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Why start from scratch when you buy your own company? 10 frequent mistakes when buying a small business

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WHY START FROM SCRATCH WHEN YOU CAN BUY YOUR OWN COMPANY?



**BUSINESS
SCHOOL**

**10 FREQUENT MISTAKES
WHEN BUYING A SMALL BUSINESS**





PART-TIME

FULL-TIME

#1

**ASSUMING THAT FINDING A
HIGH-POTENTIAL BUSINESS
FOR SALE IS A PART-TIME JOB**

ASSUMING THAT FINDING A HIGH-POTENTIAL BUSINESS FOR SALE IS A PART-TIME JOB



- Finding a company for sale can **take 12 to 24 months**.
- Statistics show that before finally signing the share purchase agreement, you will have
 - > looked into over 100 teasers
 - > done preliminary due diligence on 15 targets
 - > signed 2 to 4 letters of intent
- Finding a company is an **emotional rollercoaster** and many potential entrepreneurs quit the search because
 1. they did not ask the fundamental personal questions:
Do I really want to do this? Does my partner support me?
Do I want to take the financial risk?
 2. they did not devote sufficient time to the search as they were still focused on their previous / current job
 3. they never clearly specified what type of business would fit their personal profile and, therefore, did not end up on the radar of brokers

ASSUMING THAT FINDING A HIGH-POTENTIAL BUSINESS FOR SALE IS A PART-TIME JOB

- Potential entrepreneurs wanting to buy a company become impatient. Watch out for the ‘entrepreneur in heat’: after a long search process, you tend to become biased and neglect some warning signs when evaluating a business for sale.

It's better to have no deal than a bad deal!



#2

**FAILING TO UNDERSTAND
THE MOTIVATION AND
EMOTIONS OF THE SELLER**



FAILING TO UNDERSTAND THE MOTIVATION AND EMOTIONS OF THE SELLER

- Business owners have strong emotional attachments to the companies they have built, and will generally be concerned about the future of a company under new ownership. When first meeting sellers, show **respect** for their achievements.
- When meeting the seller first time **listen 80% of the time** to understand the motivation to sell, to learn about the fundamentals of the business, to know the concerns of the seller, and to identify blind spots.

FAILING TO UNDERSTAND THE MOTIVATION AND EMOTIONS OF THE SELLER

- **Be humble! Do not be arrogant** and tell the owner what you would change and what you think you can do better. The owner generally knows the business better than you do. Show respect and schmooze!
- **Connect with the seller** in terms of your business values and the language you speak (e.g. a McKinsey consultant versus someone who started a business without a higher education). Be authentic.
- Always ask yourself: **‘Why does the seller want to sell?’**



#3

**FAILING TO UNDERSTAND THE
FUNDAMENTAL DRIVERS OF
THE BUSINESS' PROFIT ENGINE**

FAILING TO UNDERSTAND THE FUNDAMENTAL DRIVERS OF THE BUSINESS' PROFIT ENGINE



It's not always easy to understand why a business generates a (hopefully) healthy profit margin. The seller and the broker will try to make the business look amazing and frequently the owner will have done earnings management to make the business look attractive. Always question why profit margins might be higher than the industry average or why they have been increasing recently. **Go deep into the financials** to understand what happened. Make sure to also grasp the broader industry picture and how it relates to the financials of the business.

FAILING TO UNDERSTAND THE FUNDAMENTAL DRIVERS OF THE BUSINESS' PROFIT ENGINE



- Conduct a **proper financial and commercial due diligence** to
 1. understand the cash flow characteristics to discover anomalies (e.g. fraud, earnings management)
 2. understand why a business has a competitive advantage (e.g. identify unique assets, capabilities, USP, etc.)
 3. draft your 'first 100-days implementation plan'
- In some cases, the success of the business has been built on the **personal network and reputation of the original owner** and is the only reason why the business has been alive. Many buy-in entrepreneurs fail to see this!



#4

**DOING DUE DILIGENCE
FROM BEHIND YOUR DESK**

DOING DUE DILIGENCE FROM BEHIND YOUR DESK

- When you conduct due diligence, you should **act as a real investigator** and **collect information** using different data sources including financial accounts, annual reports, (former) employees, industry experts, suppliers, (former) customers, investors, and competitors. It's clear you will need to **get out into the field** to collect this data to confirm or reject your assumptions (e.g. sustainability of the profit margin).
- Going out into the field is necessary to obtain **intangible data** on e.g. positioning of the products in a store, company image, company culture, quality of the inventory, loyalty of customers, customer satisfaction, customers' perceptions of how the company compares to competitors, etc.

DOING DUE DILIGENCE FROM BEHIND YOUR DESK

- In many small companies, financial data is not easily retrievable because of a lack of IT systems. The speed at which you get information says something about the company. Go into the raw data to understand trends in margins, discounts, revenue, etc.

No numbers, no deal!



DOING DUE DILIGENCE FROM BEHIND YOUR DESK



- Don't believe (too strongly) in due diligence checklists. Each company has its own specific issues!
- **Don't be stingy on advisors.** “Penny wise, pound foolish”. If needed, ask specific advice for specific issues (e.g. environment, pension, insurance, permits, etc.).
- If the shoe doesn't fit at the store, it's unlikely to stick when you come home.
Follow your instinct when things don't feel right!

#5

OVERESTIMATING THE VALUE OF THE BUSINESS



OVERESTIMATING THE VALUE OF THE BUSINESS

“Valuation is not a science; it is an art”. It’s one thing to run the financial models behind valuation, it’s another thing to apply common sense and to know what parameters to plug in. Always **be conservative when forecasting future cash flows** – watch out for the hockey stick forecast!



OVERESTIMATING THE VALUE OF THE BUSINESS

- When running your financial models, always **focus on the bottom-line free cash flow**. Many entrepreneurs and investors underestimate future capital expenses including IT investments, machinery and equipment, maintenance and working capital needs.
- Normalise the numbers when performing the valuation including the revenue and cost statement, the cash flow statement and certain balance sheet items. **Take contingent liabilities into account.**



OVERESTIMATING THE VALUE OF THE BUSINESS

- When conducting the valuation of the business, don't forget to include your own (market-based) **salary** and the salary of other people you might need to hire to replace or complement the management, as company expenses.
- Owners are fairly often unrealistic when setting the **acquisition price**. Use benchmarks (e.g. multiples) to provide objective evidence. (The **M&A Monitor**, an annual study by Vlerick Business School, investigates the average prices for SMEs in the Belgian market.)
- **Better to pay too much for a good business, than to pay too little for a bad business.**



6

**STRETCHING YOURSELF
FINANCIALLY**

STRETCHING YOURSELF FINANCIALLY

Buying a business requires a significant **personal investment**. A common mistake is to overextend yourself financially. If you spend all your money on the purchasing price, you might not have any room to invest additional personal funds (e.g. to cover investments, setbacks) if the business would need this. During the owner transition, you will often have a disruption in cash flows (e.g. some customers leaving because of a lack of attention). Make sure to calculate this in.



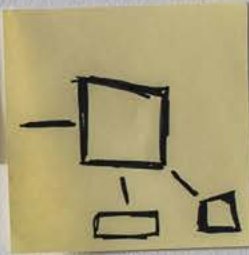
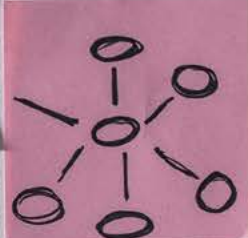
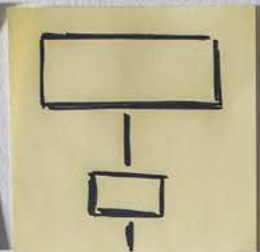
STRETCHING YOURSELF FINANCIALLY



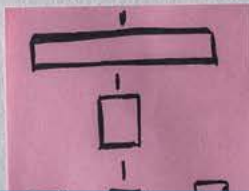
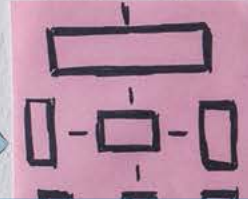
- Consider **different options** to **increase your personal budget**
 1. by waiting and saving more personal funds
 2. by looking for additional team members who can put money on the table
 3. by considering different types of deal structures including vendor financing, earn-outs, mezzanine financing, government funding (e.g. PMV offers different instruments including guarantee schemes), and private equity funding. Always model different deal structures to understand the different options.
- **Dare to think big** when looking for targets and be creative in how you finance the deal. Ask yourself: do you prefer a small piece of a large pie, or a large piece of a small pie?
- **Never ever give a personal guarantee to the bank if you cannot afford it!**

#7

BEING ILL-PREPARED TO
PRESENT YOUR BUSINESS
CASE TO THE BANK



Like!



VISION

Teamwork

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BEING ILL-PREPARED TO PRESENT YOUR BUSINESS CASE TO THE BANK



- Banks are the most important source of funding to finance buyout transactions. You should provide a **well-prepared and well-written business case** that thoroughly reflects your knowledge of the business. This also includes a number of scenario analyses to assess the debt capacity of the business under both good and bad circumstances (e.g. recessions).
- Many entrepreneurs fail to understand that **banks are not risk capital providers**. The average level of traditional bank debt ranges between 50-70% of the total transaction price, depending on collateral, cash flow fluctuations, etc.

BEING ILL-PREPARED TO PRESENT YOUR BUSINESS CASE TO THE BANK

- Always **visit more than one bank** and start with your least preferred bank to practice your case and get feedback. Include the feedback when visiting other banks.
- Know what to negotiate: the **amount of debt** and the **flexibility** offered by the **loan conditions** are more important than the interest rate.
- Treat a **bank as a partner** by giving favours to the bank in terms of cross-selling opportunities (e.g. commercial lending). Good banks will help you to set up solid deal structures.
- Banks don't like surprises: always be proactive if issues come up before and after the deal. Be **transparent**.



8

**NOT DEVELOPING A GOOD
NEGOTIATION STRATEGY**

NOT DEVELOPING A GOOD NEGOTIATION STRATEGY

- Make sure you understand the **different deal terms** you will need to negotiate.
- A common mistake made by potential buyers is that they don't prepare well when starting the negotiations. For example, clearly distinguish must-haves from nice-to-haves and understand what the must-haves and nice-to-haves might be from the perspective of the seller.
- Know what **benefits you can offer to the seller** during the negotiations, e.g. honorary titles, vendor loans, board seats, future involvement including a salary, independence of the company, a shared dream to grow the business, etc.

NOT DEVELOPING A GOOD NEGOTIATION STRATEGY

- In many cases you will **need the seller after the deal** has been concluded (e.g. to introduce you to customers, to help you understand the business).
Don't treat negotiations as a zero-sum game (i.e. what you lose, I win).
- Always put things **on paper** and use experienced lawyers to draft the contracts. And remember: trust is the basis of a good contract and the glue of a good post-transaction relationship.
- Use a **third party** (e.g. broker, lawyer) to conduct the **technical aspects** of the negotiations and to put difficult issues on the table.



#9

**UNDERESTIMATING THE
IMPORTANCE OF CULTURE
WITHIN AN ORGANISATION**

UNDERESTIMATING THE IMPORTANCE OF CULTURE WITHIN AN ORGANISATION

- Don't forget to do a **cultural audit**! A strong organisational culture can be a key asset and a source of sustained competitive advantage. The opposite is also true: a strong organisational culture can be a major impediment to improving company performance. Culture cannot easily be changed. Therefore, it's key to understand the strengths and weaknesses of the organisational culture.
- Small businesses are often run like a family, and it's not easy to suddenly impose a corporate culture. Ask yourself whether **your management style fits well with** the organisational culture.

UNDERESTIMATING THE IMPORTANCE OF CULTURE WITHIN AN ORGANISATION

- Make sure you understand the formal and informal **organisational chart** and how (informal) power is distributed.
- In most organisations, a **few individuals** have a **proportionally large impact** on culture. Try to identify those individuals and assess whether they contribute positively to company performance or whether they act as saboteurs. Don't wait to intervene if the latter is the case.





#10

**OVERESTIMATING YOUR OWN
CAPABILITIES AND UNDERESTIMATING
THE TIME IT TAKES TO CHANGE THINGS**

OVERESTIMATING YOUR OWN CAPABILITIES AND UNDERESTIMATING THE TIME IT TAKES TO CHANGE THINGS



- The number one mistake many potential owner managers make may be failing to recognise their own weaknesses and not seeking complementary team members or managers who are better in their fields of specialisation. Dare to put your own ego aside. **To attract top talent, you should be willing to give up equity.**
- If you buy a company as a team, make sure to have a good shareholder agreement! Additionally, a deep understanding of the values, ambitions and fears of each of the team members is essential. Many acquisitions ultimately fail because of team struggles. Get to know each other inside out before starting your journey.

OVERESTIMATING YOUR OWN CAPABILITIES AND UNDERESTIMATING THE TIME IT TAKES TO CHANGE THINGS



- After the share purchase agreement has been signed, new owner managers often start to implement an ambitious change plan to improve the business performance. Your **first goal** should always be to **provide continuity** by
 1. familiarising yourself with the business
 2. checking your assumptions of the business plan
 3. connecting with the people.Be aware that this exercise takes time.
- Focus on the **low hanging fruit** in the first months or years after the acquisition.
- Before introducing changes, make sure you to have your radar screen on to track key numbers (e.g. net debt position) and KPIs (e.g. sales pipeline) and understand the financial situation accurately!

YOU WANT TO OBTAIN MORE INSIGHTS ON ACQUIRING YOUR OWN BUSINESS?



- Attend the Buy Your Own Company Conference
<https://www.vlerick.com/byocc>
- Subscribe for the Entrepreneurial Buyout Academy
<https://www.vlerick.com/entrepreneurial-buyout-academy>

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“Developing and disseminating knowledge concerning best practices in the entire M&A field”

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- Covering the whole value chain: from deal origination to completion, from financing to integration
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