Is Buying a Business in Debt Worth the Risk?

In today's uncertain economic climate, making any business decision carries an element of risk. But what if, as an entrepreneur, you've set your sights on acquiring a new business? Perhaps a company that is already in debt? Weighing up the pros and cons is a vital step when acquiring any new business, but debt certainly shouldn't be a reason to discount the purchase.

To help you get the best out of your decision, Gary Edwards, Marketing Manager at Business Valuation expert Company Valuation Services give his top tips and speaks to entrepreneurs to help ensure you future financial performance and take risks that pay off.

Think like a strategist

The first step towards a successful purchase is understanding the strategic risk associated with acquiring any new business. This requires careful thinking about what the future will look like, and how this new business can fit into your plans.

James Lloyd-Townshend, CEO at Frank Recruitment Group, tells us how entrepreneurs everywhere can balance the success of their current brand and an expanding portfolio, as well as considering the risks involved.

"Back in 2006, our business consisted of just one core brand, Nigel Frank, which was – and still is – our original Microsoft recruitment arm.

"After seeing further opportunities for hiring services in hyper-growth markets, we made a decision to expand our portfolio with the introduction of new brands dedicated to other niche technologies. Whilst there's always a risk of diluting the original brand and stretching your resources too thin, we made sure each business had a clear purpose and product range that allowed them to dominate their specific market. We also didn't grow until we could afford to."

Since making the decision to expand his business portfolio, James has created seven separate niche brands operating in various markets across offices in five countries.

Financial risk versus business risk

Whether you are a business owner looking to fund your next move or an entrepreneur analysing the positives and negatives associated with purchasing a company in debt, understanding the difference between financial risk and business risk is important. Many large corporations even have entire teams dedicated to deciding whether the risks involved in financial decisions work to counteract associated business risks.

In short, financial risk is a company's ability to manage and leverage debt, while business risk relates to a company's capacity to generate enough revenue to cover the expenses that are integral to its operation.

When making a calculated financial risk, analysing whether your current or projected revenue allows for the coverage of operational costs and interest payments on financing is vital to striking the right balance.

Taking on a business in debt

When selling a business, many company owners assume that debt will disappear with the sale. However, not every transaction sees the new buyer take over existing debts. An asset sale involves the transfer of specific assets, meaning the buyer can ultimately select which assets and liabilities they want to keep. Alternatively, a stock sale involves the transfer of all assets and liabilities. It is estimated that less than 5% of businesses are sold as a stock sale.

Risks can pay off

Growth and risk often go hand-in-hand for businesses and entrepreneurs serving multiple market sectors, as Paul Russell, Director and Co-Founder at Luxury Academy London, explained:

"For Luxury Academy, the real risks we've taken have been those that have ultimately led to growth, situations that have happened twice. The first risk we took was when we moved from targeting a small segment of the market to the larger luxury market and the second was when we expanded into India. Business risk often involves change, and change is something that people can shy away from based on the assumption that what is known is safer. But in business nothing stays the same forever, markets change, customer tastes evolve, the economy may falter or soar, and you have to be willing to make changes to survive. And, in most cases this involves some element of risk."

Understanding whether taking on a business in debt or leaving these liabilities behind with an asset sale is right for you is an essential part of the buying process. Debt is common throughout the business world, particularly in the financial services industry. Having a clear understanding of a company's corporate life-cycle during the valuation process often provides a reliable indicator of whether the purchase is viable for you, and whether the financial risk and business risk can be offset.

If you consider all the factors and calculate all the financial outcomes, there's no reason why you can't expand your business portfolio and profit from a business in debt.