Don’t Fall For “The Tangible Trap”

Overpricing is the number one mistake sellers and their brokers make when putting businesses on the market. Even profitable, well-managed businesses can get buried under a bad number.

One of the chief culprits in over-estimating value is what I call “The Tangible Trap.” I find a lot of business owners misunderstand how their tangible assets impact value. Specifically, their equipment and tenant improvements. As a broker, it’s often disheartening to show owners how these tangible assets don’t provide as much bang for the buck as they’d hoped.

Months ago, I was working with a restaurant owner who had not turned a profit in any of his four years of operation. In that period, he had spent roughly $300K in improving and building out the restaurant space, another $100K in expanding his outdoor patio, and roughly $80K over the years in upgrading his kitchen equipment, freezers and fridges. To make matters worse, he had just one year left on a 5-year lease, with no options and a poor working relationship with the landlord.

He shared a common false presumption. He anticipated that potential buyers would see all the dollars that had been spent on the buildout and they’d look past the intrinsic flaws in his operation. In his mind, he’d spent half a million bucks on this restaurant and these investments made his business worth at least $350K or more.

He was gracious and professional when I explained that my opinion of value was nowhere close to what he hoped. But he wasn’t coming down from his lofty price expectations. And he wasn’t going to hire me either.

Small business valuations typically combine the Income, Asset and Market Approaches to reach opinions of value. The most favored method seeks to approximate the value of a business by applying a multiple to the discretionary cash flow. This seller’s discretionary earnings (SDE) figure is multiplied by a factor that considers industry type, market conditions, competition levels and indicators unique within their business categories.

Here’s what many owners struggle to understand. When they are told their business could net a sale price of 2.5x net earnings, they often want to add the cost of their tenant improvements and tangible assets on top of that calculation. Or they believe their tangible assets are far superior and more valuable.

But your equipment and TI's are generally "baked into" that multiplier already. Say you had a liquor store and a textile manufacturer who showed the same gross revenues, same net income and had identical balance sheets. An appraiser would still use a far higher multiplier for the manufacturer than the liquor store. It would not be uncommon for the liquor store to be valued at less than 2x SDE (inventory aside) while the manufacturer is valued at 4x SDE. Why?

The difference in multipliers is grounded in many value factors - the assignment of risk, strength of industry, lender favorability, workforce expertise, depreciation timeframes, equity investment desirability, plus many other longstanding conditions. A huge part of the multiplier disparity involves the typical forms of equipment and tenant improvements involved in particular industries. That's why the multipliers are sometimes arbitrary, but still often accurate, yardsticks for estimating what a buyer may pay.

My restaurant owner made the mistake in believing he could simply add $250K-$300K as a raw figure representing the fair market value of his equipment and TI's, to offset his negative cash flow and reach a favorable value conclusion. He never put his restaurant on the market. He wound up getting a considerable amount of money in an asset sale of his equipment, furniture and other tangibles, plus a separate sale price for his recipes.

Every business has its own unique value drivers. Highly-improved businesses will indeed net higher prices than modestly-equipped companies, all else equal. Putting numbers to your tangible assets can be tricky, so I'd certainly recommend professional input. Just don't be surprised if that expert tells you that a sizable chunk of your tangible asset investment is not recoverable.