and large format printing are growing segments. The business in *very* profitable. The cash flow it creates can even out the financial performance associated with the election cycle and provide our enterprise needed cash."

"Sure," Jack said dismissively, "but what's stopping all the other commercial printers from competing in this space?"

"Large capital investments are required," I replied, "and specialized skill sets that most printers don't have."

Jack shrugged, "You have to assume that, eventually, all of your competitors will have the same machines you have. Then those profits get competed away."

We sat for a moment in uncomfortable silence. It seemed this proposal wasn't going anywhere.

Jack broke the tension, “You know, Warren Buffett describes an ideal business as being surrounded by a moat that protects it from competing firms and alternative offerings. Election services has many small moats that keep competitors out. The capital investment barrier is high. The skill set needed is difficult to develop. Then, even after you’ve invested the money and time to do elections competently, you only get two to three major production periods per year. The cyclicality scares the competition away. On top of that, the headline risk is extreme. One mistake and you’re on the front page of the newspaper. There aren’t a lot of businesses willing to deal with that. *But*, t*hat’s a moat!* That’s defensible and leads to above average returns. That’s where I think we should stay.”

Due Diligence Questionnaire and Data Request

Now that you have an LOI in place and have thought through the competitive factors, it is time to dive deep into the particulars of the business. This starts by requesting information from the seller. This request is comprised of a questionnaire and a list of supporting documentation.

Think of the questionnaire as the opening salvo of questions for the seller. These are mostly open-ended questions designed to extract insight beyond what is evident from the financials. The questionnaire should be segmented by topic. The topics addressed should be tailored to fit the acquisition.

Even so, I will provide some examples drawn from my most recent acquisition. That questionnaire was split into: Recent Operations, Macro-Economic Conditions, Financial Anomalies and Pricing Data, Competitive Landscape, Sales Team and its Process, Critical Suppliers, Press Coverage, Enterprise Resource Planning, Customers, Employees, Material Assets and Production, and Environmental Compliance.

Let’s dive into each topic:

Recent Operations – It is important to understand any recent developments that materially affect the business. A major operational failure that results in customer loss or bad press falls into this category. Asking the seller to *“describe any notable operational issues over the last year”* is important. If you are already aware of any such issues, ask directly for the details.

Macro-Economic Conditions – This book was written in the midst of the COVID-19 pandemic that started in 2020. At the time of this writing, macro-economic conditions are of the utmost concern. Periods of economic stress, whether due to catastrophe or cyclicality, can tell you a great deal about a business and the industry of which it is a part. While I am currently asking sellers very specific questions pertaining to the pandemic, below I’ve suggested some macro-economic questions that apply at all times:

1. How would the business fare in a recession?
2. How susceptible is the business to supply chain disruption?

3. Please provide all financial statements for 2006-2010.
4. Please provide all financial statements for 2018-2021.

Having done market research, you should already have a well-defined view on how economic downturn will affect the business. Even so, it is useful to review the seller's answer and even more useful to review financial performance during economic stress. I've suggested requesting financial data surrounding the 2008 sub-prime housing crisis and the 2020 COVID-19 pandemic, but similar periods would also work. The key is to understand how revenue and profit are affected by hard economic times.

Financial Anomalies and Pricing Data – You have the basic P&L and balance sheet, but more granular data is required. Financial data always requires some explanation. The balance sheet provides principal outstanding, but a detailed debt schedule, which includes interest rate, loan term, and retirement date, will give you a better understanding of how the business is currently managing debt. You also need to understand the business' pricing strategy. Are prices high or low relative to market rate? Are the prices defensible moving forward? The following questions should provide the needed insight:

1. Please describe any anomalies or extraordinary occurrences in the presented financial statements.
2. Please provide all debt schedules.
3. Please describe how your prices have changed over the last five years.
4. Please describe your philosophy as it relates to pricing? How do you put that philosophy into practice when considering a price increase or decrease?
5. Please provide all current pricing for key products and services.

Competitive Landscape – This cuts to heart of the previously discussed Porter's Five Forces. You need to know who you will be up against. Start by asking the seller to *"list all direct competitors and discuss their market share relative to your company."* This is the type of question that generally leads to more questions. That is typical in due diligence and often a very productive exercise. As you go down the rabbit hole exploring each competitor, you will learn crucial details of the market you may soon enter.

Sales Team and its Process – A business' sales team and process are the key drivers in growing a business after you acquire it. Often, this sales engine is undeveloped. In very small businesses, the sales team may consist of just the owner. These deficiencies present both risk and opportunity.

A business without sales professionals implies that the customer relationship lies with the owner. When they sell, there is no guarantee the customers will stay. Furthermore, you will need to hire a sales force and build the tools to make it successful. That can be an expensive proposition.

On the other hand, even a small sales force can be optimized. Through strategic management and the implementation of systems and processes, a previously neglected sales force can create significant growth.

I recommend asking the seller the following questions:

1. Please describe your sales strategy and process.
2. Please provide any documents (handbooks, manuals, etc.) that describe the sales process and are used by the sales team for reference.
3. Please describe marketing efforts and their effectiveness over the prior year in the following categories:
    a. Direct Mail
    b. Email Marketing
    c. Advertising (online, print, radio, etc.)
    d. Conference sponsorship and participation
    e. Face-to-Face Meetings / Sales Presentations
    f. Other

Critical Suppliers – Competition and customer concentration are natural concerns of anyone acquiring a business. Suppliers, however, often go overlooked. Suppliers that provide the materials necessary to create your product or provide your service are critical. *Is the business dependent on a small number of suppliers? If those suppliers went out of business, could they be easily replaced?* If the answer to those questions is *yes* and *no* respectively, the business suffers from an unfavorable condition called *supplier concentration*. In terms of Porter's Five Forces, this would mean that supplier power is high and the business' supply chain power is low. To explore this issue, ask the seller the following questions:

1. Please list all important suppliers and the goods or services they supply the business.
2. For each supplier listed above, please list a supplier that could replace them and note the advantages and disadvantages of making that change.

Press Coverage – Having done acquisitions in the elections services industry, in which every mistake makes news, I am hyper-focused on press coverage and its effects on a business. Most industries are not so unforgiving. Even so, be sure to ask the seller to *"provide copies of all press coverage relating to the company for the last 3 years."*

Enterprise Resource Planning (ERP) – Most small businesses are unsophisticated in this area. ERP consists of workflow documentation from sales order to billing. These processes may be united by an overarching system or segmented. Particularly in businesses using paper-based processes, there is an opportunity to implement technology that will enhance efficiency and managerial oversight. But be careful! ERP implementation is expensive. If this is part of your plan for running the business, ensure you have budgeted for it.

I recommend asking the seller the following questions:

1. Please explain your process for:
    a. Receiving orders from customers
    b. Forwarding orders to production/operations for processing
    c. Managing work in process
    d. Shipping completed orders
    e. Billing completed orders

2. Please describe any Enterprise Resource Planning systems/technology you are using to manage the processes above and list any integrations with external technology (i.e. integration with UPS WorldShip or Intuit's QuickBooks).
3. Please state the accounting software the business uses. Is data entered into the accounting system manually or is the accounting suite integrated with upstream ERP technology.
4. Please describe the business' process for inventory management. How often is inventory counted for valuation purposes? How often is the balance sheet inventory value updated? How are adjustments made between inventory asset and cost of goods sold? Does your ERP technology integrate with your accounting software to automatically implement the GAAP matching principle as product is sold?
5. Please describe any software critical to running the business.
6. For any and all software used at the business, please explain whether it is proprietary.

These questions will give you a good sense of how business is getting done. I am a proponent of small businesses using QuickBooks by Intuit. I specifically recommend the QuickBooks Online (QBO) product because of its online accessibility, user friendliness, and functional simplicity.

Some of the questions above are born out of lessons I learned the hard way. It will be clear why I'm asking them later in this book, when we delve deeply into ERP selection and the accounting implications.

Customers – I once heard a CEO say, "The customer is not always right; but the customer *is* always the only source of revenue." Wise words. Retaining quality customers post-acquisition is crucial in continuing a successful business. It is imperative to take a skeptical look at whether key customer relationships will survive a change in ownership. The best customers provide recurring revenue. Customer concentration increases risk to the business and must be examined carefully. One rule of thumb says that a business' top five customers should not constitute more than 25% of revenue.[v] I recommend asking the seller the following questions:

1. Please provide a list all customers and their total sales amount (revenue to business) for the last five years.
2. Who owns the customer relationships, especially with respect to the business' top 20 customers by sales? If a customer has a serious complaint, who provides direct customer service and support?
3. Which portion and what percentage of the revenue is recurring? Please provide details as to why this is the case.
4. How much of the recurring revenue is the result of active contracts? Please provide all customer contracts.
5. Please provide a summary of significant customer complaints over the past 3 years.
6. Please provide a summary of significant customer losses over the past 3 years.

Employees – A business does not run without employees. In any acquisition, it is crucial to identify *key man risk*. Which employee departures would threaten the near-term operations of the business? How are the employees compensated? What are their benefits? Have conflicts with employees occurred in the recent past? I recommend asking the following questions:

1. Please list all vital employees and their job functions. In your estimation, how long are they each likely to stay with the company?
2. Please describe all employee-related problems over the past three years, including claims of alleged wrongful termination, harassment, or discrimination.
3. Please describe employee healthcare benefits.
4. Please describe all qualified / non-qualified retirement plans. *Note: Qualified retirement plans are those that comply with the 1974 enacted Employee Retirement Income Security Act (ERISA) guidelines. Examples of qualified plans include Simple IRA, 401k, 403b and profit sharing. Examples of non-qualified plans include deferred compensation plans and split-dollar life insurance plans.*[vi]
5. Please describe all other employee benefits.
6. Please provide all agreements between the company and employees (contracts, special arrangements, etc.).

Material Assets and Production – Time to dig into the particulars of how the product is being manufactured. Obviously, this is of limited applicability to service businesses. I recommend asking the seller the following questions:

1. Please provide a list of all production assets and their fair market value.
2. Please describe your production process in detail.
3. To what extent are subcontractors used in your production process?
4. Please list all subcontracted companies.
5. Please provide amount spent per subcontracted company per year for at least five years.

Environmental Compliance – Compliance with environmental standards is essential. Even if you are not buying the real estate on which the business operates, you must complete environmental due diligence. Should a serious environmental issue be found post-acquisition, your business operations could be seriously disrupted by remediation efforts, costing you time and money. I recommend asking the seller the following questions:

1. List all hazardous materials used in operations.
2. Describe the business' disposal methods of hazardous materials (HAZMAT).
3. Please provide copies of all Phase 1 inspections for the real estate upon which the business operates.
4. Please provide copies of all communications with the EPA.

For your convenience, I have compiled these due diligence questions into a questionnaire in Appendix A.

Sea Story

(Un)Representative Financials

I ended my call with Matt and buried my head in my arms, which were crossed upon the desk. My fears had been realized. I slowly raised my head to look at the clock. As I did, a red *4* on a black screen flickered and became a *5*. *Five minutes 'til midnight*. Rain battered my office window and thunder rumbled softly in the background. *A dark and stormy night indeed*. How could we have missed this? Neither of us asked the right question, but this was a financial oversight and I was most to blame. After all, I was supposed to be wearing the CFO hat. This was the kind of mistake that left the company woefully undercapitalized. This failure could culminate in bankruptcy.

Tomorrow was a new day. I planned to get to work promptly with hopes of mitigating our newly understood financial challenges. It was too late and I was too tired to do anything just then. So, I took about half an hour to sit and think about how I would conduct diligence differently if I had it to do over again…

The election business is subject to a four-year cycle. Even numbered years include three high turnout elections, culminate in either a gubernatorial or presidential general election, and produce impressive financial results for election services companies. Odd numbered years include a spattering of local elections and drain election vendors' resources. Seasonal businesses are challenging because they only make good money during one period every year; these challenges are amplified when feast and famine occur on a multi-year schedule. An election vendor must effectively budget for off-years if it hopes to survive.

The election company we acquired had provided five years of financials, a standard look-back period for a business its size. The five-year period contained one full election cycle – starting in the 2014 gubernatorial year and ending with the 2017 off-year. The elections years looked great! The 2014 gubernatorial year had recorded $2.3 million in revenue and the 2016 presidential year booked $3.8 million. Both showed profit margins in excess of 35%. As expected, the off-years were a challenge. 2015 achieved $1.2 million in revenue and 2017 only $510k, leading to net profit losses on the P&L.

These historical results were key to calculating how much working capital would be required to successfully run the business from the election year windfalls through the off years. Having conducted research, we appreciated that off-year elections were conducted on an *as needed* basis by each local government, making revenue difficult to project. Even so, we were heartened that 2015 (and presumably other years just before the nation geared up to elect a president) tended towards higher revenue.

The acquisition closed mid-2018 and that year finished as expected. *But then something changed*. It was now September 2019 and year-to-date revenue was only $420k, nowhere near the $1.2 million of 2015. At first, we had assumed that local elections were required more seldomly than four years prior, that we were experiencing the ugly side of idiosyncratic off-year risk.

But that wasn't it at all. Matt had done a call earlier that evening with the business' former owner. He learned, for the first time, that there had been a state-wide election in 2015. State-wide off-year elections were not the norm, occurring only out of rare legislative necessity. This oddity had not been disclosed to us. There were no footnotes in the company financials, nor had the sellers mentioned it in conversation.

We now knew that 2019 should look like 2017 rather than 2015. Indeed, we finished the year with $500k in revenue and were left with the cash flow challenge of coming up $700k short of plan.

Worst of all, we had not asked the right questions…

The moral of this story is clear. A buyer must never assume that presented financial results are a reasonable indicator of future performance. A buyer must ask pointed questions designed to draw out extraordinary circumstances not likely to repeat. *Is there any reason the historical financial statements are not a good indicator of future performance? Is it safe to assume that the financial performance in a given year will be generally repeated four years later?* The answers to these questions would likely have saved us a great deal of pain.

Years later, at the time of this writing, the business is still undercapitalized, though quickly recovering through organic growth efforts. Even so, failing to interrogate a seller regarding the predictive value of historical financials is a mistake I won't make again.

Sea Story

I Do Everything Around Here!

Matt and I diligently took notes as we sat and talked with Terry, the owner of Riverside Graphics. This was the first commercial print acquisition we'd considered. So far, diligence was going well.

This was our second site visit. Terry had given us the tour. The production area had been shut down for the night, but stacked paper sheets staged by hulking Heidelberg printing presses indicated a busy day and busier tomorrow. The administrative areas showed wear. The industrial-grade carpet looked as though it hadn't been cleaned in twenty years and the egg white walls needed a new coat of paint. Terry's lack of tidiness was evident in his conference room, which was lined with desktop computer towers, all at least ten years old. His office was worse. Framed posters hung askew on the walls and stacks of print samples formed mounds on every surface.

This clutter, however, stood in contrast to how he ran the business. The ERP system was ancient, but tracked every aspect of workflow, including time spent producing each job. Price estimation was systematized and the business knew its costs down to the penny. We were impressed.

Our discussion had gone on for about half an hour. We'd been back and forth on nearly every aspect of the business. I leaned back in my chair as Terry finished explaining how diverse his customer base was and how quickly his customers paid their bills. As the discussion started to wrap up, I bent down and began to gather my belongings. As I did, Matt asked, "Terry, one last question, what do *you* do here on a day-to-day basis."

Pride shone in Terry's eyes. He smiled and let out a sigh. "Well," he said with a chuckle, "I do *everything* around here!"

As he elaborated, it became clear that was not strictly true. Even so, he *had* personally retained many critical business functions. He was providing customer service to about a third of the accounts. He was doing all of the price estimation and job quoting. He was overseeing proof checks. He was making accounting entries. Worst of all, he was invoicing each and every job himself.

The disconnect between us was enormous. Terry took pride in his expert execution of these tasks. He knew he would do them best. He wasn't about to let one penny get away by delegating these critical functions to an employee.

The problem was, upon completion of the acquisition, he was leaving.

Terry leaned forward in his chair expecting us to be impressed. I struggled to conceal a frown. Terry's micromanagement had prevented the business from developing systems. All of Terry's hard work made his business less valuable to us.

In any small to mid-sized business, the owner will spend some time tending to the business' day-to-day tasks. In his book *The E-Myth Revisited*, Michael Gerber calls this working *in* the business as opposed to working *on* the business. When conducting due diligence, it is vital to gain a full understanding of exactly what the seller is actually doing. Systems and processes make it possible to responsibly delegate critical business functions. The more of these systems the seller has put in place, the more valuable the business is. A wise buyer will ensure these considerations are reflected in the price.

The Process

Outsourced Professional Diligence

Unfortunately, you can't properly accomplish all diligence yourself. Some areas are best researched by specialized professionals. A good lawyer and smart accountant are indispensable partners in the due diligence process.

Legal Compliance

To complete the diligence process, you will need to partner with an attorney specializing in business law. This attorney should be experienced in contract analysis and business acquisition. The following topics should be diligenced:

Debts – Your lawyer should understand the business' existing debt. Most of these will be settled at close (business acquisitions are usually on a *debt-free, cash-free* basis). However, special attention must be paid to any debts that will be transferred to your ownership. Equipment leases are an example of a debt obligation that may be transferred to you.

Pending and potential law suits – Your lawyer should investigate any pending or potential law suits against the company. This is particularly important if conducting a stock purchase because liabilities remain after control is passed to you. However, even in an asset purchase, this must be understood. Beyond the fact that law suits can be indicators of a troubled business, some liabilities remain with the business even after an asset sale. These *transferee or successor liabilities* vary state by state, but tend to include Title VII[1] matters such as race-based discrimination and sexual harassment.

Leases – Your attorney should advise you on leases that are intended to survive the acquisition. Building and equipment leases are the most likely to come up. In the case of a stock purchase, you need to understand the provisions of the business' leases as they relate to a change in control. In the case of an asset purchase, you must understand whether the leases are *assignable* – meaning they can be transferred to you post-acquisition. Manufacturing equipment leases are usually assignable. Often a seller who owns both business and real estate, will sell you the business, but rent you the facility in which it operates. When this is the case, your attorney should carefully review the seller's proposed lease to ensure that it is fair.

Contracts – Contracted revenue is a highly desirable characteristic in an acquisition target. However, you must be sure that a change in control of the business does not void those contracts. Agreements with suppliers are equally important. If change in control were to void a contract guaranteeing special pricing, costs under your ownership might be much higher than anticipated.

<u>Tax Compliance and CPA Verification</u>

No matter how strong your background in finance and accounting, certain due diligence functions should be outsourced to a certified public accountant (CPA). These include proof of cash, quality of earnings (QofE), and employee tax verification.

Proof of Cash – A proof of cash is similar to a bank reconciliation, but more detailed for the purpose of catching fraud. It assesses bank statements by scrutinizing account activity. Bank statements are broken down according to the following formula:

$$Beginning\ balance\ +\ Cash\ receipts\ -\ Cash\ disbursements\ = Ending\ balance$$

The CPA seeks to understand each cash inflow and outflow to ensure the adequacy of the bank reconciliations and the appropriateness of all transactions.

[1] Title VII is a section of the Civil Rights Act of 1964.

Quality of Earnings (QofE) – A QofE analysis seeks to represent the earnings a buyer should expect post acquisition by eliminating anomalies from the financial data. Such anomalies include extraordinary items and accounting sleight of hand. A CPA performed QofE serves an important check on the financial work you've already done. QofE earnings should be similar to your determination of adjusted EBITDA. If this is not the case, it is important to understand why. Nothing is more dangerous than buying a business based on misrepresented financials.[vii]

Employee Withholding Tax – When a business struggles, owners are tempted to preserve cash by leaving employment taxes unpaid. This is a dangerous practice. Employment tax liability is not limited to the business. To collect, the IRS can pursue the personal assets of the business' owners, executives, and anyone else with power over business finances.[viii] *But doesn't acquiring the business through an asset purchase protect the buyer from such a liability?* Maybe. Certain liabilities survive an asset purchase. These are called *transferee* or *successor liabilities*. These vary state by state, so be sure to understand the law as it applies to you. *But wait, it gets worse!* Employment tax liability is not dischargeable in bankruptcy, so you owe it until it is paid.

The Process

Real Estate Due Diligence

<u>Environmental Due Diligence</u>

The decision to buy or lease the business real estate will be addressed later. Either way, you need to conduct environmental due diligence. If entering into a lease, you need the assurance that environmental problems will not disrupt business operations. If buying, you need to understand the condition of the asset and the liabilities associated with it.

The Environmental Protection Agency (EPA) provides standards for environmental due diligence, which are implemented by Environmental Professionals (EPs). These EPs decide the scope of the assessment. The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) determines who is ultimately responsible for contamination.[ix]

The following are the stages of environmental due diligence. An Environment Site Assessment (ESA) is a report that seeks to identify possible contamination on site. The report considers past uses of the property and the likelihood of contamination. The phases of an ESA are described below:

- *Phase I* – Consists of an analysis of past events on or around the property to determine the potential for pollution obligations. Does not include invasive sub-surface samples. Upon conclusion of Phase I, an EP will summarize the results and recommend remediation steps. Any condition identified as a *recognized environmental condition (REC)* will likely lead to a Phase II ESA.
- *Phase II* – Includes gathering soil, groundwater, and/or building material samples to be tested for contaminants. This provides direct evidence regarding the extent of onsite pollution.

- *Phase III* – Includes any additional testing required to determine the required remediation of the property.

Buy or Lease

If the business owner also desires to sell the real estate, the decision to buy or lease can be difficult.

In his book *Buy Then Build*, entrepreneur Walker Deibel indicates his preference to keep real estate investments and business acquisitions separate. After all, these are fundamentally different asset classes. He does, however, note that acquiring real estate along with a business adds the benefit of bankable physical assets to the deal. Real estate acquisition can also be used as leverage in negotiations between buyer and seller.[x]

Sea Story

I Have Much Better Offers, But…

“Listen, guys,” Terry said impatiently, “I have better offers on the table. Two local printers have offered over a million dollars for my business.”

Randy, the business broker, raised his eyebrows, interested in how we would respond.

Matt leaned back in his chair. “OK,” he said in a puzzled voice, “why then are you still talking to us?”

“Well,” Terry replied, sounding conflicted, “those offers are shut down deals – print companies that wanted to serve my customers from their facilities. I don’t want to see everyone here lose their jobs,” he paused a moment, “Also, you agreed to buy the real estate, which is helpful since I plan on moving to southern California.”

There it was! Terry’s pain point and our leverage!

Negotiations proceeded quickly from that point. We acquired the business at a very attractive price because we agreed to pay market price for the real estate. A couple of years later, we flipped the property to a real estate investment company, producing $250k in free cash for the business. We locked ourselves into a 10-year lease in the process, but it was well worth it.

Cost Segmentation Study for Accelerated Tax Depreciation

If you do acquire the real estate, consider having a cost segmentation study conducted on the property post close. The standard IRS treatment is to apply straight-line depreciation (equal dollar amounts) to commercial real estate over a 39-year period. A cost segmentation study can provide your tax CPA a basis for depreciating certain property assets over shorter periods, meaning you get the tax benefits sooner.

We have had success partnering with Tri-Merit Specialty Tax Professionals to conduct this study. Tri-Merit describes this service as follows:

Cost segregation is a commonly used tax planning strategy and a smart way to increase cash flow by accelerating the depreciation of commercial building costs. Many businesses overlook cost segregation, but it can save a company thousands of dollars a year.

A ***cost segregation ("cost seg") study*** *is an in-depth engineering analysis of the depreciating value of long-term fixed assets, like newly constructed buildings, property acquisitions, and renovations. From this data, companies can* ***accelerate tax deductions*** *and improve their cash flow.*

A quality engineering-based cost segregation study from Tri-Merit allows building owners to write off their building (new and existing) in the shortest amount of time permissible under current tax laws. The favorable depreciation rules contained in the Tax Cuts & Jobs Act (TCJA) create incentives for the greater use of cost segregation studies.

It's important to work with a partner that has the right experience and can deliver a quality study that meets all IRS guidelines—a partner like Tri-Merit.

Chapter Summary

The Essential Process

Once under LOI, begin due diligence (DD).

1. Quantitative financial analysis (conduct internally with your team)
    a. Create P&L Format Cash Flow Model – designed to mimic free cash flow (FCF) under your ownership
        i. Conduct trend analysis to understand the ebbs and flows of the business' finances.
        ii. Scrutinize add-backs that adjust net operating income to adjusted EBITDA.
        iii. Reduce adjusted EBITDA by acquisition debt service, expected CAPEX, and business taxes to arrive at FCF under your ownership.
        iv. Once you understand the FCF that is expected to be created (or drawn down) each month, build a running cash balance into the model. This is an estimate of monthly bank balances – make sure it never falls below zero!
    b. Pay attention to profit margins
        i. Low margins businesses aren't worth the hassle.
        ii. Very high margin businesses might have unsustainable pricing.
    c. Carefully review the balance sheet
        i. Pay attention to the working capital required to operate the business. The key elements of working capital are cash, A/R, inventory, and A/P.
        ii. Since the seller will take the cash at close, negotiate the business' retention of enough A/R to secure a working capital line of credit. You will need cash on Day 1!
2. Qualitative analysis will help you understand the industry and how the business fits into it (conduct internally with your team)
    a. Consider how the business relates to Porter's Five Forces.
    b. Send the seller your due diligence questionnaire (see Appendix A) for an example.
    c. Don't assume that historical financial performance is a reasonable predictor of future performance. Ask the seller directly if the historical financials contain any extraordinary circumstances.
    d. Be sure to understand the day-to-day of the seller. The less the seller does *in* the business, the more valuable the company is to you.
3. Legal compliance (partner with a good lawyer)
    a. Understand the business' existing debts, especially those that will transfer to you.
    b. Investigate pending and potential lawsuits against the company.
    c. Understand the business' current leases and whether they are assignable to you.
    d. Ensure contracts with customers and vendors are assignable to you.
4. Tax compliance (partner with a good CPA)
    a. A Proof of Cash analysis can help identify accounting fraud.
    b. A Quality of Earnings (QofE) analysis helps a buyer understand the business' true FCF.
    c. Ensure the seller is not behind in paying employment withholding tax.

5. Environmental due diligence (partner with environmental professionals)
    a. The EPA seeks to understand potential contamination at a site through an Environmental Site Assessment (ESA).
    b. ESAs have three phases. Phase I is non-invasive and should always be done.
    c. Subsequent phases are conducted if warranted by Phase I results and involve ground samples.

The Essential Partners

- BizBuySell.com – find businesses for sale
- Axial.net – aggregates businesses for sale and tracks deal progress
- Tri-Merit Specialty Tax Professionals – cost segregation study that can accelerate depreciation tax benefits on purchased real estate

The Essential Library

- HBR Guide to Buying a Small Business by Richard S. Ruback and Royce Yudkoff
- The E Myth Revisited: Why Most Small Businesses Don't Work and What to Do About It by Michael E. Gerber
- Buy Then Build by Walker Deibel

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