



## The Flower Shoppe Case Study

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John Doe is thirty-eight years old and an employee of a manufacturing firm, RM Corporation, where he has been employed for nearly twenty-years. Following the announcement of significant redundancies (including John) at RM Corporation, John Doe decided to put his entrepreneurial spirit to the test by buying a small business that would provide him and his wife with a comfortable lifestyle. His first step was to search the internet for business brokers or real estate agents with listings of small businesses in his town. After examining the qualifications of each of the brokers and their listings and discussing his intentions with several of his former co-workers (still employed at RM Corporation), he decided, at the recommendation of one of his closest friends, to approach Jay Smith at Hometown Business Brokers.

Jay Smith had joined Hometown Business Brokers over five years ago and spent a great deal of time cultivating relationships with his clients. He had received several awards and recognitions as a successful business broker in the region, having sold over one hundred “quality” businesses in the past five years. His crowning achievement was the sale of a local beer distributor to a group of investors at a transaction price of over \$20 million. In addition to a good reputation, Jay brought a great deal of credibility to Hometown Business Brokers, enabling the firm to grow into the largest business brokerage in the region. When John Doe approached Hometown Business Brokers, Jay and his colleagues had an inventory of over fifty businesses in industries ranging from florists, hotels, and golf courses, to retail clothing stores, restaurants, and manufacturing firms with sales between \$50,000 and \$5 million.

John Doe and his wife, Jane, set up a meeting with Jay Smith to discuss various business options that were available and to get to know him a little better. After the initial meeting, John and Jane were impressed by Jay, his credentials, and his business listings. They were able to also narrow down the list of businesses in which they would be interested to three—a florist, a fitness center, and a franchise restaurant. Given his wife’s interest in gardening and the low stress associated with the business, John and Jane decided to pursue a purchase of the florist shoppe.

The Flower Shoppe had been established for roughly seven years. The original owner sold the business three years ago due to health problems. At the time, the company's seven area shops generated revenues of roughly \$1,750,000 per year (approximately \$250,000 per location), as reported on the company's compiled financial statements. Net loss before taxes (the firm was incorporated and taxed as a S-corporation) was roughly \$20,000. The owner worked one of the shops himself and took a salary of \$35,000. The current owner grew the Company's sales from \$1,750,000 per year to over \$3,000,000 for the most recent fiscal year with net income before taxes of \$100,000, according to the company's tax return.

Total assets as reported on the tax return were \$610,000 of which \$150,000 was non-floral inventory often associated with flower shoppes (greeting cards, balloons, artwork, etc.), \$100,000 attributed to the company's two delivery trucks (depreciated value), and \$140,000 in equipment. The company maintained about \$70,000 in cash and receivables, and the remaining \$150,000 was attributed to floral inventory. The facilities were leased from a local real estate development company for a market rate of rent. Though the leases would be up in the next six months, the real estate development company assured that the leases could be renewed at the same rate of \$7,000 per month. The current owner, who was planning to move out of the state to be closer to her daughter, was seeking to sell the company for \$750,000.

Jay arranged for a site visit to The Flower Shoppe so that John and Jane could see the operations and meet with the current owner to ask any questions they may have about the business. After a very positive meeting during which John and Jane asked some basic non-financial questions regarding the business' operations, Jay suggested that they put together an offer to be submitted to the owner of The Flower Shoppe sooner rather than later. He informed them that there were several other parties looking to acquire The Flower Shoppe, so time was of the essence.

Though their financial and accounting knowledge was limited, Jane did have some experience as a bookkeeper at a construction company during her college days nearly fifteen years ago. Since then she has been employed as a supervisor at a local grocery store. Feeling that the asking price was reasonable given the level of assets of the company, John and Jane decided to make an offer for The Flower Shoppe. With Jay's help, they put together an offer of \$575,000 for the company. The owner of The Flower Shoppe quickly countered with \$650,000. John and Jane readily agreed, feeling that they were getting a deal for the business.

To finance the deal, John borrowed \$25,000 from his brother, and Jane borrowed \$25,000 from her parents. Roughly \$40,000 of this money was to be used as part of the purchase price with the remaining portion used as a contribution to working capital. Jay suggested that they approach Hometown Bank to seek financing for the acquisition. He put them in touch with his close friend at the bank which had worked with him on many of his deals in the past. After reviewing the loan request, the bank was reluctant to

make the loan given John and Jane's limited business experience, lack of substantial collateral, and lack of an appraisal of the inventory and equipment.

To assuage the bank's concerns regarding the value of the assets, Jay arranged for a local real estate appraiser that had also worked with him on several deals to provide a "fairness opinion" on the value of the assets. The real estate appraiser sent a letter to the bank stating that he believed the inventory and equipment of the business was probably worth at least the book value of the assets. The letter did not indicate that he was not qualified to appraise fixed assets such as inventory and equipment.

Meanwhile, at the suggestion of Jay, John convinced several of his former co-workers to co-sign on the \$610,000 business loan. Five of his closest friends from RM Corporation agreed to do so in order to help get the loan to go through. In addition, John and Jane pledged \$20,000 they had invested in marketable securities—their entire savings—along with their house appraised at \$150,000 of which \$75,000 was equity.

Within a matter of days, the bank agreed, still reluctantly, to close on the loan. To help with the legal aspects of the closing, John and Jane used a lawyer recommended by Jay. The deal was closed in less than thirty days from the time John and Jane made the initial visit to The Flower Shoppe, with virtually no due diligence and without a formal valuation the company.

In the first several months, John and Jane operated the business at a substantial deficit of roughly \$10,000 per month. The expenses on a monthly basis were little changed from what they had been under the previous owner. It quickly became apparent, however, that The Flower Shoppe would need additional working capital in order to fund continuing operations until seasonal volume increased towards Valentine's Day. John and Jane returned to the bank to secure a working capital line of credit of \$75,000. Realizing that the company would fail without the additional working capital, the bank decided to approve the requested line of credit with a term of one year.

Within the next six months, it became evident that The Flower Shoppe's revenues would fall substantially below those in the previous year. For the fiscal year, John and Jane expected revenues to be roughly \$2,900,000 or \$100,000 less than the prior year's revenues. Confused, they contacted Jay to request that he attempt to secure information relating to The Flower Shoppe's sales for the major holidays during the last year prior to their acquisition of the company. Though Jay was reluctant to help, claiming that the only revenue figures were those available on the tax return, he did contact the former owner (his client) and get a rough estimate of the sales for Valentine's Day, Easter, and Mother's Day.

After reviewing the owner's sales estimates, John and Jane realize that their holiday sales were not significantly different (were slightly higher, in fact) than those under the previous owner. Sensing that something just wasn't right, John and Jane contacted Jay once again to ask for clarification on The Flower Shoppe's previous year's revenues. An obstinate Jay refused further assistance to John and Jane, saying

that they were obviously doing something wrong in running the business. Subsequently, he refused to answer their calls and e-mails.

John and Jane were now convinced that they had been duped. A new acquaintance from their church, Jake, is an attorney and is familiar with their situation. Jake offers to call Jay in an attempt to elicit a response and resolve the matter. Jay stonewalls Jake during their conversation but indicates that he will contact the owner and ask some questions as a way of trying to smooth things over. Upon threat of litigation, Jay and the owner reveal that The Flower Shoppe's revenues included roughly \$1,000,000 in non-recurring bridal consulting work that the owner had in the last year. The marginal cost associated with these revenues was minimal and related to the salary of another bridal consultant to help the owner who was primarily responsible for managing the consulting.

John and Jane are stunned to learn that The Flower Shoppe is not profitable without a significant increase in the company's revenues. Likewise, they are concerned that the ability to increase revenues to a break-even point, let alone to profitability, solely on flower sales is a low probability event. With the business continuing to hemorrhage cash, John and Jane are quickly pushed into financial distress. They are unable to pay the rent and they get behind in their loan payments to the bank. In an effort to save the company and their finances, John and Jane file Chapter 11 bankruptcy. In the end, the bank is unable to collect on the note from John and Jane and seeks to collect from the co-signers.

Protracted litigation follows John and Jane's decision to liquidate The Flower Shoppe. As part of the litigation, an independent business appraiser is engaged to provide a value estimate for the company as of the date of the Doe's acquisition of the business. Using well-documented methodologies and widely-accepted approaches, the valuation analyst determines that the value of the business was roughly \$400,000 as of the date of the acquisition. This value is significantly lower than the book value of the firm's assets of roughly \$610,000 and implies that, at a purchase price of \$650,000, John and Jane significantly overpaid for The Flower Shoppe.

This case should illustrate several points:

- John and Jane were not savvy with respect to buying a business. They did not have the proper background to pursue an acquisition of a business, and they did not have competent advisors to assist them through the process of buying a business.
- The financial information provided by the owners and Jay with respect to The Flower Shoppe was inaccurate and incomplete. Ethically, Jay and the owner may have acted in an inappropriate manner by failing to reveal the non-recurring revenue. This could be likened to "cooking the books" to make the financial performance appear better than was the actual case. The most

prominent examples of this type of corporate malfeasance are Enron and WorldCom.

- The bank relied on a “fairness opinion” of The Flower Shoppe’s inventory and equipment from a real estate appraiser who was not qualified to appraise either.

Sadly, this complicated mess may have been avoided had either John and Jane or the bank sought a valuation of The Flower Shoppe. The skilled financial analyst would have sought to determine the source of any non-recurring revenues and the impact this would have had upon the financial position and sustainable earning power of the firm. In addition, a valuation would likely have considered the future earnings capacity of the business in developing an indication of value. The value estimate prepared by the qualified business appraiser may have been substantially and materially different from the book value of the business and/or its assets, prompting the prospective buyer to reconsider their offer and the bank to reconsider their willingness to loan money to finance an acquisition of the company. Needless to say, this case study illustrates the importance that valuations play in the acquisition of any small business, but in particular of businesses being acquired by individuals who do not have a strong financial analysis background.