

Buying a Business, Part I

How do you determine the fair market value of a day spa?

By J. Tol Broome, Jr.

You've decided to buy a business. You could start a day spa from scratch, but you've heard the statistics on the high number of businesses that fail in their first three years, so you want to buy an existing operation. Perhaps this is your first venture, or maybe you already own one and are looking to expand.

Buying or selling a business all comes down to deciding on a "fair price"—a relative term because of the large number of variables from both the buyer's and seller's points of view. In this article, we'll look at how a business's value is determined and the questions you should ask before you make a purchase; next issue, we'll review the negotiating process.

IN THE BEGINNING

The first step to becoming a day spa owner is to find the right business to purchase. There are

three ways that most purchase contacts are made. The first is through *direct contacts*. Call people you know in the industry and let them know of your interest in purchasing a day spa business. Don't be shy; just because a particular spa owner has never mentioned an interest in selling her business doesn't mean she won't. Most businesses are perpetually for sale if the right offer comes along.

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A second source is *business professionals* such as attorneys, accountants and bankers who are usually kept well informed of their clients' affairs and may know of a business for sale. In my 15 years as a banker, I've had many small business owners ask me if I could find them a prospective buyer.

The third most likely source for finding a business for sale is through a *business broker*. A broker, like a real estate agent, represents either a buyer or a seller during the sale of a business. "The broker acts as an intermediary and serves as a trustee to either the seller or the buyer. We normally help the seller value his business and help him put together a plan to sell," explains C.J. Harris, president of C.J. Harris & Co., a regional management consulting firm with offices in Raleigh, Greensboro and Greenville, North Carolina.

BUSINESS VALUE

Once you've found a likely prospect, you need to determine a fair value for the business. There are many variables that factor into setting a value, but according to Harris, all valuations come from one of three basic approaches:

- Market value of assets
- Earnings based on potential cash flow, including owner's salary, perks, benefits and net income
- A combination of asset market value and earnings

Potential cash flow is usually the main factor in determining a price. Service businesses, such as day spas, tend to sell for two to three times the amount of the owner's annual discretionary cash flow. The accepted rule for the combination method is usually fair market value of the spa's assets plus one year's discretionary cash flow.

To determine a day spa's prospective cash flow, start by looking at the historical level of the net profit and owner's compensation. Ask for a line-item evaluation to find hidden costs that may be passed on to a new owner; if the spa is currently family owned, for example, family members may be working there for little or nothing. If you must replace them with employees paid at a fair market rate, the extra cost will affect your cash flow once you buy the business.

Also, carefully examine any unusual fluctuations in sales or overhead expenses. A large jump in sales might have been the result of a one-time contract with another business—income you can't expect again. A downward trend in gross profits might indicate that the cost of doing business, such as insurance premiums and lease payments, is becoming more expensive. If gross profits continue to decline after you buy the business, your cash flow will suffer.

When you dig deeply, however, you also might find "fat" in the budget that you can trim once you purchase the spa. For instance, you might discover that there are too many employees, compensation is too high or overtime pay is out of control. These findings can be an "ace in the hole" when negotiations begin.

A day spa business's value, then, might look like this: With a current owner's salary and bonus of \$50,000, perks such as whole-life insurance and pension buildup of \$10,000, other benefits such as health insurance of \$5,000 and a net business income of \$20,000, the day spa would have a total discretionary cash flow of \$85,000. Using the earnings approach of two to three times the cash flow, you might expect to buy the day spa for \$170,000 to



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\$255,000. If the fair market value of the spa's assets is \$125,000, the combination method would produce a selling price of around \$210,000—one year's discretionary cash flow of \$85,000 plus the \$125,000 asset value.

Harris cautions, however, that using multipliers doesn't always work. "Multipliers by themselves will typically over- or under-value a business," he says. "Every business is different, and multipliers are meant to be used as a rule of thumb, not as an end-all, for valuation. There are literally hundreds of variations that can affect the value of an individual business."

The bottom line for any purchase should be based on one thing: the business's bottom line. You must be comfortable that the cash flow level will be enough to give you a fair salary, pay any debts and provide a good return on your investment. If, on paper, the cash flow doesn't appear to be enough, you shouldn't buy the spa. Seek advice from your accountant, banker and business broker—professionals trained to analyze cash flow potential. In addition, Harris notes that many communities offer free small-business counseling services, such as SCORE (Service Corps of Retired Executives) and SBTDCs (Small Business, Technology and Development Centers).

A FEW QUESTIONS

Purchasing a business is a risk, and there are questions you should ask before you buy. Remember to maintain confidentiality. You might inadvertently bring in other bidders by leaking rumors.

As a buyer, consider the following:

- What's the seller's motivation? If she seems in a hurry to sell, doesn't give

you a good reason why she's selling, or insists on an all-cash transaction, proceed with caution.

- How old is the business?
- How much expense is required to run the spa?
- Does the spa own all necessary equipment and supplies, or will you have to make purchases after buying the business?
- Is the equipment up to date and in working order?
- Have suppliers been paid on time in the past?
- Is the local or regional market growing or declining?
- What is the spa's reputation in the community?
- Can you continue to use the business name? Do you want to?
- How dependent is the business on the current owner and employees?

The last question is vital to maintaining a profitable spa business. Many clients visit a spa primarily because of their relationship with the owner and/or employees. If you pay a premium for a spa only to lose half the customers because the previous owner is gone and several of the employees leave, it's unlikely the spa will be able to generate enough revenue to cover day-to-day expenses, bank debt payments and a decent level of compensation for you.

Next issue, we'll look at negotiating a fair price with the seller and closing the deal. ♣

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