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What Determines Business Value?

We recently worked on the sale of a business that had some unique aspects, definitely more than most. While we identified many potential buyers, they spent quite a bit of time evaluating it to come up with suitable offers. Because of the unique aspects of this business and how it might be valued, I reached out to Shawn Hyde; he heads the International Society of Business Analysts (ISBA). Shawn and the ISBA have been an important resource for us when valuing Businesses.

Shawn's answer was pretty simple. *"Value comes from the potential income stream for a business. It is valued based on the risk of that income stream in the future. Value = income / risk. The hard part is making sure the risk rate matches the income stream being measured."* As is often the case, difficult issues usually have a solution based on a simple concept. Applying the concept means looking at the factors that will or might change it.

Two buyers looked at Business A. One will relocate the

Excessive Personal Expenses and Skimming Cash When Selling a Business

In reviewing a marketing package for the sale of a business, one of the first things a buyer is going to see is the normalization of cash flow (SDE) that show those "junked up" or messy personal expense add-backs. First impressions are lasting impressions and messy normalizations definitely create a negative impression from the beginning.

Types of personal expense add-backs when selling a business

Personal expense add-backs might include a number of non-business expenses related to vehicles for you and your family; household; travel, vacation, and entertainment; insurance; professional fees; membership dues; country clubs; and season tickets. It may also include payroll checks to family members not working in the business, etc.

A buyer will want a seller to prove those non-business add-backs. Particularly if they are material to the calculation of SDE, a buyer is not going to just take the seller's word for it. The need to prove/verify those add-backs can lead to some uncomfortable moments for both parties during the acquisition process.

There are three reasons to eliminate or minimize personal expense add-backs

- 1) Avoid messy cash flow (SDE) normalization. Buyers prefer businesses that are clean. Some buyers are permanently turned off as soon as they see such a presentation. Especially if the add-backs are immaterial, (\$200 here, \$350 there), **it's better to not add them into SDE.**
- 2) ***Buyers tend to be distrustful lot.*** If a buyer sees personal expenses that are so exorbitant that they may border on tax evasion, they begin to lose faith in the integrity of the seller. They may think, "If you're not being honest with the IRS, how can I expect you to be honest with me?"
- 3) Many business sale transactions are financed by lenders. While you may be able to convince a buyer that personal expense add-backs are justified, **lenders will not consider those expenses as part of SDE for their evaluation purposes.** In other words, if you have \$150,000 in SDE, which includes \$25,000 of personal expenses, the bank is only going to evaluate the business on \$125,000 of

Business for a lot of good reasons. Another will keep it where it is, but to grow will need to add to the facility. Both have upcoming costs to consider for their prospective plans. Business B is easy to relocate, and one buyer will move it into his existing facility, but employees will not move. Another buyer has a facility a mile away and whether it moves to an adjacent facility or not they should be able to retain employees. Business C has one large customer that makes up for 80% of their sales. Seller has a great relationship with the main customer contact but what happens when the contact retires? How secure is the business from that customer and does the customer have legitimate options to replace the business?

In the examples above, businesses A, B, and C all successfully produce and sell products, but what risks exist? Do the products have life cycles? How long do they last before wearing out? Are they subject to being replaced by the next, best version? Can they be knocked off by cheaper materials or lower production costs? There are many questions to consider, and all are relevant to each specific buyer.

Risk is most often different for each potential buyer. How will the buyer operate it? What's the buyer's plan? Who will replace the departing

SDE. In small business lending evaluations, it is not unusual for the personal add-backs to be such a significant portion of SDE that the lender is unable to approve the financing of the acquisition.

Clean records help facilitate a smooth business sale

Many owners have been running small personal expenses through the business for so long, they've forgotten about them. Family cell phone bills, family insurance bills, family automobile repairs, etc., can be so routine, you almost forget they are non-business. Those expenses can add up quickly and significantly reduce SDE.

In preparing for a sale of your business, the best thing to do is to completely eliminate those non-business expenses so you can maximize cash flow (SDE), thus maximizing the value of your business. It's also best to eliminate non-essential business expenses. A couple of years of "clean" records will make the selling process smoother and yield a higher sale price.

Stop skimming cash when selling a business

In my extensive years of business brokerage, I've been continually flabbergasted by the amount of cash that prospective sellers indicate "never sees the light of day." First of all, I'm not really interested in hearing about it and neither are prospective buyers. They will not pay for cash that is not run through the company's books, nor should they. Sellers cannot "have their cake and eat it, too." Again, buyers may perceive the skimming of cash as a trust issue. So, if you are skimming cash, keep it to yourself. But when it comes to preparing to sell your business, stop doing it, period. The extra cash flowing through the company coffers will increase the value of the business, likely by a factor of two to four times the unreported cash.

Excessive tax avoidance negatively impacts your ability to sell C-Corporation stock

In a previous newsletter, we discussed how to avoid double taxation of a C-Corporation, a possible alternative is for the C-Corporation owner (stockholder) to sell his shares of stock in the corporation (as opposed to the corporation selling its assets) to achieve favorable capital gains tax rates.

Prospective sellers should be aware that **buyers are unlikely to acquire the stock of a C-Corporation that has a potential tax liability for excessive personal expenses run through the business or for skimmed cash. This is just another reason to run your business on the "up and up."**

Do you need to minimize the personal expenses you run through your business?

owner? What skills are needed? Can the seller's contacts be retained? Will the business be relocated? Will employees stay? Is there a customer concentration? Is there a large supplier? What about competition? What about general economic factors? If business slows, can it meet debt obligations? So maybe "simple" isn't simple at all, and certainly different for each buyer.

What really happens is that for a buyer to acquire a business, a PLAN to operate the Business is essential. If the buyer believes in the plan and is willing to take on the risk, an offer will be forthcoming. If the offer (to be negotiated) is acceptable to the seller, a deal will get done. It's not complicated, but getting there is.

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NEXT ISSUE

Burned Out Owner Ruins Business Value

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