

Buying a business? What to buy?

Buying an existing business, which is already generating cash flows and profits, is often a more prudent decision than starting from scratch. An existing business has an established client base, reputation, and employees who are familiar with different aspects of the business. There is no need to reinvent the wheel with respect to setting up new procedures, systems, and policies as a successful formula for running the business has already been put in place.

Although significant benefits are associated with buying a business (including the ability to obtain financing and attract new investors), this comfort comes at a price. The purchase price of a business usually depends on various factors, such as the company's past performance, expectation of future performance, and a good track record, which is likely to increase the valuation. When assessing these elements, the buyer must perform due diligence (financial, tax, legal, commercial, forensic, etc.) to ensure that it gets the fair deal.

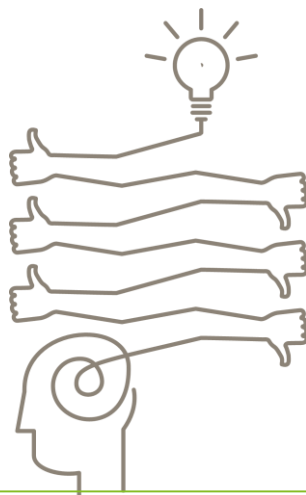


Some pros and cons of buying a business vis-à-vis setting up a business are mentioned below:

Pros



- Track record
- Income
- Financing



Cons



- Poor fit
- Integration challenges
- Vision conflict

The timing of acquiring a business is also important. For instance, if a company incurs losses despite a viable business model with good projections, acquiring the business at an early stage may be a good idea. If an entity has profits but no future prospects, conducting a cost-benefit analysis may be a good idea before making an investment decision.

Different investors' objectives of acquiring the same business may vary. For instance, private equity investors may invest in an entity that is expected to provide higher returns in the short-to-medium term. However, strategic investors may have an objective of expanding their existing business (including by way of inorganic growth) and providing value to stakeholders.



Businesses may consider the following key aspects to get the best deal when buying an existing business.

Choose the right business

Buying a business starts with choosing the right type. Matching your skills with the type of business you want to purchase is an essential element of the process. Familiarity with an industry/business type will make the due diligence process smooth and help run the business. An incorrect business choice may lead to poor acquisition, thereby resulting in a loss of shareholder value.

Organisations may take into account the following factors while buying a business:

- Location:** It affects labour costs, taxes, and other financials that can change a business's bottom line.
- Size:** Buying a larger business could mean bigger profits. However, this will also involve a higher purchase price and more stress during transition.
- Industry:** Industry experience/necessary skill sets are important factors that can generate a high return on investment in the long term.
- Applicable laws:** Understanding of regulatory, tax, cyber, forensic, and other applicable laws, including the impact of government policies on business, can help take an informed business decision.

For instance, the technology potential for technology-driven businesses should also be measured as an equity, given a dynamic business landscape. Customer base or potential incremental offerings that can be generated using digital platforms and technical scalability will become critical elements in the evaluation of a business to be acquired.

Determine whether to buy business, assets, or an entity

Structuring the buyout of a business in an appropriate manner is crucial. Buyout can be done in several ways, including purchasing individual assets or the entire business for a lump-sum consideration, or buying out the shares of an entity conducting the business.

Individual/itemised purchase: This involves individual purchase of assets where consideration is identifiable against each asset. In case of an itemised purchase, liabilities are usually not transferred.

Business purchase: The assets and liabilities related to the identified business are acquired.

Stock acquisition (share deal): The shares of an entity conducting the business, along with the underlying assets and liabilities, held by such an entity are acquired.

Apart from commercial considerations, evaluating the following tax and regulatory considerations is imperative while choosing the manner in which a business needs to be bought out:



Choose the right professionals

Acquiring the right set of professionals to assist in the business buying process is essential. These include financial advisors, bankers, accountants, and lawyers. These professionals are required throughout the due diligence process as they have industry expertise and are typically familiar with several aspects of a deal.

For instance, a lawyer may be aware of certain licences required for the business. An accountant can review the financial data and determine the best tax strategy for you. A banker can provide certain financing options to you.

Conduct due diligence

Due diligence means reviewing and verifying data related to the targeted business. It is an essential part of the business buying process as it validates whether the business is worth what you are paying for, and allows you to look at the financial and other information of the target.

During the due diligence process, the proposed purchase price may change and the review gives buyers a much better understanding of what they are buying.

Determine fair price

Businesses usually sell for a higher price when the economy is expanding. On the other hand, they get a much lower price during recession.

Most businesses are priced based on a multiple of the net cash flows or net income or return on investment methods. Internationally acceptable valuation methodologies to calculate a business' valuation are available. The value of the tangible and intangible assets is also factored in the business valuation.

In the fast moving consumer goods sector, a brand's value is typically high. Hence, the valuation of the business owning that particular brand will also be high. However, if an entity operating in the media sector does not have enough subscribers and incurs losses, it may not be in a position to command higher valuations.

Avoid common mistakes

Being aware of common buyer mistakes is necessary while purchasing a business. If these mistakes work their way into a mergers and acquisition deal, they can undermine relationships and jeopardise the deal closing. In a worse-case scenario, a buyer may close the deal and face the consequences of those mistakes later.

Some of the common mistakes that buyers make are mentioned below:

Succumbing to sunk cost fallacy

- Do not continue on a course of action that does not make sense on a go-forward basis simply because you have already incurred expenses.
- Consider the expected return on investment and then take a conscious decision whether to acquire the business or pass on the deal or put the money in treasury investments.

Deal financing

- Do not use the entire cash for the down payment on the business and set aside a sum for working capital purposes and possible contingencies.

Deal valuation/working capital adjustments

- Note that the receivables outstanding for a considerable period (say 90 / 120 days) are very risky because the older the account, the more difficult it will be to collect receivables. Therefore, it is suggested to obtain appropriate protection by way of price adjustment and/or holdbacks, indemnity, etc.
- Include a material adverse change clause (also known as a MAC) in the agreement that gives the buyer the right to terminate the agreement/adjust the valuation before completion if the business is materially and adversely affected by certain events occurring between a specified point in time and the closing date.
- Create a detailed plan for buying a business. The plan should be flexible enough to accommodate modifications if there are any unforeseen events after acquiring the business.



Investing in or purchasing a business of any size is one of the important business decisions. Hence, it should be made after considering the points mentioned above. The decision has a long-term impact on the business environment, the community, and employees' lives. With the right connection and hard work during the transition phase, converting a good business model into a better business is possible.

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