Are You A Virgin?

Have you bought many businesses or is this purchase your first business purchase – Are You a Virgin?

Few people buy or sell more than one business in a lifetime, this means that the other party has an advantage over you – he or she has almost certainly engaged an experienced agent (be it a Business Broker or Corporate Advisor) to get the best deal for him – this means they are paying someone to get you to pay more than you probably should.

Any virgin buyer is in danger.
We have witnessed friends and acquaintances being bullied into bad deals. Franchises with their implied promises of a guaranteed system for a locked in fee can be particularly dangerous. The same principles hold for larger businesses. The total amount at risk obviously increases with the size of transaction, but our experience is that smaller transactions with less sophisticated buyers are often the most flawed.

We recently looked at 2 fast food franchises for a friend. In both cases, once a commercial wage was included for the Owner/Manager they were loss making. In one the owner could work 50 hours per week for $10 an hour to breakeven or if they paid someone $45,000 for the role the business lost $20,000. The expectation was that it would sell for $200,000. A person that was capable of earning $50,000 in a job could earn that, have their $200,000 invested earning 4% and not risk their savings. So they would be earning $58,000. By contrast, if they purchased this particular franchise, they could work 50 hours per week for $25,000 a year and risk losing some or all of their $200,000 while earning zero return on the money. Our friend earned $300,000 in their day job, their wife $80,000, luckily we helped them avoid the lunacy.

There are 2 particularly critical concepts for buying businesses that you must learn.

1. The first is this concept of defining earnings as being after the payment of a commercial wage for the owner/operator, not before it. Otherwise you are effectively buying a job, one that if you are a capable purchaser, you could get without buying it and having your money at risk.

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2. The second concept is around add-backs and stock. If the expense was needed to be incurred in the ordinary course of business, then it should not be ‘added back’ (thereby inflating earnings). Thus a car that is substantially for deliveries is not an add back, nor is required equipment purchases. Likewise if a level of stock is required to deliver a level of earnings, if you are paying for the business based on a multiple of earnings, the stock cannot be added back. Business Brokers often quote a price for a business + SAV. It is not a German sausage reference, it stands for Stock At Valuation. SAV is a danger sign that the broker is framing things for you to pay twice.

Understanding the sustainability of earnings, the level of annuity income justifying the purchase price and understanding market value for a given business is fundamental to you not being taken for a sucker. Supplier or customer concentration, excessive stock or SKUs and one-off earnings are some other traps for younger players. Whether the purchase price is $200,000 or $20,000,000, if you don’t spend your day buying and selling businesses, expert advice will save you money; either on the purchase negotiation or by avoiding the purchase altogether.

We have heard too many horror stories of decent people losing their life saving on botched business purchasers. While it is caveat emptor (buyer beware), please get expert advice so you are buyer aware to the tricks and traps for virgin players.

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