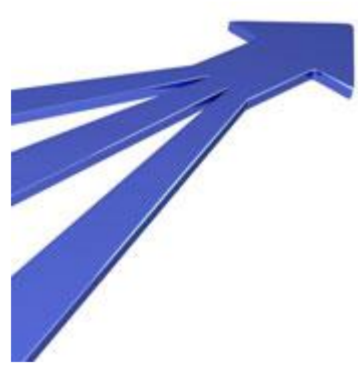
# Buyers and Sellers: It Takes Two to Make a Deal

**Selling a business takes two parties:** a willing buyer and a willing seller, and these parties rarely see eye to eye.



Normally, sellers want the highest possible price, while buyers want to pay as little as possible. To complicate matters, deal terms — such as tax issues, noncompete agreements, post-deal consulting contracts, earnouts and installment notes — may affect the cash exchanged at closing. Arriving at a reasonable selling price requires skilled negotiation and thorough due diligence.

Internet auction site eBay demonstrates how the free markets work in negotiating prices. Let's say a woman lists a used pair of exclusive brand name sunglasses on eBay at the manufacturer's suggested retail price of $180. Shoppers are free to make bids at any time. After a week, no one has made an offer and the woman withdraws the listing. She takes the glasses to a brick-and-mortar resale shop, which offers a mere $38. So she lists the sunglasses on eBay again, this time asking $75. She receives an acceptable offer three days later.

**Eye of the Beholder**

This demonstrates how value is in the eye of the beholder. In this case, the value range starts with an asking price of $180 and a bid price of $38 from the resale shop. Eventually, the seller negotiates a price in the middle of this range ($75) with an online buyer.

The same general principle applies to small business deals — although the negotiation usually takes much longer.

When it comes to buying a business, cash flow typically drives value. The more accurately future cash flow can be predicted, the easier it is to estimate a reasonable bid-ask spread. Selling price boils down to a seemingly simple formula:

**Selling Price = Future Cash Flow / Required Rate of Return**

However, it can be difficult to estimate future cash flow, especially for companies with volatile or uncertain forecasts. Identifying the risks associated with owning and operating a specific business can be challenging. These risks are the building blocks for an investor's required rate of return.

Further complicating this equation is the fact that small-business owners may not necessarily operate the business solely to maximize shareholder value. Some expenditures may be above or below their fair market value (FMV).

**Compensation Issues**

The most common discretionary expenditure that valuators need to adjust for is the compensation required to competently run the business. The smaller a business, the greater the probable effect owner compensation will have on its value. Owner-operators of small businesses may draw substantial amounts of cash flow through distributions or salaries. If so, the simplified valuation formula tends to undervalue the business — unless the valuator makes an adjustment to future cash flow.

Owner compensation often needs to be adjusted to reflect the FMV of the individual's contribution to the company. In other words, how much compensation would the owner have to pay another person to perform the same management duties?

In addition, owner compensation should reflect the added risk and responsibilities of ownership. Those responsibilities require additional compensation to determine the total market value for owning and running the business. This combined amount should be compared to the actual compensation the owner takes. Expected future cash flow should be increased by any excess amount to determine the value range for the business.

**Take Out the Guesswork**

If the owner draws too little salary, expected future cash flow may need to be lowered to reflect the FMV of the services provided. This scenario is more common with struggling businesses or start-ups that have limited cash on hand. Buyers who fail to make a downward adjustment in these situations risk overvaluing the business.

Most private business owners negotiate a limited number of deals in their careers, so it's important to conduct thorough due diligence and make the necessary adjustments.

If you or your client are contemplating buying or selling a business, contact Gryphon Valuation Consultants to help you consider both sides of the equation when setting your ask or bid price — and take the guesswork out of small business deals.



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