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May 2021

Focus on the Numbers

Numbers can be used to identify and track revenue, manage expenses, understand profit or Loss, manage cash flow, and understand EBITDA (Earnings before Interest, Taxes, Depreciation & Amortization). All of these numbers are often attributed to how a business is valued. The "value" is often estimated by a percentage of revenue, a multiple of profit or even EBITDA amongst other things. Numbers are one of the most critical management tools when understanding a business's success and the ability to make informed decisions.

Our specialties are advising business owners who are wanting to sell, advising business buyers who are wanting to purchase a business, and providing business valuations for many purposes. In each of these scenarios we use numbers ALL THE TIME! We've worked with business owners that understood and heavily relied on numbers to manage business. We've worked with business owners that didn't have the aptitude for the numbers and instead relied on financial professionals, consultants, and staff to provide the financial input. We've also worked with business owners that ignored the numbers and were adamant that they "just knew" what was going on in their business.

If you read this, you might conclude that determining what a business will

Real Estate Value too High vs. Return on Investment (ROI) When Selling a Business

In the last newsletter, we provided an example of a business owner who died after making a substantial expenditure on new equipment. As a result of that large investment, when his wife attempted to sell the business to a senior employee, the business cash flow was insufficient to provide an acceptable ROI to the prospective buyer. It is not uncommon to encounter the same type of obstacle with high-value real estate.

An example of a business that cannot be sold due to the high value of its real estate

Seven years ago, John Smith personally acquired a 10,000-square-foot building on a major thoroughfare in an area that he expected would experience significant commercial and residential growth. After converting the property to an automobile collision repair shop, he had invested \$400,000. Since John owned the real estate personally, he had his company pay him annual rent of \$30,000 per year to cover the mortgage payment. Four years ago, John had an evaluation of his business which determined that his Seller's Discretionary Earnings (SDE) was \$125,000 after deducting the \$30,000 rent expense. The business was valued at approximately \$335,000 and it was assumed that the real estate had a value of \$450,000. Last year, Walmart built a new shopping center across the street, and McDonald's built on an adjacent lot. In the meantime, John's business had remained steady with approximately the same level of revenues and expenses, so he assumed the SDE was still about \$125,000 and the business value was still about \$335,000. But as he had hoped, the real estate value had increased significantly to approximately \$1,200,000. John assumed, wrongly, that he could sell the combined real estate and business for \$1,535,000. Why was he wrong? The mortgage payment on the increased value of the real estate has to be factored into the computation of SDE. Here's what that means:

SDE, per adj. financial statements	\$125,000
Add back rent owner paid himself	<u>30,000</u>
Subtotal	\$155,000
Impute the annual mortgage payment on \$1,200,000 of real estate 20% down payment, 7.5% interest, 20-year amortization	<u>(93,000)</u>
Adjusted SDE	\$ 62,000

At this level of SDE, the business may not even be able to be sold. Would a buyer of the business be willing to make a \$240,000 (20%) down payment on a \$1,200,000 piece of real estate that requires him to work full time in a business where he may not even be able to pay himself

sell for, be acquired for or be valued at is a matter of examining the numbers. It's not always that simple or straight-forward but one thing is for certain, numbers play a significant role. When we are advising our clients, we always include a summary of the financial aspects of a business that is for sale. We also ask for the same information when advising business owners who are looking to acquire other businesses. Financial statements and tax returns provide a lot of valuable information but don't tell the entire story of how a business is performing. Other numbers that we take into consideration are customer concentration, Invoice payment terms, supplier payment terms, profitability by customer, and other similar calculations. These and other "numbers" will determine how much risk a buyer will accept and ultimately is willing to pay.

If you are considering the sale of your business or would like to understand its value for any reason, let's get together. Please call or E-mail any time.

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\$50,000? It is highly **unlikely**. Despite the real estate being worth \$1,200,000, the combination of selling the business and the real estate is not likely to occur at more than \$1,250,000 - \$1,300,000, if at all. In other words, in light of the debt service on the real estate, the business value itself is probably only \$50,000 - \$100,000, assuming it can be sold at all.

Consider moving the business

In reality, because the business may never sell, John may cash out sooner by just selling the real estate and closing the business. Or he could relocate the business to less valuable real estate and probably succeed in selling the business once he's proven his customers have followed him to the new location.

I know personally of similar scenarios over the years. In fact, one owner for whom we performed an evaluation several years ago realized that he needed to move his company out of its existing location to be able to maximize the proceeds from the sale of his real estate, and ultimately his business. By doing so, he was well on his way to setting himself up for a successful retirement.

Have you monitored the value of your Real Estate versus the Enterprise Value (fair market value as an ongoing concern) of your business?

NEXT ISSUE

LARGE WORKING CAPITAL REQUIREMENTS

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