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Shopping for a Small Business? Avoid the Boca Raton Problem

The three red flags that should send a potential buyer running for the hills.

Photo courtesy thinkpanama

I've written frequently in this column about what to look out for when running a small business. What about what to look out for when buying the business in the first place? When we were shopping to buy a company in the mid-1990s, before we found Marlin Steel, three challenges cropped up repeatedly.

I'll get to other two in a minute, but the biggest problem was one I called "the Boca Raton problem." That is, most every seller we talked to basically wanted to make enough money to retire in Boca Raton, regardless of the value of their enterprise.

We met with many people who wanted 20 or 30 times the free cash flow of their business. An acceptable price is closer to three times free cash flow, or EBITDA--earnings before interest, tax, depreciation and amortization. The metric is used to assess the profitability of a company by separating out variables that aren't part of the core business.

An exceptional company, with growing profitability, a good, stable management team and low customer concentration might be worth five times EBITDA. An enterprise with unique intellectual property or patents might attract seven times EBITDA. But for 95 percent of private small businesses, three to five times is market rate.

If a small floral shop has an EBITDA of $100,000 annually, for example, you might pay $300,000 for it, possibly $500,000 if it has a huge contract with a major hotel chain. But you're not going to pay a couple million dollars. If you do, you'll always be a cash bind.

The second problem that surfaced too often was honesty--or lack of it. A restaurant supplier we examined wasn't turning over sales tax to the state. We could tell from their books that they were collecting the tax, but the collection wasn't showing as going out.

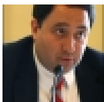
When we inquired about it, they said, "The state's really lax about collecting it." Maybe so, but if this person was willing to be dishonest with a revenue authority that could put him in jail, how willingly dishonest would he be in a deal with me? We immediately walked away.

The third issue was due diligence about the seller's clients. We had another prospect, a company that made a little gadget. They were very profitable and their offer price was refreshingly rational. I was very enthusiastic, even as I kept asking myself: Where's the wart? Well, we noticed a drop-off in sales in the most recent six months. We made some inquiries and discovered that their biggest customer, who represented nearly half their sales, had bought their own equipment to make what they had been purchasing from this company. The customer was basically in the process of "firing the vendor."

When pressed, the seller acknowledged the problem, but he had committed a lie of omission that we figured out only through our own due diligence. It was a frustrating waste of months of effort and thousands of dollars spent on accounting and legal fees to prepare paperwork. Even though his profitability suddenly didn't seem so strong, the prospective seller didn't want to budge on his price, so we ditched that deal.

I don't know if that owner ever made it to Boca or not.

http://www.inc.com/drew-greenblatt/shopping-for-a-small-business.html



Drew Greenblatt *is the president of Marlin Steel, a U.S.-based manufacturer of wire baskets and sheet-metal fabrications. Marlin has grown 25% over the past three years and has a record of 1,422 days without a safety problem.*

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