

Financial modeling for acquisitions sits at the intersection of judgment and arithmetic. You will spend hours in spreadsheets, yet the model that guides a wise offer is rarely the one with the most tabs or the thickest formatting. It is the one that captures how money really moves through the target business, how risks show up in cash, and how the deal structure affects your downside and upside. This is the heart of Business Acquisition Training when you are Buying a Business: translating messy operations into a disciplined, defensible forecast tied to a financing plan.

Start with the deal thesis, not the spreadsheet

A model that does not reflect a clear deal thesis is a castle on sand. Before a single row is built, articulate the few sentences that will direct every assumption you make. What exact problem do you solve by buying this company, what edge lets you maintain or improve cash generation, and what risks can kill the story? A typical thesis might read: “Acquire a \$6 million revenue B2B services firm with 20 percent EBITDA that has stable recurring contracts, finance with SBA senior debt, a modest seller note, and use my sales leadership to improve net retention by 5 points while holding costs flat.” That short statement guides you toward recurring revenue analysis, churn cohorts, labor utilization, and working capital needs for growth.

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Buyers often jump to a three-statement model and end up backfilling their logic. You are better served with a one-page scaffold: revenue drivers, gross margin mechanics, operating leverage, capex and working capital cadence, taxes, and the sources and uses that fund the purchase. Once you see how the engine makes cash, you can add statements and detail.

What you need from the seller and how to normalize it

Clean inputs are rare. Small and mid-sized companies rarely keep accrual-basis financials that tie neatly to tax returns and bank statements. This is where craft matters. I ask for three to five years of monthly P&L and balance sheets, tax returns for the same period, customer and product revenue by month, headcount by department, payroll registers, AR aging, AP aging, and a fixed asset roll-forward. If the company claims recurring revenue, I want cohort retention by dollar, not just customer count. For inventory businesses, I ask for inventory turns and shrink.

Expect to clean and normalize. Owner compensation often mixes market wages with distributions. Family members may take salaries disconnected from market rates. Discretionary expenses like personal travel or an overbuilt vehicle fleet need to be stripped out. I once reviewed a distribution company with 14 percent EBITDA on the broker’s deck; after removing three family salaries that would not exist post-close, and adding back a market wage for a real controller they lacked, the adjusted EBITDA was 11 percent. The difference changed both the debt capacity and my maximum price.

Normalization has two directions. You add back personal or one-time costs, and you subtract spend that must exist post-close. If the owner is the head of sales, you must include a replacement sales leader or your own compensation. If the company has deferred maintenance or outdated software the lender will require you to upgrade, budget for it. Lenders and quality of earnings providers will press on these judgments, so document each adjustment, the evidence supporting it, and the post-close rationale.

Choosing the modeling frame: three archetypes

A single format rarely fits every industry. In practice I use three archetypes and adapt them.

- Recurring revenue and contract-driven businesses: Build from cohorts and net dollar retention. Start with beginning ARR, add new logo ARR, remove churn, apply expansion or contraction, and set timing for cash collection against revenue recognition. Headcount scales with accounts managed and go-to-market motion. Working capital hinges on deferred revenue and receivables.

- Unit and capacity businesses: Build from price times volume, less direct labor and material per unit, constrained by capacity and utilization. For a specialty manufacturer, machine hours and throughput matter more than total addressable market. Downtime and scrap rates move margins more than textbook “scale.”



- Project and backlog businesses: Build from backlog burn, bookings, and average project margin. Services with milestone billing frequently have revenue that outpaces or lags cash. Your model should track WIP, billings in excess or costs in excess, and the timing of collections.

You can still produce standard income, cash flow, and balance sheet outputs, yet the driver section needs to match the way money is earned.

Revenue: from story to schedule

Revenue forecasting is where optimism sneaks in. My rule is to ground the first two years in current pipeline and operating capacity, then allow improvement in year three only if the plan shows the hires, the spend, and the lead times to support it. In a HVAC service roll-up I advised, the buyer wanted to grow revenue 20 percent in year one with no incremental technicians. We rebuilt the schedule around truck count, technician billable hours, win rates, and average ticket size. The capacity math allowed 8 to 10 percent growth unless they hired and trained six technicians, which would themselves take three to four months to reach full productivity. The revised plan included a recruiting ramp and training costs, plus the working capital to carry them. It also lowered the year one cash available for debt service, which saved the buyer from an overly tight coverage ratio.

When you model revenue, include ramp and decay. New sales hires do not produce on day one. New locations take months to break even. Seasonal businesses swing more than you expect. A landscaping firm might earn 70 percent of its profit in six months and burn cash in winter. If your debt service is level, a seasonal cash crunch can occur even when the annual coverage looks healthy. In Business Acquisition Training, this is where modeling moves from theory to survival.

Gross margin and COGS: do not blur lines

COGS lines get slippery. Put direct labor and materials above the line, and management or overhead labor below. If you tuck supervisors, dispatchers, or a fleet manager into COGS just because a seller did, your gross margin will look artificially high and you will misjudge operating leverage. Lenders and investors notice. Create a schedule for direct labor with headcount, wage rates, overtime, payroll taxes, and benefits. For materials, use historical percentages of revenue but stress test for supplier price moves. A 2 percent swing in input cost can erase thin margins. I track two or three scenarios for material inflation and check whether contracts allow pass-through within a reasonable lag.

Freight, scrap, and warranty all deserve their own rows. A specialty electronics assembler we evaluated showed 28 percent gross margin. Once warranty claims were resurfaced from “other expenses” and freight was properly matched to shipments, true gross margin was closer to 24 percent. That four-point drop made year one debt service coverage unacceptable unless we negotiated a lower price or the seller left more on a subordinated note.

Operating expenses: operating leverage and reality checks

Operating expenses should be tied to drivers or indexed to inflation when no better link exists. Rent is often the easiest to forecast and often the one buyers overlook while negotiating. Confirm lease terms, options, escalation, and whether a relocation or consolidation looms during your hold period. If you plan to integrate the target into an existing platform, your model should include one-time integration costs and ongoing savings. I prefer to place one-time costs in a separate schedule to keep the operating P&L clean, then flow those costs into cash.

Marketing spend should connect to lead generation and conversion, not a flat percent of revenue. If the company has a stable referral base, pushing ad spend [Buy a Business](#) might increase customer acquisition but harm payback periods. Your assumptions must reflect channel realities, not wishful ratios.

Payroll below the gross margin line requires specificity. Titles, market-based comp, merit or COLA increases, benefits burden, and timing of hires. Many mid-market lenders discount models that show generalized “SG&A” growth because they cannot see the mechanism that produces the number. Show them the mechanism.

Working capital: the silent killer or the safety valve

Working capital movement decides whether you breathe easy after closing or wake up calling your lender. Too many buyers set AR at 45 days, AP at 30, inventory at a flat percent of COGS, and call it done. It rarely holds. If the target is growing, AR and inventory will absorb cash, sometimes far more than EBITDA grows. Conversely, deferred revenue businesses can accelerate cash collection and fund growth, but only if you understand refund obligations and seasonality.

I build a 13-week rolling cash view during diligence, then translate the patterns into the long-term model. For AR, I look at aging buckets and write-off history. If 20 percent of receivables sit past 90 days, your effective working capital needs will be higher than a simple DSO suggests. For AP, seller relationships matter. A distribution company with 2 percent ten-day discounts that the seller takes out of habit might lose those terms post-close if the seller’s personal guarantee disappears. Bake in a modest deterioration unless you have confirmed those terms with suppliers.

Inventory should be built from turns and lead times. If your plan calls for doubling a product line with 90-day lead times, inventory will spike well before revenue. I model safety stock explicitly rather than relying on a percent of COGS. Once you quantify working capital this way, you are less likely to get surprised when lenders or the seller ask you to true up net working capital at close.

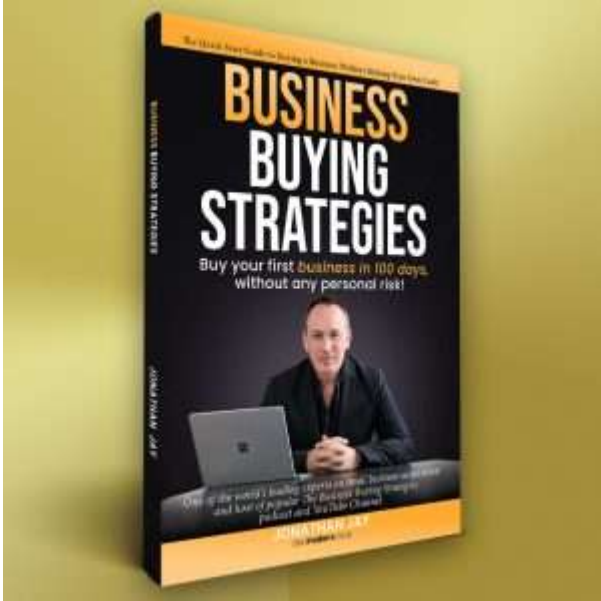
Capex and maintenance: separate what you want from what you need

Buyers often understate capex because they confuse growth initiatives with the maintenance necessary to stay in place. The useful life printed in the books is not the same as the life remaining on trucks, presses, or servers. Walk the floor, open the hood, ask for service logs. In one roll-up of commercial cleaning businesses, equipment looked new in the binder but was near end of life in reality. We added a replacement cycle over three years that consumed an extra 1.5 percent of revenue annually. Without that, the model’s free cash flow would have been fiction.

I treat capex in three buckets: maintenance, compliance, and growth. Maintenance keeps current revenue intact. Compliance satisfies regulators or lenders. Growth expands capacity or capability. Maintenance and compliance are non-negotiable, so they should be shown before calculating cash available for debt service and distributions. Growth capex should be timed to demand and funded with equity or excess cash, not assumed to appear magically from debt that lenders will not provide.

Taxes: pragmatic and lender-aware

Tax modeling does not need to replicate a CPA’s software, but it should be defensible. Know whether the acquisition is structured as an asset purchase or equity purchase and whether a 338(h)(10) election applies for S-corps. A step-up in basis from an asset deal can yield higher depreciation and near-term tax shields, which improve cash flow. On the other hand, some lenders will cap allowable add-backs. Confirm assumptions around state taxes and gross receipts taxes in local jurisdictions, which can be material for services firms. I generally model an effective tax rate that steps up over three years as add-backs fade and one-time integration costs disappear.



Debt, equity, and the spine of the deal

Sources and uses is the spine of the acquisition. Every buyer should be able to recite it and explain each line. Uses will include purchase price, cash to balance sheet, transaction fees, financing fees, and any payoffs of existing debt or leases. Sources will include senior debt, mezzanine or SBA loans, seller note, rollover equity, buyer equity, and potentially an earnout.

The shape of your model changes with the debt stack. Senior lenders care about fixed charge coverage ratio, leverage ratio, and debt service coverage ratio. They will test these both on a historical basis and pro forma with your adjustments. In SBA-backed deals, allowable add-backs are narrower and personal liquidity matters. In cash-flow term loans, covenants may be tighter in early years when risk is highest. If your model shows a year one DSCR of 1.25 times with no cushion, you are living on the edge. When interest rates move 50 to 100 basis points, which happens, your coverage collapses. Build a rising-rate sensitivity.

Seller notes and earnouts can bridge valuation gaps, but only if the cash waterfall respects senior lender rights. Many lenders require seller notes to be fully subordinated with no payments until the loan is seasoned. If your model shows current payments on a seller note in year one, you might be modeling a capital stack your lender will not approve. Align terms early, then reflect them in the cash flow statement.

Building the model: a practical sequence that holds up

Over the years, I have settled on a build order that produces fewer errors and clearer thinking.

- Draft the deal thesis and write the revenue engine in words. One paragraph, then drivers.
- Assemble and clean historicals, including a bridge from tax to management accounts.
- Build a driver sheet that translates operating levers into monthly revenue and gross margin.
- Layer operating expenses tied to headcount and contracts, then one-time integration costs in a separate schedule.
- Model working capital with explicit AR, AP, inventory, and deferred revenue dynamics.
- Add capex by bucket with timing to reality, not to a perfect growth curve.
- Create sources and uses and a debt schedule that matches likely lender terms.
- Produce income, cash flow, and balance sheet statements.
- Add covenant and coverage tests, then build three to five sensitivities that reflect real risk.
- Only then, decide on a price range and structure that the cash flows support.

This is the first of the two allowed lists. It adds clarity because it lays out a true sequence, not a template for every section.

Sensitivity analysis: finding the edges

Clever models hide risk in averages. Strong models expose edges. I prefer to stress a small set of variables with business significance rather than blanket plus or minus 10 percent toggles. For a subscription software company, stress gross churn, net

expansion, enterprise sales cycle length, and discounting pressure. For a plumbing contractor, stress call volume, conversion rates, technician turnover, and fuel cost. In a food manufacturer, stress input prices, labor availability, and retailer chargebacks.

Then test compound risks. When sales slip, working capital usually worsens. When you raise prices, churn may rise. When you grow quickly, training costs escalate and rework drags margins. Build two or three scenarios where risks cluster the way they do in real life, not in independence. Your lender will appreciate it, and you will see whether an equity cushion or a larger seller note is warranted.

Valuation the right way around

Valuation metrics belong downstream of cash flow. Multiples help you triangulate, not justify a number you already want. I typically triangulate with three anchors: a discounted cash flow based on the forecast I believe, a market multiple applied to normalized EBITDA with qualitative adjustments for customer concentration, cyclicalities, and moat, and a debt capacity method that asks how much leverage the business can carry while keeping DSCR above a target in the downside case. The tightest of these tends to dictate the maximum bid.

For example, a light manufacturing target with \$2.5 million adjusted EBITDA and modest cyclicalities might trade at 5.5 to 6.5 times in the current market. If working capital absorbs cash in growth and the business requires 2 percent of revenue in maintenance capex, the free cash flow suggests a DCF closer to 5.0 to 5.5 times. If senior debt appetite is limited to 2.5 times EBITDA at a 9 to 10 percent blended cost, and year one DSCR falls below 1.3 times in your realistic case, then your maximum enterprise value is probably capped around 5.25 to 5.75 times unless the seller is willing to carry a subordinated note with PIK interest for the first year. This is not pessimism, it is discipline that keeps you solvent.

Cohorts, concentration, and customer health

Many acquisition models die quietly because they ignore who pays the bills. Customer concentration above 20 percent for a single client requires a specific plan and a modeled contingency. Do not bury it. If a top account can cancel on 60 days' notice, show a downside case where they reduce volume by half and the business scrambles to replace it at lower margin. Absent protective contracts, you are not Buying a Business as much as renting a revenue stream.

For recurring revenue, cohort analysis reveals truth. Track each monthly or quarterly cohort's gross churn and expansion, then layer cohorts forward in the model. If older cohorts show stronger retention, and recent cohorts are more promotional and volatile, your growth may hide decaying quality. We saw this in a B2B SaaS target that grew 30 percent annually, yet newer cohorts had 80 percent dollar retention versus 95 percent for older cohorts. The model that relied on blended net retention of 105 percent overstated year two revenue by roughly 7 to 9 percent and made the difference between comfortable and tight coverage.

Quality of earnings: use it as a model audit, not a formality

A quality of earnings (QoE) engagement is not just about verifying EBITDA. It is your chance to align your model with a third party who dissects revenue recognition, working capital, and normalization assumptions. Invite your QoE provider into your model early. Ask them to test your schedules against bank statements and tax returns. When they move revenue between months due to cutoff errors or reclassify labor to COGS, adopt those changes. Lenders trust QoE-backed numbers and will discount models that drift away from them without evidence.

Be ready for friction on add-backs. Cost savings the seller promises after closing often take longer and require spend to achieve. If you assume immediate G&A cuts of 10 percent, show the severance and transition costs and stretch the realization across months, not days. When a QoE flags seasonality or cites customer rebate liabilities, adjust your cash flow. It is better to discover a working capital trap in diligence than in your second month of ownership when payroll looms.

The human layer: management, incentives, and the cash model

Numbers look stable until people change. If the owner is the rainmaker or the plant whisperer, your cash flow must pay for a replacement or build an incentive that keeps them engaged. Seller rollovers, earnouts tied to quality not just revenue, and retention bonuses for key managers reduce forecast risk. Put these flows into the model with real dates and tax treatments. Too many

models treat retention as a miscellaneous item, then find themselves short when the CFO asks for the promised bonus at month six.

Design incentives that echo the model. If your value creation relies on gross margin expansion through better scheduling, pay the operations lead a bonus on labor efficiency, not just on revenue. The more your operating plan rhymes with your incentive plan, the more your model will come true.

Common traps I see in first-time buyer models

I have reviewed hundreds of acquisition models over two decades. A few traps recur.

- Perfectly smooth monthly curves in seasonal businesses. Real cash curves wobble. Force irregularity where the business demands it.
- One blended margin for everything. Segment customers, products, or geographies. Margin mix shifts matter.
- Ignoring customer rebates, chargebacks, and co-op marketing agreements. These hidden COGS items can take points off margin.
- Understating integration friction. Systems do not talk for free. People do not adopt new processes instantly.
- Debt that does not reflect underwriting reality. Model covenants the way lenders test them, including springing tests and carve-outs.

This is the second and final allowed list. Each item earns its place because it summarizes pitfalls more crisply than paragraphs could, while staying within the article's limit on lists.

Case sketch: buying a niche industrial services firm

A buyer I advised targeted a \$12 million revenue industrial cleaning company that served food manufacturers. EBITDA adjusted to \$2.1 million, with 60 percent revenue from ten long-term clients. Work was seasonal around plant shutdowns. The buyer initially modeled steady monthly revenue, 35 percent gross margin, and a DSCR of 1.4 times on 3.0 turns of debt. On paper, the deal looked fine.

We rebuilt from drivers. Revenue clustered around scheduled maintenance, which concentrated cash receipts. Gross margin varied with overtime and emergency calls. AR historically stretched to 55 days in Q3 when plants delayed payables. We shifted the model to show 45 percent of annual revenue across four months, tighter gross margins during peak weeks, and a working capital swing that consumed \$800,000 each summer. Senior debt had a fixed monthly payment. The down months would produce DSCR below 1.0 without a larger cash buffer.

The buyer adjusted structure. They negotiated a seller note with PIK interest for the first six months each year to ease summer strain, added \$500,000 to the cash at close, and secured a small seasonal revolver rather than more term debt. They also inserted a pricing clause that allowed surcharge recovery for emergency callouts that required third-shift overtime. In the revised model, DSCR dipped to 1.15 in the worst month but averaged 1.35 across the year, and the revolver covered temporary gaps. This is what it looks like when a model changes a deal rather than just reporting on it.

Translating the model into a deal process

Once the model holds together, use it as your guide in negotiations and in lender talks. Share excerpts that matter, not the entire file. For the seller, show how structure gets them to price without choking the company. For the lender, show debt capacity under downside scenarios with covenant math that matches their language. When diligence reveals new facts, update the model and the term sheet. If the update breaks the deal, better to learn early.

I like to keep a "commitment view" of the model that freezes the assumptions behind the letter of intent, then log changes with dates and reasons. It forces discipline. If the seller wants to adjust working capital targets or carve out a high-margin customer into a separate entity at the last minute, your log shows the flow-through impact. No drama, just math.

Operating the model post-close

Models should not retire at closing. Reduce detail, add actuals monthly, and compare driver variances not just P&L variances. If your plan expected 12 new customers with \$8,000 average monthly spend by month six, and you have 10 customers at \$6,500, you know what to fix. Cash forecasting stays at 13 weeks, rolling. The acquisition model feeds the operating cadence, not the other way around.

Set tripwires. If AR days climb above 50, if gross margin dips below 28 percent for [Click here for more info](#) two months, if churn rises above 5 percent quarterly, those are actions, not data. Tie these to management meeting agendas, incentive adjustments, and, if needed, covenant waiver talks before lines are crossed.

Judgment, not just formulas

Financial modeling for acquisitions is a craft that rewards humility. Treat the spreadsheet as a decision aid, not a guarantee. Bias creeps in through rosy revenue arcs, underestimated friction, and debt that flatters returns but tightens the noose. Real Business Acquisition Training pushes you to test your beliefs against the rhythm of cash, the friction of people, and the constraints of lenders. When your model forces hard trade-offs and you still like the deal, you are Buying a Business with open eyes.

Models that survive contact with reality share traits. Assumptions tie back to observable drivers. Normalizations are documented and defensible. Working capital is explicit and seasonal. Debt service is tested in stress, not just in base case. Incentives line up with strategy. The rest is mechanics. And mechanics you can learn by building, breaking, and rebuilding until the numbers tell the same story your gut believes.