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**RE: EVALUATING A BUSINESS**

Over the years I have encountered scores of would-be business buyers who had one critical shortcoming: they didn't know how to calculate a realistic value for the business they were determined to buy. Unfortunately, in many of these cases they went ahead with the purchase and suffered some tragic consequences. Essentially, their emotions won out over sound logic.

Here's a typical case study. Last year I was contacted by a lady from another state who wanted me to "coach" her regarding the acquisition of a retail business in a popular tourist area. The seller was asking \$1.2 million for both the business and the real estate. Rachael (not her real name) had already emotionally purchased the long-established boutique, but to her credit, wanted some verification before making an offer.

In order to evaluate the business, I asked Rachel to get me the business's tax returns for the last three years (2001, 2002 and 2003) along with the most current income statement and balance sheet for 2004. I also requested a description of the real estate and a list of the assets that were being transferred in the sale, including the value of the existing inventory.

After obtaining the requisite information, I discussed the property value with some of the retail specialists in my office. At the heart of the discussion was the question, does being on the National Historic Registry make a property more valuable, and if it did, how much more valuable? To my surprise, the consensus was that being on the National History Registry could be a detriment well as a blessing because of the restrictions that can be placed on the property to maintain the designation.

I then reviewed the sale prices of properties that have sold in Albuquerque's historic Old Town and found that most of the buildings sold at a multiple of between \$95.00 and \$150.00 per square foot. I asked Rachael to supply me with "comps" from her resort area and they showed a similar multiple range of \$75.00 to \$135.00 per square foot. The subject building was 3,300 square feet in size and situated on a 5,000 square foot lot. If I applied the high end of the multiple range, \$135.00 per square foot, the value of the building would be nearly \$450,000.

Using a mid-range multiple of \$105.00 per square foot, the value would be closer to \$347,000. Having established a target range of value for the real estate, I next turned my attention to the value of the retail business.

Most small businesses are valued at a multiple of 2.0 to 3.0 times cash flow. Businesses with declining sales, obsolete equipment, month-to-month leases or other serious problems, court the bottom end of the scale, while the established "shooting stars" command the top multiple. The trick is to determine the true cash flow of the business so a fair multiple can be applied.

Like many business owners who own rather than lease their premises, this owner did not have an *arms-length* lease agreement and therefore was not charging the business any rent. When trying to determine the cash flow of a business, some premises cost must obviously be included in the operating expenses. If we peg the building's value at \$347,000 (certainly no more than \$450,000), a fair market rent can be calculated using 10% of the building's value. This would create a fair market rent of about \$35,000 per year with a top-end of \$45,000.

Most business appraisers consider cash flow to be the earnings of a business before interest, depreciation, taxes and amortization (EBIDTA) are expensed. In laymen's language, cash flow is the money left over after all the bills have been paid, but before owner's compensation and debt service. In my analysis of the cash flow, I included all owner's compensation, i.e. wages, personal insurance, pension plan and other benefits, because they can really skew the net profit of any business depending on how well an owner treats himself or herself.

The business in question had a net profit of \$39,000, depreciation of \$6,000, interest of \$14,000 and an owner's compensation package of \$55,000, for a total cash flow of \$114,000. When the fair market rent of \$35,000 was deducted from the cash flow, the net result was \$79,000. Because the boutique's sales had been slipping over the past three years, I felt a cash flow multiple of 2.4 would be appropriate, giving the business a value of about \$190,000 (including its assets).

When the estimated value of the business (\$195,000) was added to that of the real estate (\$330,000) the result was a total value of about \$525,000 - less than half of the \$1.2 million requested by the seller. If Rachael had paid the asking price (which would have required an investment of more than \$250,000), the resulting debt service would have destroyed her (assuming some financial entity would have funded the acquisition).

When Rachael reviewed my report, she was understandably disappointed, but nonetheless, happy that she didn't make what could have been the biggest mistake of her life.