Buying A Business—Sometimes It’s Easier Than Starting One

One way to gain new revenue for your organization is to buy a business. But be sure to follow this checklist before making a decision.

By Peter Brinckerhoff and Leslie Wilson

A family planning agency wanted to “spin off” a new, income-generating enterprise to attract patients with the ability to pay privately. The new business would provide gynecological services, which were badly needed in the area, and tap the talents of the agency’s experienced management team and medical staff, which included physicians, nurses, and nurse practitioners. The idea was well received by board and staff, since it would generate added revenue to support the agency’s mission and expand services to low-income women and teenagers.

The major hitch in the planning was the agency’s concern about starting a practice from scratch. Then a new possibility presented itself when a local gynecologist died and his practice came up for sale. The agency decided that, instead of starting anew, it would buy the practice.

By purchasing, the agency solved many of the problems associated with starting a new practice. It did not have to worry about generating patients and building a reputation. As long as it provided patient services which were as good as or better than they were before, the practice would thrive, allowing the agency to recoup its initial investment in a relatively short period.

In another case, an east coast agency serving people with development disabilities considered starting a microfilming lab which would employ its clients and generate added revenue. As board members and staff looked at the business environment, they realized there was potential; however, tapping it with their limited marketing expertise and resources posed a major hurdle.

By performing a market analysis, they found that their major source of competition was a lab owned by a man who was planning to retire. With the help of a local banker, they agreed to buy the lab, with some special arrangements. They would keep the owner on as manager for two years, with the buy-out price contingent on continued profits. The result: the agency became an immediate business owner and was able to employ its clients more quickly than it would have if it had started its own business. Also, the agency was able to pay for the business over time rather than coming up with the sale price all at once.

When you buy a business, you purchase the goodwill, employees, and reputation of the entire operation.

The Advantages

For nonprofits, there are many advantages to buying a business that is already established. These include the following:

- The existing business has a reputation, a customer base, and a positive cash flow. It has probably survived its shakeout period and is now in the maturation phase of its growth.
- The existing business has competent, experienced managers and employees, who know the customers and the industry.
- The existing business has a track record that you can discuss with lenders and/or investors.
- The existing business can, if managed correctly, contribute to your organiz-
The Disadvantages

There are, however, some disadvantages you should be aware of before you consider buying a business. These include:

- When you buy a business, you buy it "warts and all." With your own business, you can create warts to your liking. But suppose you have decided to take the plunge and are looking for a business to buy. The first step is to determine what type of business your organization could run successfully, given your expertise and available resources. In addition, you should decide what type of business would help you meet your dual goals of enhancing your mission and generating revenue. Once you’re sure what type of business you want, ask your banker, Small Business Administration representatives, state or county economic development agency, and business brokers for help in locating such a business. Give them specifics about your organization’s capabilities, financial resources, and business requirements.

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- When you buy a business, you are thrown into the thick of things without a break-in period. The suddenness of this process can be overwhelming, especially if the new business is outside your area of expertise.

- A purchased business has its own personality, one which may not fit well with your organization.

- The staff you inherit may not be people you can work with. If turnover occurs as a result, a once successful business could experience some problems, including loss of established customers.

- On the surface, customer relations may appear to be in good shape, but recent problems may be silently eroding customer satisfaction. This situation is difficult to detect.

- Equipment that you purchase with the business may not be state-of-the-art and may need to be replaced to improve efficiency. As a newcomer to the business, you may not recognize this deficit.

- The cost of an existing business can be high. This may force your organization to take on some debt to finance the purchase and could mean that your financial risk is higher than if you started your own business.

Finding a Business to Buy

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Business Review Checklist

Remember that when you buy a business you are not just purchasing the building and equipment. You are also acquiring the goodwill, employees, and reputation of the entire operation. Use the following checklist to protect you from making a bad business decision.

- Review and have evaluated the financial statements, tax returns, balance sheets, and profit-and-loss statements for at least the last five years. You will want to see steady and increasing sales, steadily increasing numbers of customers, healthy profits, good financial ratios, and a stable debt-to-equity ratio. If the business's sales are declining, if receivables are changing dramatically in comparison to sales, or if the business is building up a great deal of debt in relation to its net worth, these are trouble signs. At this point, you want to know whether the problem is poor manage-
ment, a deteriorating market, new competition, or an insolvable combination of all three.

- Request cash flows and a statement of liquidity. Does the business fuel its cash needs from its profits, or does it need new debt and/or equity to feed its working capital needs? Does the business have good relations with a local banker? Is short-term credit easily available?
- Analyze a listing of debts, ownership, and other contingent liabilities; all pending legal actions; and all pending employee grievances. When are the debts due? Are there any balloon payments due shortly? (These are large payments on a debt that is being paid slowly). Are the creditors traditional lenders, individuals, or other financial institutions such as insurance companies? Can you work with these lenders to renegotiate the existing debt? Are there any legal actions being settled in or out of court? If so, what are the likely outcome and cost? Can repeat suits be avoided, or is there an inherent problem with the business's products (in the case of asbestos, for example)? What employee grievances are pending, and why were they filed? Does the business have a disgruntled workforce that will cause you endless grief?
- Request a listing of all the business's assets, including their age and condition. Be sure to request service records on any equipment you are purchasing, especially items which could be expensive to repair or replace. See if there are existing maintenance agreements on major pieces of equipment.
- Ask for a listing of the amounts and ages of receivables. Be careful if customers are not paying promptly. Ask what percentage of the receivables are written off as uncollectible each year.
- Review the table of organization, including credentials of all present employees, their positions, salaries, and tenure with the organization. If possible, review personnel files to check for disciplinary actions, poor evaluations, etc.
- Review the business's five largest customers and the percent of revenue they contribute to the business's annual gross income. Meet with these customers to ensure that their needs are being met and to determine how, if you purchase the business, you can satisfy those needs even better. (Note: Be wary of businesses which have one to three large customers: lose one and the business could suffer a major setback).
- If possible, survey a number of customers to get a feel for their satisfaction with the business. If this is a walk-in business, ask the proprietor if you can talk to customers who come and go on a given day. Find out why former customers, if you know who they are, are not buying from this business any longer.
- Take a look at this type of business nationwide. Is demand for this product or service increasing or decreasing? For instance, if the prospective business is building road barricades using wooden parts and the industry is moving toward plastic road barricades, demand for the wooden barricades could suddenly die.
- How "trendy" is the product or service this business provides? Trends fade over time. Can you recoup your investment and still make money before this happens?
- The location of the business should be convenient to target customers. If you are planning to market to other segments of the population, will the present location work?
- What is happening with the business's competitors? Is the number of competitors increasing or decreasing? Is one competitor beginning to dominate the market? Today the competition may be slim, but if the idea is a good one the competitive climate could change drastically. A few years ago, for instance, delivering pizza to customers' homes was a unique way to edge the competition, but today almost all pizza makers deliver.

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**Analysis Carefully**

All that glitters is not gold; some of it is fool's gold. It is imperative that you protect your organization's reputation from a business failure. Evaluating all the above points will ensure that you have done your homework.

In some cases, the analysis will bring to mind new opportunities which offer less risk than buying a business. Take, for instance, the nonprofit organization which was planning to get into the snack packaging, selling, and distribution business. Through a market analysis, the organization discovered that a competitor was planning to run an identical operation—a situation which would have split the market, leaving both businesses with a less than enviable bottom line. Through a mutual agreement, the organization agreed to take on the packaging end of the business. It was thus able to provide jobs for its clients, which was its ultimate goal, and obtain added revenue without taking the full risk of buying its own business. It was also able to avoid those aspects of the business—sales, marketing, and distribution—which it was least prepared to handle.

As in any business decision, it is up to you as a nonprofit manager to assure that your actions support the mission of your organization. If the purchase of an existing business can do that better than starting one, then pursue this option. But do it carefully, with caution and outside help.

**It is imperative that you protect your organization's reputation from a business failure.**
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