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Offsite Planning

It's not uncommon for many business owners and leaders to take a break from the day to day running of their businesses to head offsite for planning purposes. In fact, it's a widely accepted practice that allows for uninterrupted planning, budgeting and strategic decision making that is often critical to a business' success.

But why offsite?

Studies have shown that a change in scenery renews energy, creativity, and the focus of the team. It allows everyone the opportunity to step out of their comfort zone and openly discuss current challenges as well as new ideas.

Another important reason for offsite planning is to find neutral space to evaluate whether or not a business owner might consider selling or potentially acquire another business. A neutral location can help with critical decisions by reducing or removing distractions.

If you are curious about the financial or other aspects with sale of your Business, or considering growing your business, through acquisition or otherwise, let's get together to discuss the situation and explore options. We are happy to help and be part of your offsite planning, selling, or buying experience. There is no cost or obligation, but there is an opportunity that you may regret missing if you do nothing!

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Losing Focus - Business Decline during Business Sale Process

On lists of deal-killers, this obstacle is often near the very top. Nothing is more important than keeping your focus on maintaining the operations and profitability of your business while you are involved in the sale process.

Owners losing focus happens often for two reasons:

- (1) after going through the emotional decision of making the decision to sell, some owners mentally check out and spend significant time focusing on their after-sale life;
- (2) some owners become too focused on the sale process at the expense of maintaining their business.

This is a huge obstacle and here's why. In a previous issue of this newsletter series, Inadequate Seller's Discretionary Earnings (SDE), we explained that your business' value is primarily based on SDE. Buyers, their advisors, and their lenders assign more importance to the most recent fiscal year's SDE than the previous fiscal year's SDE. If your recent earnings are less than previous earnings, the recent earnings will depress the value of your business.

An example of declining SDE with a \$135,000 negative effect

Let's look at an example using three years of the same SDE numbers, but in a different order. Let's assume increasing annual SDE as follows: Year 1 SDE = \$250,000, Year 2 SDE = \$300,000 and Year 3 SDE = \$315,000. The three-year average of SDE is \$295,000, and at a multiple of 3.0, the business is valued at \$885,000 (3.0 x \$295,000).

Now let's assume the same numbers in decreasing order: Year 1 SDE = \$315,000, Year 2 SDE = \$300,000 and Year 3 SDE = \$250,000. Because the most recent year is substantially less than the previous two years, the buyer, his advisors, and lenders are only going to value the business based on the most recent year's SDE (\$250,000), not the three-year average SDE (\$295,000). Valuing the business at a multiple of 3.0 on the \$250,000 of SDE yields a valuation of \$750,000. That's \$135,000 less because the current year's SDE was less than the previous two years' SDE. **It is a very important concept to understand.**

The same concept applies to your interim earnings in the year of your attempt to sell the business. Buyers, their advisors, and lenders will always request to see a comparison of your current year-to-date earnings vs. previous year-to-date earnings for the same period of time.

Continuing the example, but with a 33% reduction in value

Again, let's look at an example. Let's make the same previous assumptions where the business was valued at \$750,000 based on the most recent year's SDE of \$250,000. Let's assume you file tax returns on a calendar year ending December 31 and you receive an offer for \$750,000 on June 15 with closing scheduled for August 15. The buyer, his advisors, and lenders are going to request to see your financial statements for the six months ending June 30 of the current year (Year 4) and will want to compare those results with the first six months of Year

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NEXT ISSUE

Lack of Negotiation Flexibility

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3. If we assume your business is not seasonal and earnings occur pretty much on a straight-line basis, as of June 30 of Year 3, the earnings would be \$125,000 (1/2 of the \$250,000 SDE of Year 3). If you provide six-month financial statements for Year 4 that show less year-to-date SDE than Year 3, there's going to be a big problem, resulting in either termination of the transaction or a downward adjustment to the purchase price.

Let's continue the example. If you have a six-month Year 4 SDE of \$90,000 vs. the \$125,000 SDE of Year 3, it appears your projected SDE for Year 4 would only be \$180,000 (2 X \$90,000) vs. the \$250,000 SDE of Year 3. Now a buyer can legitimately argue, at a multiple of 3.0, the business is only worth \$540,000 (3 x \$180,000). In addition, at a level of \$180,000 of SDE, the threshold for achieving a 3.0 multiple may no longer be valid. At a multiple of 2.8 times the Year 4 projected SDE of \$180,000, now the business values at \$504,000. That would be \$246,000 less than the \$750,000 offer you accepted, a 33% reduction in value!

Maintaining focus is extremely important

Until due diligence is completed, including the buyer's review of your interim operating results, the buyer can usually escape the transaction or attempt to renegotiate the offer. Can you see how difficult it would be to successfully resolve the situation created in the example above? After seeing the interim results, the lender will not finance the transaction at an acquisition price of \$750,000. The buyer and his advisors will want to renegotiate to a level of about \$500,000 to \$550,000. The seller will not want to accept 25 - 33% less than the original offer. Unless the seller gives in, this deal is likely to fall apart, and the seller will likely have to take the business off the market if he is unwilling to settle for less than his original asking price. The example above is a painful scenario, but it happens - way too often.



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