

# FRB's "Buying Or Selling A Business" Series

## Understanding Valuation and the Financial Aspects of the Transaction

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### Front Range Business, Inc.

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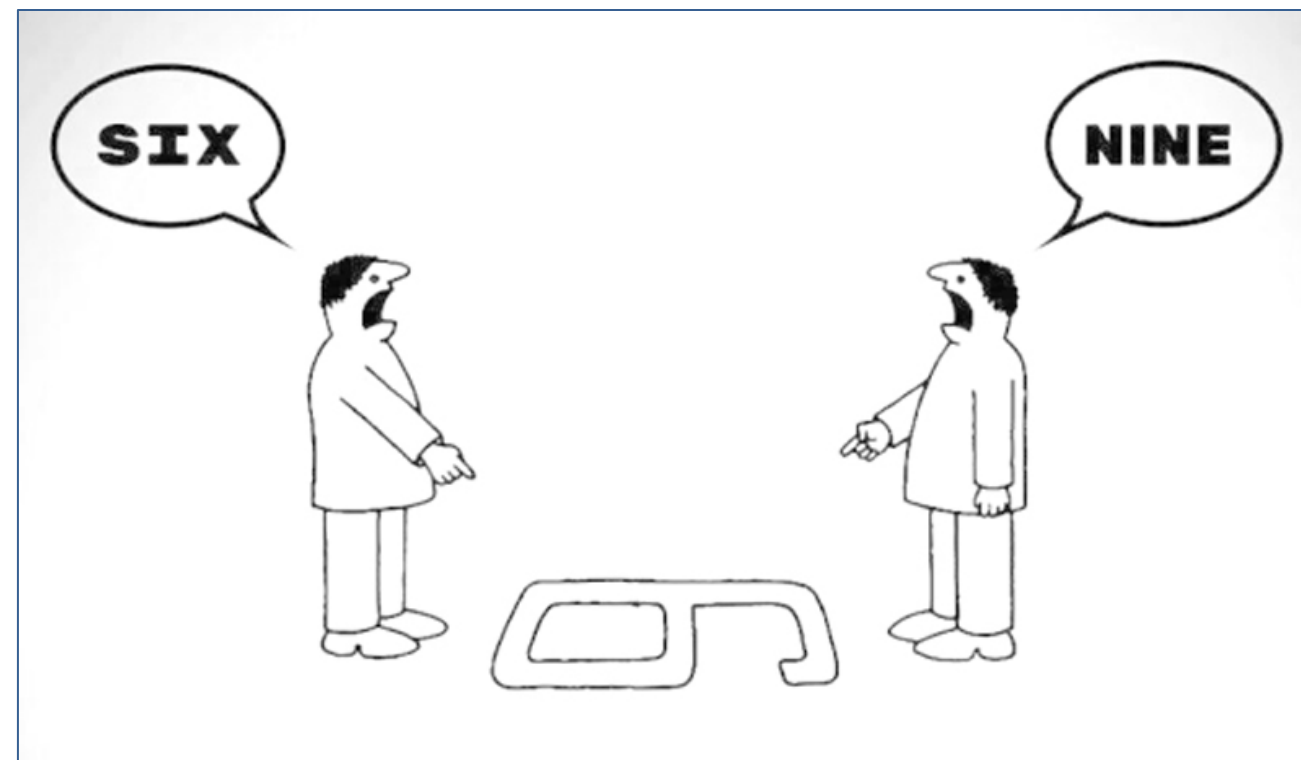
*Offices In Boulder, Denver, Evergreen,  
Fort Collins, and Breckenridge*



*Bill Scott  
Don Hobbs  
April 22, 2021*

# Shared Vision

*A successful transaction depends on all parties having a shared vision.*



# Today's Program Topics

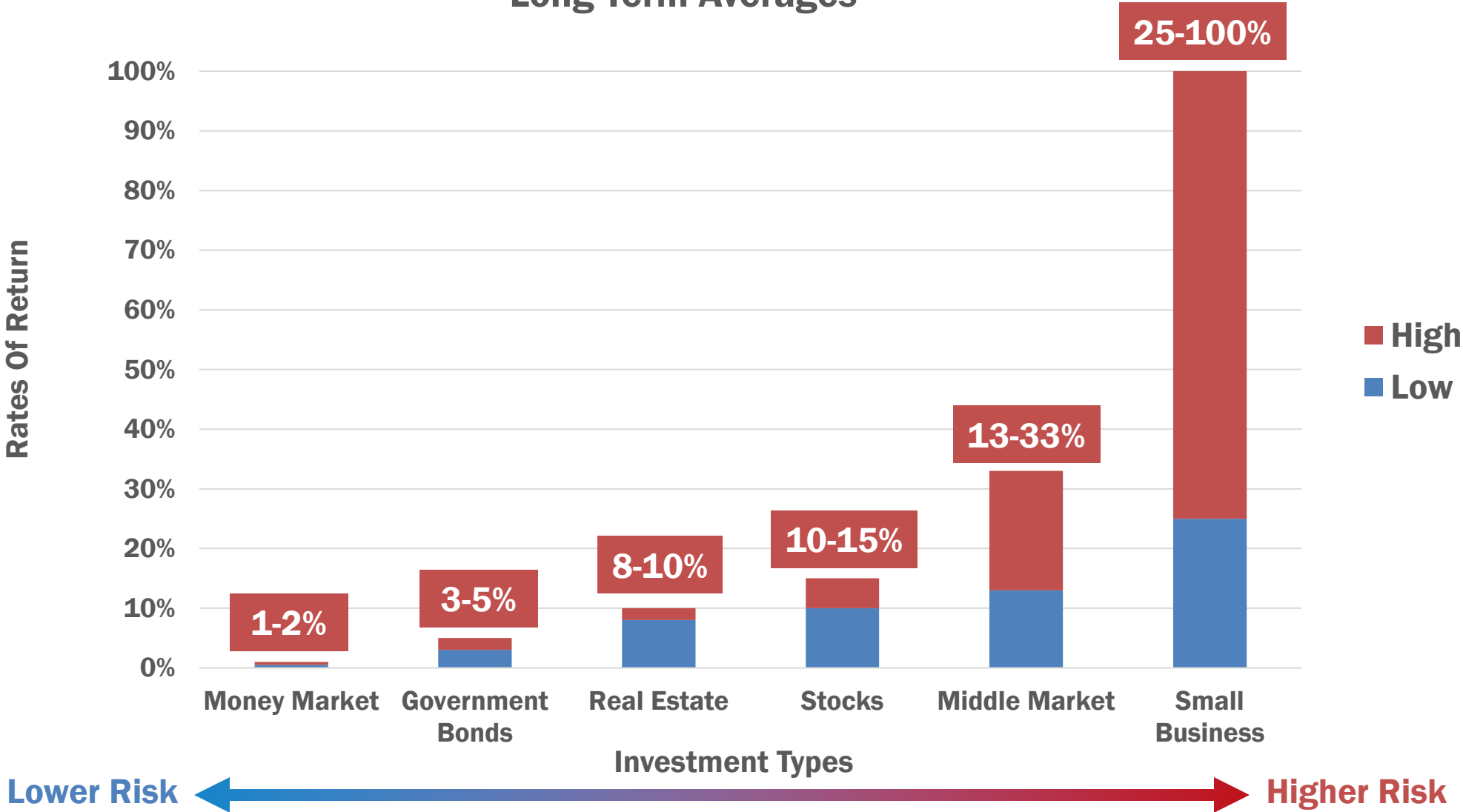
- *Expected Returns - Rationale To Invest*
- *Primary Elements Of A Business Sale*
- *Business Valuation*
- *Financing the Transaction*
- *Purchase Price Allocation*

# 1

## Expected Returns - Rationale To Invest

# Annual Investment Returns

Long Term Averages



# Reasons to Buy an Existing Business

- *Access immediate cash flow*
- *Seller has gone through learning curve*
- *You buy a slice of the pie (existing market)*
- *Business-specific training provided*
- *Risk may be lower and/or quantifiable*
- *Potential to improve the business*
- *Investment leverage through SBA loan*

# Business Returns Must Support...

- *Acquisition Loan Repayment*
- *Working Capital Loan Repayment*
- *Taxes*
- *Business Reinvestment*
- *Owner Lifestyle*

# 2

## Primary Elements Of A Business Sale



# Focus on Asset Sales

- *Seller retains possession of the business entity*
- *Buyer creates a new company or uses existing one to acquire*
- *Some or all assets of the business transfer*
- *Seller retains existing and contingent liabilities such as accounts payable, taxes, pending litigation, etc. (Note: taxes follow the assets!)*
- *Seller retains cash, accounts receivable, etc.*
- *Deposits, gift cards, work in progress negotiated*

# 4 Elements Of A Business Sale

- *Real Property Interests*
- *Tangible Assets (Personal Property)*
- *Goodwill / Intangible Assets*
- *Working Capital Needed*

# Real Property - Seller Owns

- *Sell to business buyer*
- *Retain, become landlord, lease to biz buyer*
  - *Rent may need normalization*
- *Sell to 3<sup>rd</sup> party on open market*
  - *The most complicated approach*

# Real Property – 3<sup>rd</sup> Party Owns

- *Buyer leases real property from landlord*
  - *Assignment or new lease*
  - *Meet SBA loan requirements*
- *Leasehold improvements*
  - *Required for business operations*
  - *Belong to landlord*

# Tangible Assets

- *Furniture, Fixtures, Equipment (FF&E)*
  - *Machinery, field equipment, tools*
  - *Office furniture, retail fixtures*
  - *Vehicles*
- *Inventory (At cost, usually included in price)*
  - *Saleable*
  - *Appropriate levels*

***Assets Exist to Generate Profits!***

# Working Capital

- *The money a buyer needs in addition to sales price for efficient operation of the business*
- *Unique needs for each business*
  - *Restaurant will cash flow daily*
  - *Manufacturing may need large reserves*
- *Typically NOT included in asset sale*
- *Factors into SBA lending*

# Goodwill / Intangible Assets

- *Customer Lists / Contracts*
- *Trade Name / Trademarks*
- *Patents / Intellectual Property*
- *Website / Social Media*
- *Experienced Employees*
- *Quality of Location*
- *Documented Systems and Processes*
- ***PROFITABILITY!!!***

# Simply Put...

*Goodwill is the difference between the selling price of a business and the value of its physical assets.*



# 3

# Business Valuation

# Value Influencers

- *Industry Desirability*
- *Sales Profile / Concentration*
- *Customer Base / Stickiness / Contracts*
- *Recurring vs. Project Revenue*
- *Competition / Barriers to Entry*
- *Owner Role / Mgmt / Staff / Labor Base*
- *Facility / Capacity / Technology*
- *Location / Lease*
- *Growth Outlook / Scalability / Economy*
- *Size Matters*

# Value By Multiple of Earnings

$$\text{“Earnings”} \times \text{“Some” Multiple} = \text{Business Value}$$

- *Most common method, provides apples to apples business comparison*
- *“Earnings” types*
  - *EBITDA: Larger, professionally managed business*
  - *Sellers Discretionary Earnings (SDE): Smaller, owner-operated business*

# Sellers Discretionary Earnings

- *All of the financial benefit that one working owner can derive from the business, assuming no debt*
- *While valuation calculation is based upon historical performance, value must be transferable to the new owner*
- *Must be paid by the business and recorded on financial statements and taxes*

***Unreported Income Is Not Included!***

# Calculating SDE

*Begins with a thorough analysis and understanding of the most recent 3-5 years of financials:*

- *Business Tax Returns*
- *Profit & Loss (P&L or Income) Statements*
- *Balance Sheets*
- *Monthly Sales*
- *Accrual Based Accounting*

# Calculating SDE

*Identify the following elements and accurately establish and line item their financial impact:*

- + *EBITDA / Net Income*
- + *Owner's Salary & Benefits*
- + *Depreciation, Amortization, Interest Paid*
- +/- *Non-operating (one time) Expense or Revenue*
- +/- *Normalized Expenses or Revenues*
- + *Reasonable (Provable) Discretionary Expenses*

# EBITDA / Net Income

- *“Bottom Line” of P&L (must match taxes)*
- *Often deliberately low as a tax strategy*

*ABC Company Net Income \$150,000*

# Owner's Salary + Benefits

- *Owner W-2 wages (+ company paid payroll tax)*
- *Guaranteed payments*
- *Owner health, life, and disability insurance*
- *Owner retirement plans – IRA, 401K, SEP*
- *Distributions NOT included*

*Owner Salary + Benefits*     \$175,000

*SDE Subtotal*     \$325,000



# Financial Items

- *Depreciation (non-cash expense)*
- *Amortization (non-cash expense)*
- *Interest (SDE assumes no debt)*

<i>Depreciation</i>	<i>\$40,000</i>
<i>Interest</i>	<i>\$10,000</i>
<i>SDE Subtotal</i>	<i>\$375,000</i>

# One Time Expense or Revenue

- *Relocation / Remodel*
- *Legal or Accounting Matter (non typical)*
- *Inventory Adjustment*
- *Specialized Eqpt/Software (not capitalized)*
- *Gain/Loss on sale of assets*

<i>Relocation</i>	<i>\$50,000</i>
<i>Legal Matter</i>	<i>\$10,000</i>
<i>Sold Vehicle</i>	<i>\$10,000</i>

***SDE Subtotal*** ***\$425,000***

# Normalized Expenses

- *To make P&L reflect typical new owner's reality*
- *Common adjustments:*
  - *Seller owns real property, rent changes*
  - *Family member salaries change to market rates*
  - *Income & Expenses Accounted for in Other Years*

<i>Spouse Unpaid Accting</i>	<i>\$25,000</i>
<i>Rent Adjust</i>	<i>\$25,000</i>

<i>SDE Subtotal</i>	<i>\$375,000</i>
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# Discretionary Expenses

- *Non-Business Travel & Entertainment*
- *Actual Charitable Contributions*
- *Personal Benefit*
  - *Cars, Tuition, New Home Patio(!) and More*
- ***Buyer & lender may have different opinions!***

<i>Personal Vehicle Use</i>	<i>\$10,000</i>
<i>Charitable Giving</i>	<i>\$5,000</i>
<i>Student Tuition</i>	<i>\$10,000</i>

<b><i>SDE Subtotal</i></b>	<b><i>\$400,000</i></b>
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# \$150K Net Income vs. \$400K SDE

<i>Net Income</i>	\$150,000
<i>Owner Salary + Benefits</i>	\$175,000
<i>Depreciation</i>	\$40,000
<i>Interest</i>	\$10,000
<i>Relocation</i>	\$50,000
<i>Legal Matter</i>	\$10,000
<i>Sold Vehicle</i>	<b>\$10,000</b>
<i>Spouse Unpaid Accting</i>	<b>\$25,000</b>
<i>Rent Adjust</i>	<b>\$25,000</b>
<i>Personal Vehicles</i>	\$10,000
<i>Charitable Giving</i>	\$5,000
<i><u>Student Tuition</u></i>	<u>\$10,000</u>
<b><i>Sellers Disc Earnings</i></b>	<b>\$400,000</b>

# That's Earnings, Now The Multiple

- *Your business is unique....just like everybody else's business!*
- *Multiple range spans 1X to 4X SDE*
- *Larger business, larger multiple*
- *Remember the Value Influencers?*
- *2.5X is the national average, minimal drift*
- *Rules change for businesses > \$10-20MM revenue, or in certain categories (technology, food products, etc.)*

# Valuation Statistics

Level	Median Revenue	Median Sale Price	Median SDE	SDE Multiple
1 <sup>st</sup> Quintile	\$2,323,249	\$1,037,799	\$345,933	3.0
2 <sup>nd</sup> Quintile	\$820,652	\$338,392	\$147,127	2.3
3 <sup>rd</sup> Quintile	\$446,000	\$183,490	\$87,376	2.1
4 <sup>th</sup> Quintile	\$240,192	\$110,306	\$61,281	1.8
5 <sup>th</sup> Quintile	\$112,571	\$62,773	\$36,925	1.7
Average	\$788,533	\$346,552	\$135,728	2.2
Based On 4,287 Business Sale Transactions From Pratt's Stats 2010-2015				
Source: Business Valuation Resources				



# Valuation Statistics

## EXHIBIT 9. MEDIAN SELLING PRICE/SELLER'S DISCRETIONARY EARNINGS BY SECTOR (PRIVATE TARGETS)

## Median SDE Multiples

NAICS	NAICS Industry Sector	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Avg.
23	Construction	2.5	2.3	2.9	2.4	2.5	2.6	2.3	2.4	2.1	2.2	2.4
31-33	Manufacturing	2.8	3.0	3.6	3.5	2.9	2.9	2.9	2.9	2.8	2.6	3.0
42	Wholesale Trade	3.1	3.4	2.7	3.5	3.7	3.2	3.2	3.6	2.6	2.9	3.2
44-45	Retail Trade	2.3	2.5	2.8	2.5	2.8	2.9	2.8	2.5	2.3	2.3	2.6
48-49	Transportation and Warehousing	2.5	2.2	2.7	3.7	2.7	3.3	3.2	1.9	2.5	2.6	2.7
51	Information	2.1	1.5	2.8	2.4	3.5	2.5	3.4	3.7	2.8	2.2	2.7
52	Finance and Insurance	3.0	2.6	4.3	3.5	3.4	3.4	5.1	3.5	3.8	3.5	3.6
53	Real Estate, Rental, and Leasing	2.1	2.5	2.7	2.3	2.6	2.2	2.4	2.9	2.3	2.4	2.4
54	Professional, Scientific, and Technical Services	2.5	2.6	2.4	2.4	2.7	2.5	2.4	2.2	2.2	2.3	2.4
56	Administrative, Support, Waste Mgmt., and Remediation Svcs.	1.8	2.2	2.5	2.4	2.5	2.3	2.3	2.4	2.2	2.2	2.3
61	Educational Services	2.1	2.1	2.6	1.8	2.9	2.0	2.2	1.9	1.8	2.3	2.2
62	Health Care and Social Assistance	1.5	2.3	1.5	1.7	2.0	2.1	2.1	2.2	2.6	2.0	2.0
71	Arts, Entertainment, and Recreation	1.8	2.0	2.9	2.4	2.8	2.8	2.7	2.7	2.6	2.1	2.5
72	Accommodation and Food Services	1.7	2.0	2.1	2.0	2.1	2.2	2.1	2.0	1.8	2.0	2.0
81	Other Services	1.7	2.3	2.1	2.0	2.0	2.3	2.2	2.3	2.0	2.1	2.1
	<b>All Sectors</b>	<b>2.1</b>	<b>2.4</b>	<b>2.5</b>	<b>2.4</b>	<b>2.5</b>	<b>2.5</b>	<b>2.6</b>	<b>2.5</b>	<b>2.3</b>	<b>2.3</b>	<b>2.5</b>

Note: Each data point in this chart is based on a minimum of 10 transactions of private targets. If an industry sector does not meet this criterion, it is not included in the chart.

[bvresources.com/dealstats](https://bvresources.com/dealstats)

\*FRB edits in red

DEALSTATS VALUE INDEX | 3Q 2020

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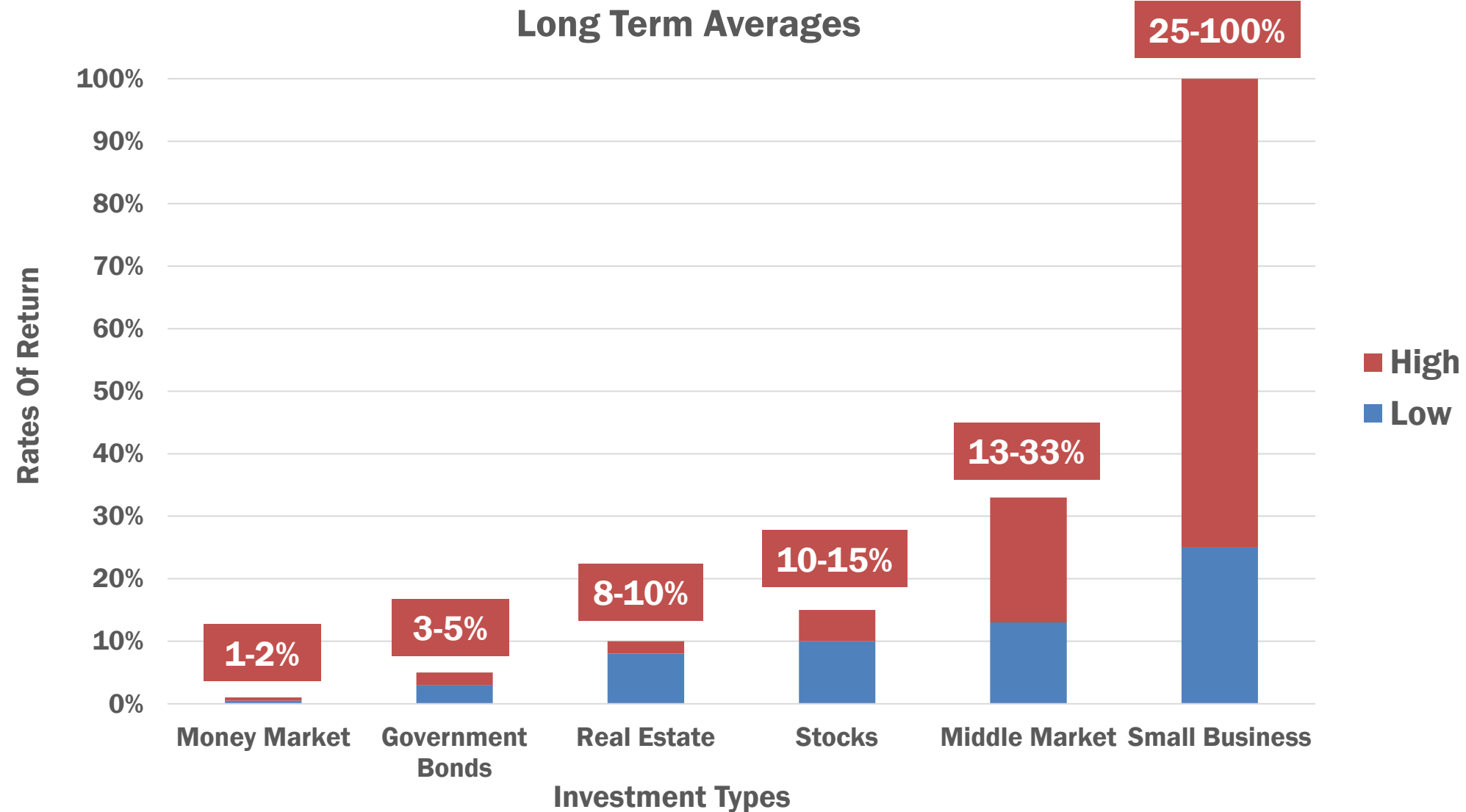


# Valuation Result

$$\begin{array}{rcl} \text{SDE Earnings} & & \$400,000 \\ & & \\ \text{Multiple} & & \underline{\quad \times 2.5 \quad} \\ \text{= Business Value} & & \$1,000,000 \end{array}$$

*\*Multiple Assumed for this Example*

# Traditional Returns



Lower Risk

Higher Risk

# 4

# Financing the Transaction

# Only 3 Sources Of Funds

**Buyer  
Cash**



**Lender  
Financing**



**Seller  
Financing**



# Buyer Cash (Equity / Down Pmt)

- *Commonly 15% - 25% of Price*
  - *Personal bank accounts*
  - *Liquidate stocks/mutual funds*
  - *Home equity loan*
  - *Liquidate IRA or retirement plan*
  - *Rollovers as Business Startups (ROBS)*
  - *Family & friends (equity or gift)*
- *Will also need working capital!*

# SBA Lender

- *Commonly 65% - 80% of Price*
  - *Offer business (8-10 years) and/or real estate loans (20-25 years)*
  - *SDE (cash flow) based lending*
  - *Emphasize debt coverage ratio and lifestyle support*
  - *Independent valuation required*
  - *Look for strong credit & operating qualifications*
  - *First position for repayment and lease*
  - *Personal guarantees & collateralize personal assets*
  - *May also provide working capital*

# Seller (Promissory) Note

- *Commonly 0% - 20% of Price*
  - *To supplement Buyer Cash + SBA Loan. SBA may require it given buyer/deal circumstances.*
  - *Can improve the price, provides deferral of taxes.*
  - *Subordinate to SBA loan, payments can be paused.*
  - *2-6 year term, may have standby*
  - *Can be the entire financing if no SBA lender available.*
- *Reverse earnout structure is common*
- *Usually personally guaranteed by the buyer*

# Buyer's Financial View

SELLERS DISC EARNINGS		\$400,000
SALES PRICE		\$1,000,000
WORKING CAPITAL		\$100,000
ACQUISITION COST (Sales Price + Working Capital)		\$1,100,000
DOWN PAYMENT (As % of Sales Price only)	20%	\$200,000
SELLER NOTE: 5 Yr / 5% (As % of Sales Price only)	10%	\$100,000
SBA LOAN: 10 Yr / 5% (% Sales Price + Working Capital + 3.5% Loan Costs)	70%	\$879,750
TOTAL BUYER INVESTMENT (Price + Working Capital + Fees)		\$1,179,750
SBA LOAN ANNUAL		\$105,387
SELLER NOTE ANNUAL		\$22,645
REMAINING SDE (Lifestyle, Taxes, Reinvest)		\$271,968



# 5

# Purchase Price Allocation

# What Is Allocation?

- *Places the respective cost of all the acquired assets into IRS defined classes*
- *Required in asset sales*
- *Seller's taxes for sale proceeds, and buyer's balance sheet values determined by allocation*
- *Seller and buyer allocations must match – IRS Form 8594*

# Allocation Example

<i>Furniture, Fixtures &amp; Equipment (FF&amp;E)</i>	<i>\$250,000</i>
<i>Inventory at Cost</i>	<i>\$150,000</i>
<i>Leasehold Improvements</i>	<i>\$50,000</i>
<i>Franchise Rights</i>	<i>\$50,000</i>
<i>Familiarization and/or Training</i>	<i>\$10,000</i>
<i>Consulting Agreement</i>	<i>\$10,000</i>
<i>Covenant Not to Compete</i>	<i>\$10,000</i>
<i>Business Tradename &amp; Goodwill</i>	<u><i>\$470,000</i></u>
<b>TOTAL</b>	<b>\$1,000,000</b>

# Taxation - Seller

*Furniture, Fixtures & Equipment (FF&E)*

*Depreciation Recapture*

*Inventory at Cost*

*N/A*

*Leasehold Improvements*

*Depreciation Recapture*

*Franchise Rights*

*Amortization Recapture*

*Familiarization and/or Training*

*Earned Income*

*Consulting Agreement*

*Earned Income*

*Covenant Not to Compete*

*Ordinary Income*

*Business Tradename & Goodwill*

*Long-Term Capital Gain*

# Tax Implications - Buyer

<i>Furniture, Fixtures &amp; Equipment (FF&amp;E)</i>	<i>3-7 Years</i>
<i>Inventory at Cost</i>	<i>N/A</i>
<i>Leasehold Improvements</i>	<i>15 Years</i>
<i>Franchise Rights</i>	<i>15 Years or Term</i>
<i>Familiarization and/or Training</i>	<i>Term</i>
<i>Consulting Agreement</i>	<i>Term</i>
<i>Covenant Not to Compete</i>	<i>15 Years</i>
<i>Business Tradename &amp; Goodwill</i>	<i>15 Years</i>

# 6

## Key Takeaways

# Keep These In Mind!

- *Importance of shared buyer/seller/lender vision*
- *Asset sales are the most common type*
- *$SDE = Net\ Income + Addbacks +/- Adjustments$*
- *$SDE \times Multiple = Value$ , apples to apples*
- *Multiple driven by size, industry and influencers*
- *Goodwill is difference between price and assets*
- *Price always allocated, there are tax implications*
- *Only 3 sources of funds: Buyer, Lender, Seller*
- *SBA is critical component, your best friend!*

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*What's My  
Business  
Worth?*

*Should I  
Buy Or  
Build?*

*How Can I  
Get  
Financing?*



# Elements Of A Business Sale

## Questions?

# Business Valuation

## Questions?

# Financing Structures

## Questions?