Buying a Mid-sized Business: Getting Qualified as a Buyer

In the first article I described the advantages of hiring a business broker to help you find, evaluate and purchase a business. Private searches can do wonders for business buyers. In the second article I discussed how to find a qualified broker. Now let's talk about how to get you qualified as a buyer.

There are two people you need to convince – the broker and the banker. The banker needs to be convinced you are a good risk. The broker, however, is your immediate concern. He or she needs to be convinced that you are committed to purchase something. Helping a buyer to purchase a mid-sized company will consume months of that broker's time. Before the broker accepts you as a client, he'll need to be convinced that you are committed to buying. That is the focus of this article – convincing the broker to accept you as a client.

We don't like to admit it, but brokers often refuse to accept buyers who are newly laid off. Why? Most of the newly freed are not serious about buying a business. It is merely an alternative to finding a job, which is usually their goal. Brokers cannot afford to invest their time in prospective buyers unless the buyer is deadly serious about buying.

On the other hand, people who have been out of work for over a year often make great buyer agency clients. They are serious and they are committed.

If you are a born-again job seeker, don't waste a broker's time. It's a form of stealing. On the other hand, if you are committed to buying a company, be prepared to convince the broker that you are serious. I'll explain how shortly, but first let's talk about the two types of buyers: individuals and corporations.

Why do businesses buy other firms? That's simple. They want to acquire something of strategic value, such as territory, customers, products, or facilities. Each need is specific and mission-critical. From a broker's point of view, corporate acquisitions are comparatively simple and straightforward. The needs are well-defined, which makes finding targets much simpler. Lenders are generally eager to fund corporate acquisitions, and the caliber of their professional advisors (lawyers, accountants, tax advisors, etc) is usually top-notch. I love helping companies buy other firms.

Why do individuals want to buy a company? They want to buy a job or a lifestyle. Individuals generally have no clear idea of what they want to buy or why, but they'll often say, "I'll know it when they see it." This phrase is peculiarly unhelpful to broker and buyer alike, but it is oh so true.

When working with individuals, often the biggest challenge is to help them define what to search for. That being said, I have never, ever had an individual purchase the kind of company they originally set out to find. Never. That's part of the challenge, but it also a large part of the fun and adventure of helping individuals.

Let's get back to helping you to get qualified as a buyer. If your intent is to wander around the MLS wilderness until something strikes your fancy ("you'll know it when you see it"), don't be surprised if the broker isn't eager to act as a guide. Their time is valuable and not renewable. They only get paid when you buy something, so engage that broker to conduct a private search on your behalf, be sure you're committed to buying something worthwhile.

What if you're serious but newly laid-off? Do your homework. Know what general area you want to search in, exactly how much cash you can put down, and what industry you wish to work in. Then you'll be in a better position to convince a broker to take you on as a client.

Do you want to look really buttoned up? Then prepare an income statement, balance sheet and brief, functional resume for the broker to review. These documents will be helpful to the broker, but, more importantly, they are the tools needed to help you get a "qualified pre-approval" from bankers. Lenders will look carefully at your credit score, education, work, and industry experience. Showing up with financial statements and a resume can make a real difference.

Smart brokers will evaluate your ability to buy and your commitment to buy. If satisfied with both, they'll ask you to sign a buyer agency agreement. By offering the agency agreement to you, the broker is offering to conduct the private search, commit months of their time and effort, and take on the risk they you will actually purchase a firm. That's a huge risk for the broker, and it no small risk for you.

So, be prepared to commit to the broker who is committing his most precious asset to you, his time. Sign the agency agreement, and be ready to buy something great.

The broker will then conduct the private search, qualifying prospective sellers, and presenting to you those firms that match your criteria (and some that don't but might still be worth investigating.)

Once you and your broker have selected a firm to purchase, then the second part of the loan process will kick in – qualifying the business for a loan.

At this point you have decided to engage a broker to conduct a private search solely on your behalf. You have interviewed and selected a broker that you want to work with, and, with the suggestions above, you've convinced that broker that you will buy something worthwhile by providing the broker with a geographic area to search within, a general industry (such as retail, manufacturing, distribution, services) to search for, financial statements, a brief resume, and a detailed description of the sources for and amount of your down-payment.

The next step is to get "pre-approved with a lender," which is a good topic for next time.

At this point, the bankers have already reviewed your finances and background. Now they'll carefully examine the business you wish to buy.

Bankers believe that a firm's past is the best indicator of its future performance, and that last year's numbers are the best predictor of next year's financials. If the target company generated enough excess net income (cash flow) to cover the loan payments AND to pay you a reasonable salary, then the bank will likely loan the money.
The size of your down-payment is important. Some businesses can be financed with as little as 15% down, but most require 25-35%, with some cash flow and manufacturing businesses requiring even more. Cash flows businesses are those that have no significant assets but generate a ton of cash. Accounting services, insurance agencies, mortgage and business brokerages, real estate offices – these are all examples of cash flow businesses.

Where can you get enough money for a down-payment? There are three sources of funds commonly used.

1) Cash & near-cash equivalents. Convert your stocks, bonds and liquid assets to cash.
2) Home Equity Line of Credit ("HELOC"). Banks can loan against the equity in your home. They lend up to 90% of the net fair market value, that is, the value of your house today less anything still owed on the house.
3) Retirement funds. There are companies, like Guidant Financial and BeneTrends, who will help you convert your IRA and 401(k) into cash for acquisition purposes.

These three components combined become your down-payment. You can usually multiply your down-payment by four to estimate the maximum purchase price.

An example might help. Let's say that you have the following assets available.

a) Cash: $ 50,000
b) HELOC: $ 150,000
c) Retirement: $ 100,000

That gives you a total of about $300,000 in cash. Let's hold back $50,000 for working capital and other needs, leaving $250,000 for a down-payment. So just how big of a company can you buy?

Description	**Input**	**Calculated**
Company's Annual Revenues	**$ 2,500,000**	
Net Income Last Year	**$ 250,000**	
SP Model: X times NI plus Inv	**4**	**$ 1,000,000**
Selling Price as % of Revenues		40%
Return on Sales % (NI/Revs)	**10%**	$ 250,000
Down payment as % of SP	**25%**	
Down payment Funds		**$ 250,000**
Loan Amount		$ 750,000
Loan Interest Rate (prime plus 2)	**10.25%**	0.8542%
Loan Term in Years	**10**	120

Annual Debt Service		$ (120,185)
Owner's Estimated Benefit		**$ 129,815**
Return on Invested capital		**51.93%**

With $250K down, you can probably get a loan for around $1,000,000. If your credit history is strong, and you have a college degree and applicable work experience, then you'll probably qualify as a buyer. So how do the numbers above work in your favor?

This company is generating revenues of $2.5 million with 10% going to the bottom line. The selling price is four times the net income, which is common. With your $250K down-payment, the loan amount is $750K. If the loan is for ten years at two points over prime, the APR would be 10.25%, a typical business loan rate in today's market. The annual debt service of about $120K will come out of the net income, leaving the buyer with an estimated annual salary over $129K! This model has a 10% return on sales, and a whopping 52% return on investment. Banks will line up to loan money on this investment, and you'll soon be working 90 hours a week at your new adventure!

Next month, let's continue defining and exploring the buying process.