

Is The Business Overpriced?

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Very often I am asked by potential buyers: How do I determine if the business is priced correctly? Of course, my pat answer involves suggesting a third party evaluation-- which usually invokes a break out of hives all over their body. Very few buyers are willing to spend money for such evaluations. Therefore, I wind up explaining to them the basics of cash flow analysis. Bottom line—the seller’s discretionary cash flow should cover three items: A fair owner/management salary, debt coverage, and a return on the cash invested.

What is considered a fair owner/management salary? Personally, I have found the best source for national salary estimates is the U.S. Department of Labor--Bureau of Labor Statistics. (www.bls.gov) This site provides national labor rates for various occupations. Once the rate is determined, subtract it from the “seller’s discretionary income” to arrive at the “free cash flow”. This “free cash flow” is the remaining amount of cash flow to cover debt service and hopefully a return on your investment.

Cash Flow Formula

Gross Sales - Cost of Goods Sold – Expenses = Net Income

Net Income + Add Backs = Seller’s Discretionary Income

Seller’s Discretionary Income - Owner/Management Salary = Free Cash Flow

Free Cash Flow - Debt Service = Return on Investment

Debt service involves determining the prevailing commercial interest rate and the loan-to-value ratio for the type of investment you are considering. A handy tool to use is the Small Business Administration (SBA) formula (max percent above prime) found on their website: www.sba.gov along with the current “prime interest rate” published by most commercial lenders. Once this is determined, you will need to amortize the

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expected loan to produce the monthly payments required to service the loan. Multiply the monthly payment by 12 months to arrive at the annual debt service required.

Hopefully, when you subtract the debt service from the “free cash flow” there is an amount remaining for a return on your investment.

Determining Debt Service

Prime rate = 8.25% plus (SBA max points charged—terms longer than 7 years) 2.75% = 11%

Loan Term = 15 years LTV (Loan to Value) = 80% Down payment = 20%

\$450,000 Sales Price Down payment = \$90,000 Amount Financed = \$360,000

Monthly Payments = \$4091.75 x 12 months = \$49,100.99 (Annual Debt Service)

Once the debt service is determined it needs to be subtracted from the “free cash flow” leaving (hopefully) an amount left over as a return on your cash invested. This remaining amount needs to be divided by the cash invested to ascertain the percentage return on your investment.

Return on Cash Invested

Free Cash Flow = \$76,000 Minus Debt Service \$49,100.99 Equal \$26,899.01

\$26,899.01 divided by \$90,000 (Down Payment/Cash Invested) = 29.89%

Obviously this particular investment yielded a respectable return on the cash invested. Not all investments perform as well. The cash flow analysis is definitely simple to perform and will act as a good “first check” on any business evaluated. Needless to say, the most time consuming task is not performing the cash flow analysis-- it is verifying the “seller’s discretionary income” because any so called bogus “add-backs” or inflated amounts could distort the whole analysis. In addition, a comprehensive examination of the income statement is also performed prior to analyzing cash flow.

Appraisers use various methods in appraising a business, and many factors will need to be considered. Ultimately, value is determined by what a buyer is willing to pay and what a seller is willing to sell for. However, the seller's discretionary cash flow from a business should cover these three items: It must compensate you for the time you invest in running the business, it must cover the debt service and it must compensate you for the money you invest in the company. If the business investment can cover all three of these things it may be a good candidate to consider spending your hard earned cash on. However, there are other items to consider when evaluating a business such as capital set-aside for continued growth. Remember, we just looked at the business from a purely investment perspective. Not all business purchases are made for investment purposes. Believe it or not some people buy a business because they really enjoy the work—go figure?