

Brooks Newsletter

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FUNDAMENTAL CONSIDERATIONS WHEN PURCHASING A BUSINESS

Deciding whether to start or purchase a business (and in which industry) is likely one of the most important decisions you will ever make. This latest edition of our Newsletter provides a list of questions to ask and issues to consider when going through this decision-making process. Most importantly, ensure that you obtain as much information as possible with respect to the business and its corresponding industry and consider all possible alternatives; only then can a truly informed decision be made.

A. Issues Prospective Purchasers Should Consider

I. The Business Generally

- 1) Why do you want to buy this particular business? This fundamental question should be answered in a detailed and comprehensive manner.
- 2) What are the advantages and disadvantages of purchasing this business? Have you compared the cost of buying the existing business with the cost of starting a new business?
- 3) Can your resources (time, money, capital, *etc.*) be utilized in a more productive alternative investment which better suits your goals, requirements, skills and vision? What is the **opportunity cost** of this acquisition?
- 4) Have you thoroughly researched and evaluated all the information available with respect to this particular business, the industry in general and the overall economic value of the business?
- 5) What do you expect in return for purchasing this business?
- 6) What liabilities will you be assuming upon closing?
- 7) What skills, resources and contacts can you bring to this business to make it more profitable, efficient and productive?
- 8) What is your previous exposure to this industry? What lessons have you learned from your past dealings within this industry and, if applicable, this particular business?
- 9) Do you have the network to provide the base of contacts required for this business venture or will you have to develop a new set of contacts?
- 10) What are you willing to give up in terms of price, assets and financial capital in order to acquire this business? What do you expect in return? Are your expectations reasonable?
- 11) Can you engineer growth and expansion of market share, client base and product/service lines? How will you capitalize on such opportunities and what resources will be required?
- 12) Can any synergies be identified and quantified which will assist you in calculating the purchase price? Can you immediately exploit such synergies post closing without added expense or resources? If you cannot, what expense and resources are required to realize such synergies?
- 13) Have you and the vendor agreed upon the general terms of the transaction? If so, what are the terms? How have you papered the transaction thus far (*i.e.*, letter of intent, oral agreement, correspondence)?
- 14) Have you obtained the advice of professionals such as lawyers, accountants, business valuers or others with specialized knowledge? If so, do they have experience within the specific industry in question?
- 15) Have you determined what legal structure you should use to complete the transaction (*i.e.*, sole proprietor, partnership or a new/existing corporation)?

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II. The Vendor

- 1) Who is the vendor, and why is he/she selling the business (*e.g.*, does he/she have alternative business opportunities that he/she is pursuing or is the target having trouble generating business)? If you can understand why the vendor is selling, you can implement appropriate strategies prior to and upon completion of the transaction to counter any potential setbacks or capture any opportunities. You can also use this information to assist in your negotiations.
- 2) Have you inquired into the vendor's business reputation and track record in the industry from sources such as customers, current or former employees, competitors, industry associations and others familiar with the business? Will you inherit the vendor's good/bad reputation? What strategies should you put in place to transfer/alter the reputation (depending on whether it is a good or bad reputation)?
- 3) Are the vendor's principals required for a transition period? Are they willing to sign a Consulting Agreement to provide support and training for you for a defined period of time and on defined terms if required post-closing?
- 4) When does the vendor want to complete the transaction? Does the timing work for you?

III. Assets and Location

- 1) What are the assets of the business or the items of value to you (*e.g.*, customer lists, intellectual property, goodwill, key equipment, *etc.*)? Do you have a complete list of the assets? Which assets are not for sale and why? Have the assets/equipment in question been appraised to determine their value *vis à vis* the purchase price?
- 2) If you are not buying the entire business (*i.e.*, you buy specified assets such as machines or trucks), what investment is required before you can make the business

“whole”? How much investment in terms of capital and labour will you have to invest before it can be a “complete business” as you envision? Can you afford the investment of time and resources?

- 3) Are the assets primarily tangible or intangible assets? If tangible (*e.g.*, equipment and inventory), are they modern and in good condition?
- 4) Has the business protected its intellectual property by using trademarks, patents and copyrights?
- 5) How sensitive is the business to an industry and/or economic downturn? What can be done to cushion such risks (*i.e.*, can the business' assets and resources be utilized in another manner to generate revenue if the core business is suffering from a downturn)?
- 6) Do you want to continue operating the business at the current location? What are the terms and conditions for remaining at the current location and how do these terms impact your ability to proceed with the acquisition?
- 7) What proportion of the value of the business is tied to its specific physical location? If you are required to move locations does the value of the business diminish significantly or is the value transferable to different locations?
- 8) Is the property in which the business operates leased? If so, what is the term of the lease? Is the rent reasonable or should you consider having it re-negotiated prior to closing? Is the lease in good standing? Are there any renewal rights at the expiry of the lease? Can you negotiate additional renewal rights or an extended term as part of the transaction and if so, at what rent?
- 9) Have you asked other business owners in the area (geographic/industry) about their thoughts on the business and the general economic viability of the area/business/industry?

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IV. Other Due Diligence

- 1) Have you conducted all the appropriate searches including PPSA (Personal Property Security Act), bankruptcy, internet and other corporate searches on the vendor and its principals?
- 2) What liabilities will you be assuming when the transaction closes?
- 3) Have you engaged in “boots on the ground” research (*e.g.*, assessing customer flow, taking samples of inventory, conducting environmental assessments, *etc.*)?
- 4) Have you selected the person in your organization to conduct the due diligence?
- 5) Have all material documents been obtained and examined thoroughly?

V. Financials

- 1) How will the purchase price be determined and allocated (*i.e.*, will it be based on multiple of earnings, revenue or book value, will goodwill be considered, *etc.*)?
- 2) How has the transaction been structured, is it for cash, shares, property or some other form of consideration or a combination thereof? Have you considered all potential closing costs and expenses when calculating the purchase price and required capital? What is the adjusted cost base of the shares (if a share transaction)?
- 3) Have you been provided with financial statements (audited or pro-forma) for the business? Try and obtain financial statements for the past three fiscal years if available.
- 4) What is the “quality” of the financial statements/other information that you have received? Is the information current or out-of-date? Who prepared the information - was it prepared by a professional accountant or was it prepared internally? Have the statements been audited? Have the statements been prepared in accordance with GAAP?

- 5) Have you had the financial information reviewed by your financial consultant and accountant? Have you developed detailed and quantified projections based on reasonable assumptions and expectations? Ensure all forecasts and projections are normalized and adjusted to realistic market-based values, and that all facts, figures and numbers used are reasonable.
- 6) What do the projected calculations and forecasts for performance indicate about the first year, post-closing?
- 7) What financial information do you still require?

VI. Employer/Employee Relations

- 1) Who are the key employees of the business? Do you require their services post closing?
- 2) Can you successfully transfer the vendor’s employees without losing value in the relationship (and the business)? If not, what can you do to minimize any negative consequences that will arise due to the business losing them?
- 3) How do you plan to eliminate employees that do not meet your requirements? How do you maintain the balance between employees you want to keep and those you want to terminate without diminishing value from the business?
- 4) Is there a union involved?
- 5) Are the employees’ compensation arrangements and government withholdings up-to-date and is their compensation in line with industry standards?

VII. Customers

- 1) What are the business’ customer profiles? Does the business predominantly have small or large customers?
- 2) What is the bargaining power of the business’ customers? What credit terms do customers enjoy?

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- 3) What is the quality of the business' receivables? Does the business suffer from a high percentage of bad debts?
- 4) Does the business have consistent sales throughout the year or is it subject to seasonal sales?

VIII. Suppliers

- 1) Who are the critical suppliers of the business?
- 2) What is required to ensure a long term supply of the business' critical goods/services?
- 3) What supply terms exist with the business at present and if they are favourable, will the suppliers continue providing you with such terms?
- 4) What leverage do you have with suppliers? How can you utilize such leverage to improve the business?
- 5) Are there better alternative suppliers to consider (*e.g.*, more cost-effective, better quality or better logistics)?

IX. Competitors

- 1) What opportunities/threats exist for the business?
- 2) Who are the business' competitors, and what are their strengths and weaknesses?
- 3) Can competitors use the transfer of the business as an opportunity to take advantage and acquire customers, employees, goodwill, suppliers and other valuable assets/stakeholders from the business? If so, what would be the result of such losses? What value does the business hold for you in such an event?
- 4) How can you attract business away from competitors? Do you have other businesses, skills, knowledge that may allow you to offer a better "value" of services for competitors' clients? Can you, and how do you, convey this message to competitors' clients?

X. Regulatory Considerations

- 1) What legal obligations are you required to undertake after buying this business? What licenses and permits do you require (*e.g.*, liquor license if a bar)?
- 2) Has the vendor operated the business in compliance with applicable laws and regulations (*e.g.*, environmental laws)?
- 3) Do you require any governmental approvals or consents in order to purchase the business?

XI. Tax Issues

- 1) What tax issues should be considered with respect to this business and structuring the transaction?

XII. Financing

- 1) How are you financing the acquisition (*e.g.*, personal, bank loan, private sources)? Have you finalized arrangements to have financing in place by closing?
- 2) What is the suitable level of debt to equity in the industry for this business (will your ratio be within industry standards)? How does this business compare with the industry standard?
- 3) In your projections/forecasts, are there any periods when cash flow will be tight and supplementary financing may be required? Is there a margin in the financing you have available to cover fixed and other costs in case of a downturn?
- 4) Do you have the finances required to maintain your lifestyle without having to divert funds away from the business?
- 5) Are you, your family and your other businesses able to cope and withstand a significant economic loss as a result of this transaction?

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B. Important Terms in the Agreement of Purchase and Sale

- 1) How will the transaction be structured? Will the purchase price be composed of cash, shares, property or some other form of consideration or a combination thereof? Have you considered the use of vendor take back financing? What are the terms of such financing compared to rates and terms available from alternative sources of financing? What are the costs and benefits of using the vendor as a source of financing?
- 2) Is a portion of the purchase price to be in the form of a deferred payment? Have you structured the transaction to include an earn-out provision or other mechanism which can adjust the purchase price based on the target's future performance or performance up to the date of closing?
- 3) What agreements are you going to require from the vendor in order to protect your investment? Consider Non-Competition, Non-Solicitation and Confidentiality Agreements. If desired, is the vendor willing to sign a Consulting Agreement to provide support and training to you for a defined period of time and on defined terms?
- 4) What representations, warranties, covenants and conditions do you require from the vendor as part of the transaction?
- 5) What indemnities is the vendor willing to provide? Does the vendor have the resources to meet its obligations pursuant to such indemnities?

C. Contact Information

If you require any further insight into starting or buying a business, or regarding any other business law issue, please contact Brooks Barristers & Solicitors at:

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Disclaimer: The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.