

# To Hold 'Em or Fold 'Em? (Part II)

**B**ernie, age 56, owns a full-line music store in Hartford, Conn. His biggest competitor in town just snagged his sales manager, who somehow managed to leave with a copy of Bernie's entire customer list. To make matters worse, Bernie's banker just cancelled his line of credit because his financial statements reported little profit for the third year in a row.

Bernie's wife is aggravated with him because he's always at work, his \$30,000 annual salary is pitiful and they haven't had a family vacation in more than 10 years. Bernie's two kids, Mick and Keith, have no involvement, interest or expertise in running the family business. Even if Bernie's employees held any interest in buying him out, they have no money. Oh yeah, Guitar Center just moved in down the block. Just like the blues tune, "If it wasn't for bad luck, Bernie'd have no luck at all."

Is it time for Bernie to sell his store? Perhaps. Hopefully these unfavorable circumstances didn't manifest themselves overnight, and Bernie has had time to consider his options. But like many music retailers who find themselves in similar situations, selling the store may be the only viable option for Bernie to transition from ownership to retirement or another career.

As discussed in last month's *Think Tank*—Part 1 of "To Hold 'Em or Fold 'Em?"—there are several points to consider before selling your store if selling your store is even the right move.

This article will assume that you've made the big decision to sell and, accordingly, will shed some light on determining the selling price of your store and your potential buyer.

## Sound Familiar?

The first step any potential buyer takes when evaluating a business is to review its operating history, with a keen eye on the business's finan-



cial statements and accounting practices. So let's take a look at the facts surrounding a hypothetical music store seller and buyer.

**SELLER:** Bernie's Unique Music Store ("BUMS"). Bernie had been thinking about selling his business for several months. He's been reluctant to do so because BUMS was founded by his father in 1920, and the store holds sentimental value. But now Bernie finds the long hours in the store a real hardship.

Furthermore, during the last three years, business declined from a high of \$3 million in gross revenues to less than \$2 million. In Bernie's opinion, the main reason for the decline in revenues is increased "school music" competition from a national competitor operating in Bernie's town.

Bernie believes he could sell his store, save the net sales proceeds for retirement at age 65, and, in the interim, work a normal 40 hour work week helping the new owner.

**BUYER:** Guitar Recording Arts Brook Music (or "GRABM"). In the last three years, GRABM has grown

beyond its home state to become a 40-store retailing chain. Its main interest is acquiring other music retailers—mainly school music dealers—in other markets. It has a fair amount of investor capital available for its planned acquisitions and is confident that it has the knowledge and resources to handle the company's growing multi-faceted operation. GRABM has also been the thorn in Bernie's side, and a major factor in his declining revenues.

Seymour Cash, the president of GRABM, recently approached Bernie to see if he's interested in selling his business. Seymour is well aware that the elimination of BUMS as a competitor would not only increase his company's gross revenues, but also allow GRABM to increase product, rental prices and net profits in its marketplace.

## Seymour Meets Bernie (A Love Story)

Last year, Seymour called Bernie. The two have met several times to discuss the potential sale of BUMS to GRABM. Seymour got very excited about the prospect of



acquiring BUMS, as it would give his company an uncontested competitive edge in Connecticut's school music business. Bernie really liked the aggressive growth plans and employee incentives that Seymour planned to implement at BUMS, including hiring Bernie as vice president of store operations for the New England region. Accordingly, Bernie gave Seymour complete access to all accounting records and provided copies of tax returns as well as financial statements for the last five years, prepared by Bernie's CPA.

Bernie hoped Seymour would pay at least \$1 million for BUMS. Just last week, Seymour personally presented Bernie with a written, bona-fide offer for the assets only of BUMS. The price offered: \$400,000. Bernie don't love Seymour no more. In fact, after calling him every four-letter name in the book, Bernie told Seymour to leave the store and never call him again. What the hell happened?

## Valuation Basics

Buyers and sellers both seek answers to the same question: "What is the business worth?" Most people see the worth of a business as the total value of store fixtures, equipment, inventory and other operating assets (i.e. rental instrument pools), less the business liabilities. This is an important indication of value, but not the true value of the business that's being sold.

A business can be valued by using any one of three different approaches: an "income" approach, "market" approach or "asset" approach. As each name suggests, the business is valued based on (1) the net income it generates, (2) the value of other similar businesses in the market or (3) the value of its net assets.

It's virtually impossible to use the market approach in valuing music stores. Guitar Center is the only public company that reports financial information, and most music stores can't compare themselves to the industry's largest superstore chain.

Also, since most music stores are not sold through business brokers, it's extremely difficult to find financial information related to their sale. Lastly, motivations to sell—which have a direct bearing on selling price—vary greatly, making it nearly impossible to compare the sale of any two music stores.

The asset approach is used only when there has been no sustainable net income. The value of the business assets, less its liabilities, provide the highest value. To put it another way, the business is worth more dead than alive.

Accordingly, it is widely believed (especially by those national music retailers on a hunt to acquire other smaller music dealers) that an income approach produces the best indication of a business's value. [Editor's note: for a more in-depth examination of issues in business valuations, see the two-part *Think Tank* "Business Valuations: Measuring Your Pot of Gold" (July and August 2000).]



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## Risky Business

Every legitimate business has the purpose of providing a satisfactory return on the owner's investment. Consequently, determining value under the income approach involves measuring the future profit of the business being sold.

Assuming that a reliable estimate of future profit has been produced, how much should be paid for each dollar of profit potential? The appropriate computation is based on the answer to the following questions:

- **What am I buying (or selling)?** A viable business, or a building full of inventory and equipment?

- **What return would I get if I invested my money elsewhere?** In stocks, bonds or other business opportunities?

- **What return should I get from the risk I take by investing in this business?**

Every profit projection includes some assumptions and risks. Generally, the less firmly based the assumption or the more apparent the risk, the less value an expected profit can support. On the other hand, a stable business with a history of documented earnings, strong management and an owner who has little bearing on the continued viability of the business will be perceived to have less risk and therefore greater value. With that in mind, let's see if we can determine an approximate value of BUMS and an appropriate selling price to GRABM.

## Income Is Queen, but Cash Is King

The chart on page 24 shows the typical analysis and adjustments made to a seller's income statement to arrive at the true net income, and resulting value, of a business valued under an income approach. It's important to note that most potential buyers are trying to calculate an annual adjusted net income that resembles the annual "cash" profits of a business. Under the premise that "cash is king," buyers are most interested in determining the annual "cash" return on their investment.

**Rental Depreciation.** BUMS has depreciated its \$420,000 rental fleet over three years, which is appropriate for a "rent-to-own" rental pool.

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# BERNIE'S UNIQUE MUSIC STORE ("BUMS")

## INCOME ANALYSIS

FOR THE YEAR ENDED DECEMBER 31, 200X

	Per Financial Statements	Adjustments	Adjusted Revenues & Expenses
<b>NET SALES</b>	\$ 1,500,000	\$ -	\$ 1,500,000
<b>COST OF GOODS SOLD</b>	975,000	-	975,000
<b>GROSS PROFIT</b>	525,000	-	525,000
<b>OTHER OPERATING INCOME</b>			
Rental income	330,000	-	330,000
Less depreciation of rental assets	140,000	(80,000)	60,000 <b>(A)(F)</b>
	190,000	80,000	270,000
<b>TOTAL OPERATING INCOME</b>	715,000	80,000	795,000
<b>OPERATING EXPENSES</b>			
Salaries - owner	30,000	45,000	75,000 <b>(B)</b>
Salaries - sales staff	220,000	-	220,000
Salaries - administrative	55,000	-	55,000
Rent	80,000	(40,000)	40,000 <b>(C)</b>
Advertising	55,000	-	55,000
Insurance	50,000	(20,000)	30,000 <b>(D)</b>
Auto, travel and entertainment	45,000	(25,000)	20,000 <b>(E)</b>
Taxes	33,000	-	33,000
Bank and merchant fees	20,000	-	20,000
Store supplies	18,000	-	18,000
Telephone and utilities	16,000	-	16,000
Depreciation - fixed assets	15,000	-	15,000 <b>(F)</b>
Office expense	10,000	-	10,000
Professional fees	9,000	-	9,000
Maintenance and repairs	4,000	-	4,000
	660,000	(40,000)	620,000
<b>INCOME FROM OPERATIONS</b>	55,000	120,000	175,000
<b>OTHER EXPENSE</b>			
Interest	30,000	(30,000)	- <b>(G)</b>
<b>NET INCOME</b>	\$ 25,000	\$ 150,000	\$ 175,000



However, BUMS' rental contracts are "rent-only" and should have been depreciated over a longer period, perhaps seven years. Accordingly, an \$80,000 upward adjustment (\$140,000 to \$60,000) was made to reduce depreciation expense.

**Officer Salary.** Bernie was paying himself \$30,000 a year. But a \$75,000 salary would be required to hire someone to do Bernie's job. Accordingly, a \$45,000 downward adjustment (\$30,000 to \$75,000) has been made to increase the officer salary expense.

**Rent.** Bernie owns his store's building, and pays himself an "above-market" rent of \$80,000. Accordingly, a \$40,000 upward adjustment (\$80,000 to \$40,000) was made to decrease the rent expense to a realistic market price.

**Insurance.** Bernie had the company pay for his life and disability insurance, in addition to health insurance for his entire family. Accordingly, a \$20,000 upward adjustment (\$50,000 to \$30,000) was made to decrease insurance expense.

**Auto, Travel and Entertainment.** Bernie had the company pay for his wife's Mercedes lease, a couple of "non-business" trips to Florida and the Bahamas, theater tickets and a couple weekends in New York City. Accordingly, a \$25,000 upward adjustment (\$45,000 to \$20,000) has been made to decrease travel and entertainment expense.

**Depreciation "Add-Back."** Since depreciation is a "non-cash" expense, it is often added back to income to better approximate cash income. But some portion of the depreciation expense should not be added back, in order to properly reflect the annual cash needed to replace both fixed assets and rental assets that have deteriorated. Accordingly, no depreciation add-back has been made, as the fixed asset and rental depreciation properly reflect the annual replacement cost of fixed assets and rental assets.

**Interest Expense.** Since most buyers will purchase the operating assets of a company and expect the seller to pay off all bank debt, interest expense should not be consid-

ered a factor in arriving at net income. Accordingly, a \$30,000 upward adjustment (\$30,000 to \$0) has been made to decrease interest expense to zero.


The aforementioned adjustments have now produced an "adjusted" net income of \$175,000, which more closely reflects annual cash profits. Using a risk-adjusted multiple of four times adjusted net income, equating

to a 25-percent return on investment, BUMS reflects a value of \$700,000 (4 x \$175,000). However, Bernie may have been more correct about his \$1 million value than Seymour's \$400,000 value. Here's why:

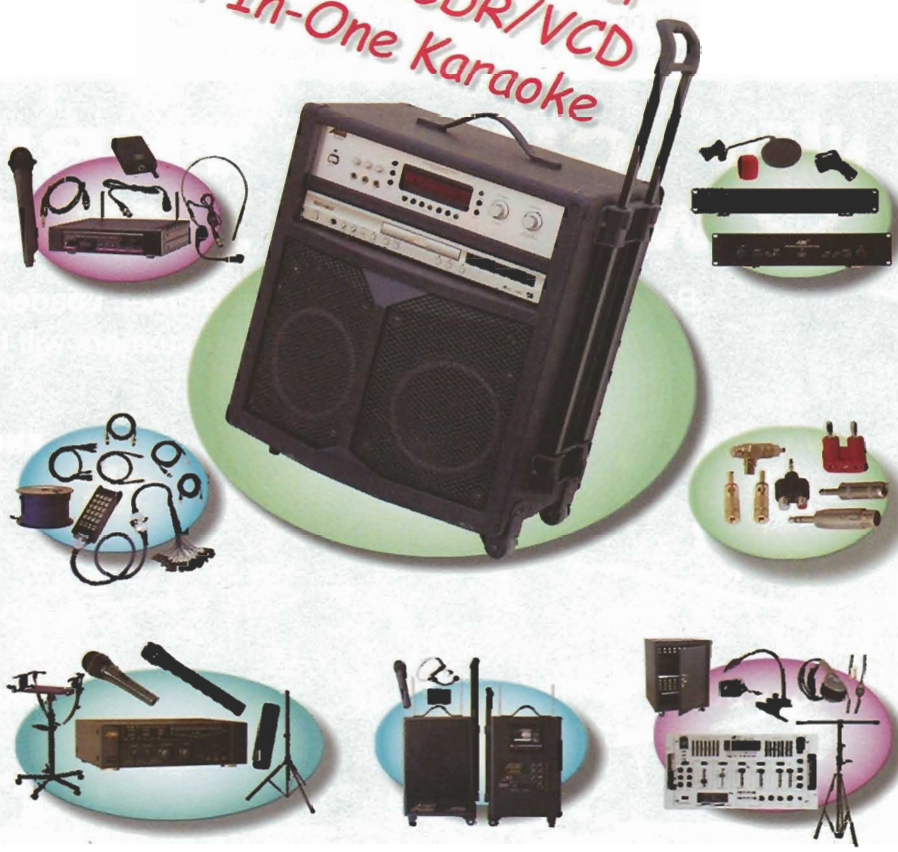
Given that BUMS' and GRABM's sales and rental revenues were being suppressed due to direct competition from one another, BUMS has a higher "investment value" to

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GRABM than another competitor. In fact, that may make BUMS worth way more than \$700,000 to GRABM—perhaps closer to the \$1 million value Bernie hoped for.

Bear in mind, just because it's worth more doesn't mean a buyer will pay more. That's why a seller should establish in their mind a minimum price they'd be willing to sell their business for, as few buyers will pay what a business is truly worth.

### Sellers Beware?

There are three major music retailers out on a national prowl to acquire other dealers, especially school music dealers. They all seem to value potential acquisition candidates based on a multiple of cash profitability. I agree with that theory. They believe the value of goodwill and other intangible assets is reflected in their candidate's profitability. I agree with that, too. And they believe that they shouldn't pay for any additional profit-producing synergy from the acquisition of the can-

didate. I couldn't disagree more.

As with Bernie's business, if the merger of BUMS and GRABM produces a proportionately greater revenue stream than each achieves separately, then GRABM should be willing—or forced—to pay for that intangible asset. It's obviously not something that GRABM brings to the table alone. If you're thinking about selling your store to a competing music retailer, make sure they pay you for the value of your store leaving their marketplace. Don't forget, this also increases the perceived market value of music stores.

### Some Final Thoughts

Is determining the value of a business that easy? In a single word, no. A definitive value cannot be determined by a process this simple. Even this illustration fails to address issues such as the buyer's working capital investment, the terms and structure of the transaction or the valuation of non-operating assets.

The topic of business valuation is

so complex that any explanation short of an entire book doesn't do it justice. The process takes into account many variables and requires a number of assumptions. Factors like rents, leases, special employment circumstances, the trade-off between cash and payment terms as well as tax allocations and consequences all come into play in arriving at an agreed price. It's a process that should be performed only by business valuation professionals.

However, performing a cursory exercise like this one can be helpful in planning for the eventual transfer of your store, establishing a price range for your consideration or perhaps convincing you that it's time to hold 'em and not yet fold 'em.



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