

## Buying a Business, Part II

*You'll need negotiating skills and contract savvy to successfully close the deal.*

By J. Tol Broome, Jr.

*I*n the last issue, we explored ways to determine a fair price for a day spa business and discussed the importance of having a correct valuation before making a purchase. In this issue we'll discuss the equally important process of contract negotiations. The deal you structure can make a real difference in your monthly payments and obligations.



Negotiating is an art that requires you to manage a huge amount of information skillfully and calmly. Of course, you'll take the information you found during valuation to the table, but you'll also want to include input from other sources, such as your accountant, banker and business broker. You may be too close to the deal to make a logical decision on what constitutes a fair price—particularly if you're pursuing a long-standing dream to own a day spa.

There are several strategies you can use during negotiations that should help you establish a favorable price:

***Don't open the bidding.*** If possible, try to get the seller to make the first offer. Knowing his starting point will help you devise a proper counter offer. I've seen cases where the buyer made an initial offer that was *higher*

than the top price the seller was hoping to get!

***Start low.*** Begin negotiations with a low dollar amount. You don't want to go low enough to insult the seller, but you're better off beginning at a lower level and working up than you are offering a price that's close to what you think the business is worth. If a day spa is well run and has a discretionary cash flow of \$100,000, for example, start out at around two times that figure, or \$200,000. The seller will probably be asking in the \$300,000 range, but this gives you a good starting point with plenty of room to bargain.

***Have a limit.*** Settle on your maximum offer before you start negotiating and stick to it. Remember that the business will have

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to generate enough cash flow to pay you a fair salary, cover all debts and provide an adequate return on investment. If you overpay, one of these areas will suffer.

**Offer choices.** Offering choices can create a win-win situation for all parties involved. For example, if you have enough cash at your disposal, you might offer a slightly higher price if the current owner provides partial financing of the deal or a lower price if you pay cash for the business.

### CONTRACT COMPONENTS

Once you and the seller settle on a price, you need to finalize a contract. Your attorney should draw up a preliminary contract when you make an offer, but there are additional provisions you should include in the final version. (This list isn't intended to be all-inclusive; contact your attorney to discuss your particular needs.)

**Itemized list of assets:** List in great detail the exact assets you will be pur-

chasing.

**Clear title to the assets:** Insist on clear title to the assets at closing. Otherwise, you may face losing money due to liens on the assets.

**Status of the existing lease:** If the day spa is on leased property, check the terms and conditions before you close the deal. If the lease is long term, make sure it's transferable. If it will run out within six months, get permission to contact the landlord. You need to know before the final purchase if the landlord plans to put someone else in the space or raise the rent.

**Collection of accounts receivable:** Include a provision spelling out whether or not you are purchasing any outstanding client debts and the party responsible for collection. The seller typically maintains ownership of receivables, with the buyer taking responsibility for collection. This allows the buyer to contact the customers without taking on the risk of potentially uncollectible accounts.

**Legal right to business identity:** This includes the business name, phone number and logo, among other things.

**Non-compete clause:** Include a non-compete clause that runs for at least five years. The last thing you want is to buy a day spa from someone who will turn around and open another day spa down the street.

**Training clause:** This requires the seller to provide you with a certain amount of training to ensure a smooth short-term transition. Training should last for two to six weeks and should be provided on a full-time basis during that period.

**Consulting clause:** While training will help with the short-term transition, a consulting clause with the former owner will ensure a smooth ongoing transfer of ownership during the first year. The clause should specify the amount of consulting services, such

### STRUCTURING THE DEAL

The typical day spa sale is structured with a combination of buyer cash, bank financing and a seller note. The buyer will usually be required to put down around 30%, with the bank and seller roughly splitting the rest.

A day spa with a \$200,000 purchase price might be financed like this:

<b>Buyer down payment = \$60,000</b>
<b>Seller financing = \$70,000</b>
<b>Bank financing = \$70,000</b>
<b>TOTAL = \$200,000</b>

Assuming a five-year payback period for the seller note at 10% interest and a three-year payback period on the bank note at 10% interest, the debt service requirements would look like this:

	<u>Monthly Payment</u>	<u>Annual Debt Service</u>
<b>Seller financing</b>	<b>\$1,488</b>	<b>\$17,856</b>
<b>Bank financing</b>	<b>\$2,255</b>	<b>\$27,060</b>
<b>Total debt service</b>	<b>\$3,743</b>	<b>\$44,916</b>

This business would need to generate an annual gross cash flow (after tax net income plus depreciation) of around \$45,000 to meet the proposed debt structure.



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as 6 to 10 hours per month from months 2 to 12 following the purchase.

**Employee contracts:** If the current owner is to stay on as a manager or if there are key employees who you feel are critical to the success of the spa, include an employee contract provision requiring these people to agree to stay for a specified time after the sale.

**Full disclosure of all records:** Include financial and personnel records if this provision isn't already in the contract.

**Due diligence period:** This is a vital clause that gives you a certain period of time—usually 30 to 90 days—to perform a thorough review of all company records. Among other things, due diligence should include provisions that allow you to:

- Review all financial information with an outside accountant.
- Get third-party appraisals of all assets involved in the sale.
- Thoroughly examine all assets.
- Meet with key employees.
- Contact key customers.
- Contact suppliers to ensure that timely payments have been made.

## FINANCE OPTIONS

Once the contract is in place, the final and most challenging hurdle is financing. You have four basic options for financing a day spa purchase:

- Your own cash
- Equity investor(s)
- Seller financing
- Third-party financing

Most small-business sales involve a combination of at least two of the above options; some include all four. I believe it's important for a buyer to ask the seller to finance at least part of the purchase price. There are two main reasons for this: First, a seller with vested interest in

the spa is far more likely to provide meaningful follow-through on training and consulting contractual clauses. Second, if there are hidden risks that went undetected in the due diligence process, the buyer retains some leverage over the seller to facilitate resolution.

Most sellers won't finance anywhere close to 100% of a business purchase, however, which means you'll probably need additional funds to complete the transaction. Typically, the buyer must have a down payment of 30% to 40% (\$60,000 to \$80,000 on a \$200,000 purchase) to bring to the close.

If you choose an equity partner, you'll have to give up a portion of the ownership as well as a portion of the control of the company and its cash flow. On the positive side, however, an equity partner usually won't require you to make a monthly payment.

A bank or other outside financing source allows you to maintain control over all facets of your new business, but you will have to make monthly payments over a set period—usually three to five years for a business loan.

Whatever your source of outside funding, you'll need a complete business plan. (For details, see "Money Matters: Business Plan Basics" in the July/August 1997 issue.) I strongly recommend that you seek outside help when preparing your business plan. If you can't afford to pay an accountant, you'll find several good books on the subject at the local library or bookstore. ♣

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