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Sunrise Presentations: A Study in Valuing and Divesting a Small Business

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ABSTRACT

Sarah Barnett has decided to go back to school to earn an MBA. For several years she has run a graphic design business. Sarah has unexpectedly been accepted into the MBA program with a scholarship a year earlier than she planned. Classes begin in two weeks and the school she is attending does not allow first year MBAs to work outside of the school curriculum. Sarah has decided to divest her business and now must consider several options to do so. She is most concerned about making sure her customers continue to receive outstanding service, and secondarily concerned about selling the business for enough to pay off the business debt and to help pay her living expenses while she is a graduate student.

I. Introduction

Sunrise Presentations was established in July of 2007 by William Barnett. He wanted to run his own business out of his home and was able to start it part time while he finished responsibilities in his other job. Sunrise Presentations is a service bureau and design house initially located in Bloomington, Indiana. It is geared toward businesses that need graphics and other materials for presentations. It specializes in the imaging of 35 mm slides and overheads, and in graphic design for presentations.

William's daughter, Sarah, worked part time with William while completing a Bachelor's degree at the University of Indiana. She graduated in 2012 and began looking for full time employment. She worked for a temporary agency for a year and then William asked her to work full time with him. She agreed it would be a good opportunity. For the next four years, William and Sarah worked together and the responsibilities slowly shifted to Sarah so that she could eventually take over the business. Many of the tasks were shared, but William kept up with the computers and the latest software, while Sarah maintained strong customer relations and fulfilled projects.

In November of 2016, William sold the business to Sarah and he started a new job. The transition was smooth because Sarah was the main contact for all of the clients, and William was still close by to offer technical assistance when necessary. Sarah ran the business on her own until late summer of 2018. William turned the business over to Sarah with the agreement that Sarah would owe $20,000 for the business. This debt was to carry a 10% level of interest, as this was the rate Sunrise could currently acquire external debt and Sarah wanted to pay her father a fair return. Over the course of working at Sunrise, Sarah volunteered to earn less than a fair market salary. That is, she agreed to a smaller wage than a similar job would earn. Sarah figures this foregone salary equals $20,500 in 2017, $3,333 in 2016, $4,000 in 2015, and $5,000 in 2014. In 2017, William allowed Sarah to defer paying the interest owed to him until she was in a better position to do so, as a result it does not appear on the 2017 income statement.

II. Office Visuals' Original Offer

Office Visuals is a company similar to Sunrise Presentations but is run out of Indianapolis. Besides being a service bureau, it also offers audio/visual equipment, particularly computer projectors, for sale or rent. Johnny Jacobs is the owner. William and Johnny met several years before Sunrise was established and William bought equipment from Johnny to start his business. In the mid 2000's, Johnny saw an opportunity to expand Office Visuals into the Bloomington area without opening another office. He proposed a partnership with Sunrise Presentations, in which Sunrise would rent and sell equipment from Office Visuals and receive a 50% commission on all transaction profits.

The relationship with Office Visuals continued strong for several years. It was based on a handshake and mutual trust and it never needed to go beyond that. Both partners met their obligations. The relationship continued strong as Sarah took over Sunrise in 2016.

In the fall of 2017, Johnny offered to buy Sunrise from Sarah. Sarah didn't want to sell the business at that time. She didn't want to work as an employee for Johnny. She opted to maintain ownership. However, Johnny wanted to see Sunrise move out of the "home office" environment so that the Office Visuals clients had a business address to refer to. He rented an office in Orem and asked Sunrise to move in. This was a great opportunity for Sunrise, so Sarah moved the business there. The rental expense in 2017 paid by Johnny was $1,500.

III. Going Back for an MBA

William and his wife June left the country in April of 2018 to volunteer for a humanitarian mission. Just prior to this, Sarah was feeling some dissatisfaction with her life, particularly about running a business that only slightly interested her and kept her rather isolated. She started thinking about going back to school for an MBA. This was something she had considered for years but hadn't yet pursued. She figured she would start in the fall of 2019. She began the application process in July 2018. By August of 2018, she was accepted into an MBA program with a scholarship. This was a year earlier than she had planned, but was an opportunity not to pass up. The problem was, she had about two weeks until classes started and had to figure out what to do with Sunrise.

IV. Finding a Buyer

A year had passed since Johnny had offered to purchase Sunrise and he was no longer in a position to do so. He had made other business ventures and no longer had the funds. Sarah contacted as many people as she could think of in the two-week period she had before school started, but there were no solid buyers. Because there was no time to keep looking and because she was not allowed to work during her first year in the MBA program, she had to move quickly. She talked to one of the parties who had shown interest in buying but wasn't in a financial position to do so yet. This was Robert Vennitte who ran Vennitte Design. His office was adjacent to Sunrise and the two companies had a lot of complementary offerings. Another interested party was Digitography. Digitography was a competitor of Sunrise.

V. Office Visuals' Second Offer

Johnny was still interested in maintaining the clients of Sunrise but his company was not in the position to make a purchase. He proposed a more tightly knit partnership in which Office Visuals would run Sunrise on a commission basis while Sarah remained as owner (see Exhibit 1). There were both advantages and disadvantages to this arrangement. The advantages were that Johnny knew the business well, and the clients would be well served by a company that had great experience. Sarah believed Johnny had a vested interest in the success of Sunrise, as Sunrise still owed him a significant amount of money from recent transactions. Also, Office Visuals wanted to continue and expand their business into the Bloomington area. A disadvantage was that Johnny was taking his business in a different direction than Sunrise was going at that time. If he took over, it was unlikely that Sarah would be able to sell the business at a later date. The two companies would be inseparable. If Sarah chose this option, she would be giving up the opportunity to sell the business and would be taking the financial loss associated with a possible sale. Sunrise Presentations would not exist as its own entity by the time Sarah finished school.

VI. Vennitte Design

Robert, the owner of Vennitte Design, had been working next to Sunrise for about a year. He had had some work done through Sunrise and was familiar with the business. When he found out Sarah was trying to go back to school, he called her to inquire what she was going to do with Sunrise. He told her that he was interested in buying the company, but that he was not in a financial position to do so immediately. He proposed an option that might work for him if Sarah felt comfortable with it. Robert wanted to run the company, become familiar with it and wait for some other ventures of his to pan out. He figured that in two or three months' time, he would have the money to purchase Sunrise.

The advantages of having Robert run Sunrise were strong enough to give his proposal some serious consideration. Robert had a design and desktop publishing business. He designed layouts for magazines, posters and other published work for many clients. Adding the capabilities of Sunrise to an already strong business was a great combination. His clients would benefit from the expanded capabilities, and Sunrise clients would also benefit from the expansion. It seemed to be a great synergistic fit.

The disadvantage of leaving the company to Robert was the possibility that he wouldn't be able to afford to buy Sunrise and therefore there would be lost clients in the changeovers. It was a risk to let Robert run the company with a hope that he would buy, and there was no assurance that he would. If this risk were not taken, however, the possibility of having Robert as a buyer would most likely be lost. It was a two-edged sword. If Robert ran Sunrise and didn't purchase, Sarah would possibly lose clients, and therefore a percentage of the worth of the company. If Sarah didn't give Robert a chance, and later Robert was in a position to purchase, he might lose interest in Sunrise.

VII. Digitography

There were only a few discussions with Digitography, a competing firm of Sunrise. A previous relationship had never been well established between Digitography and Sunrise. Digitography felt that they were interested in working with Sunrise. However, Digitography didn't want to purchase Sunrise, but instead wanted to create a partnership in which they would run the company, while Sarah maintained ownership. Digitography's owners wanted to look at Sunrise's books, see all of the financials, and know the clients before they committed to a real interest in the company. They also expressed that they believed they would inherit, and were already doing so, many of Sunrise's clients because of the changes that were happening with Sunrise. It was difficult to see advantages in working with Digitography, however they were an option.

VIII. Valuing Sunrise Presentations

Now that Sarah had three potential options for Sunrise, she had to come up with the figures that would represent the value of the company. She needed to determine as many factors of the business as she could so that she had something to present to interested buyers. This was new to her, and she was struggling with where to begin. As she began her graduate studies, she read case after case, most of them irrelevant to her immediate experiences. She was disappointed that the business classes read cases that were already history, and no matter what the students thought of them, the facts were over and done.

Passing by a professor's door one day, Sarah peeked in and asked, "Why don't we work on a case in which we can actually influence the outcome? Why don't we value and sell my business as a class?"

The professor was very supportive of the idea, within limitations. He challenged Sarah to take on an independent study course to do just that and got her started in the right direction. She found a professor who supported the idea and was able to be a mentor and be involved in the process. Together they gathered the financial information and began the process of divesting Sunrise Presentations. Sarah determined the two steps in divesting the business were first to value the firm and second to choose which of the potential acquirers' offers to go with. Sarah had three main sources of data. The first was the written offer from Johnny (Exhibit 1). The second was an income statement (Exhibit 2) that she constructed from Sunrise's QuickBooks and previous tax returns. The third was Sunrise's equipment rental and sales information for 2017 that she had obtained from Johnny (Exhibit 3). Sarah thought Exhibit 3 may be useful because it would allow her to estimate a value for each of the two segments of the business (graphic design and equipment rental/sales).

IX. Questions to Consider

1. With the available information, how would you value Sunrise Presentations? What do you feel is a fair value for the firm?

2. Which of the buyers would you most strongly consider and why?

Exhibit 1. Letter from Office Visuals to Sunrise Presentations

August 23, 2018

Sarah Barnett
Sunrise Presentations

Dear Sarah,

Sorry it has taken so long to get back. We are a bit short staffed for the amount of business we are doing.

I appreciate your financial analysis of the business. I want to go with the 30% option. Here are the particulars I would like to suggest:

1) Office Visuals will pay Sunrise a commission of 30% of the gross margin (revenue less any cross-rent cost) on each job sold to a Sunrise customer. You will need to produce a report showing these customers so we can give you proper credit. All new accounts will belong to Office Visuals.

2) Office Visuals will staff the Orem office and supply the labor and equipment to properly rent to the Sunrise customers.

3) We agree upon two notes payable from Sunrise to Office Visual Products, Inc and JimHouse, LLC for the amounts owed. I suggest an annual interest rate of 12% (1% of the balance per month). No less than 70% of the commission calculated in article one above will be applied to these notes each month. Office Visuals will produce a monthly statement showing the principal and interest due and the commission applied.

4) The commissionable portion of this agreement will remain in effect until either 1) Sunrise Presentations sells the business (in which case the new owner must negotiate a separate agreement) or 2) Office Visual Products quits the audio visual rental business in Bloomington. Any remaining portion of the notes payable will be due regardless of any termination of this understanding.

I know we are losing business in Bloomington because we lost another one yesterday. Please call or reply by email if this is agreeable. If so, I will have notes payable written up with figures.

Sincerely,

Johnny Jacobs
Office Visual Products
555-444-3333

Exhibit 2. Sunrise Presentations' Income Statements

	2017	2016	2015	2014
Total Revenues	$126,402	$146,023	$74,535	$106,746
Expenses				
CGS	$17,889	$59,939		
Advertising	$350	$1,071	$1,521	$1,401
Vehicle	$3,196	$2,138	$1,996	$1,704
Emp Benefit	$423	$1,070	$984	$984
Insurance		$954	$500	$468
Legal/prof svc	$335	$405	$401	$320
Eqmt Lease	$5,400	$5,205		
Supplies	$50,259	$7,350	$7,448	$12,224
Utilities	$188	$250	$230	$257
Wages		$17,454	$13,547	$18,191
Other exp	$3,107	$9,921	$10,063	$10,672
	$81,147	$105,757	$36,690	$46,221
Business License	$186	$2,005	$809	$2,448
Depreciation	$3,709	$8,069	$14,753	$30,253
Amortization	$3,477	$580		
Home Business Tax Deduction Expense		$1,062	$1,615	$1,733
EBIT	$37,883	$28,550	$20,668	$26,091
Interest		$7,176	$6,008	$5,542
EBT	$37,883	$21,374	$14,660	$20,549
Federal Taxes	$9,573	$5,401	$3,705	$5,193
State Taxes	$1,619	$913	$627	$878
Net Income	$26,691	$15,059	$10,329	$14,478

Exhibit 3. Information on Equipment Rental and Sales for 2017

Equipment Rental and Sales	
Gross Revenue	$68,402
CGS and Supplies	$42,161
Gross Profit	$26,241

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Teaching Note

Sarah Barnett has decided to go back to school to earn an MBA. For several years she has run a graphic design business. Sarah has unexpectedly been accepted into the MBA program with a scholarship a year earlier than she planned. Classes begin in two weeks and the school she is attending does not allow first year MBAs to work outside of the school curriculum. Sarah has decided to divest her business and now must consider several options to do so. She is most concerned about making sure her customers continue to receive outstanding service, and secondarily concerned about selling the business for enough to pay off the business debt and to help pay her living expenses while she is a graduate student.

Background

This is an actual case. The details are exactly as they occurred. Sarah felt a great deal of pressure as she was between the proverbial rock and a hard spot. The case is written to allow students to experience at least a portion of the stress that Sarah (and many other entrepreneurs) feel in the course of running their own business. The teaching note below answers the two specific questions asked at the end of the case. It is written in such a way that instructors can stress that in the real world, things don't always turn out the way one would like. I like this case because it goes much further than the mechanics and assumptions of valuing a firm. This teaching note particularly gives the instructor the insights of what Sarah was thinking as she made each step and considered each option. Encourage students to put themselves in Sarah's shoes and, after they have valued the firm, to discuss how and to whom they would negotiate for the divesture of the firm.

Answers to Questions

1. With the available information, how would you value Sunrise Presentations? What do you feel is a fair value for the firm?

Sarah determined the value of Sunrise using the Gordon Growth Model. Sarah first calculated the free cash flow (FCF) for each year. Then she valued the firm using 1) the average FCF over the four years and 2) only the 2017 free cash flow figure. For the other inputs of the growth model, Sarah used 10% as the discount rate, as this was her current cost of borrowing, and she calculated the simple growth from 2014 and 2017 to be 4.6%. (Instructors may want to increase the cost of capital to include equity opportunity cost. Spreadsheets are available from authors upon request.) Using the average FCF, Sarah valued the firm at $532,031. Using the 2017 FCF, the value was $191,450. (See TN 1 for the calculation of adjusted and unadjusted FCF and TN 2 for the valuation details.) Sarah wanted to have both numbers so she could establish an upper and lower bound in her negotiations. Of course, the large discrepancy depended on which FCF figure best represented *future* FCFs. If potential acquirers would accept the average FCF assumption, then Sarah could negotiate for the higher price. Some students may use the unadjusted FCF to value the firm. Instructors may want to stress that items such as foregone salary, deferred interest that does not appear on the income statement, and the rent covered by another firm, should be considered when calculating free cash flow to value a firm.

Sarah realized that the assumption of a 10% discount rate was very simplistic. It did not include the cost of equity. Sarah felt that trying to estimate a cost of equity would be fairly arbitrary, so she chose to use the current cost of borrowing. Students may conduct scenario analyses using varying costs of capital to check the robustness of their valuation.

Sarah also considered dividing the business into the two areas of operation and selling the two parts to two different bidders. Because Robert ran a design house, Sarah thought that he might be interested in purchasing just the graphic design/presentation portion of the business. Likewise, because Johnny concentrated on equipment rental and sales, she thought that he might be interested in the equipment portion of the business. Following this logic, Sarah valued each segment. She used net revenues (from Exhibit 3 in the case) to determine the weight of each segment and then multiplied each weight by the total value of the firm assuming 2017 FCFs. She estimated the slide/presentation portion of the firm was worth $105,297 and the equipment portion of the firm was worth $86,153. (See TN 3 for the numerical details.) Sarah thought that although Johnny and Robert could not afford the entire business, perhaps they could each afford part of it.

2. Which of the buyers would you most strongly consider and why?

Sarah felt like she had to take some risks in whatever she decided for Sunrise. If she could sell the business, it would pay for her living expenses and life would be fairly comfortable. She didn't want to throw that opportunity away. She chose to work with Robert. Johnny was willing to be an option at a later date, if things didn't work out with Robert. This was a comfortable safety net and it seemed to reduce the level of risk involved. As far as Sarah was concerned, Digitography was not a reasonable option.

Robert and his staff moved all of Sunrise's equipment over into the Vennittee Design office and took over Sunrise's clients and responsibilities at the end of August, as Sarah started school. Sarah was under the impression that Robert would handle the operations of Sunrise himself, but soon found out that he was having his secretary do most of the work. Though she was intelligent, she was not good with the clients. She didn't understand the procedures, constantly exposed her ignorance, and was generally silly and unprofessional. Sarah demanded that Robert remove her from the Sunrise responsibilities and he let her go entirely.

As the next few months passed, Robert's finances were worsening rather than improving, and it was apparent that he would not be able to purchase Sunrise. In the mean time, Johnny had been offering to run the business without buying it. Sarah was uncomfortable with this because she knew she wouldn't have a business to sell once Office Visuals took over. She felt strongly that it was in her best interest to try to sell it, so she worked with Robert for several more months.

During the course of that time, from August to November, there were a couple of companies that showed minor interest in purchasing Sunrise. Digitography remained interested in Sunrise. However, they were able to acquire many of the Sunrise clients during the months of transition due to Robert's inability to service them. Digitography still wanted to see the books and get an idea of what Sunrise was worth to see if they would still be interested. What they actually wanted to do was form a partnership in which Sarah would be a silent partner. This was very uncomfortable for Sarah. She wouldn't have her hand in the business except mainly as a risk absorber, and she knew very little about their company. They were demanding to see everything and were hesitant to share their own information.

By the time Robert was no longer able to maintain Sunrise, Johnny was the only option left. In December, all of the equipment was moved back into the Sunrise office and Johnny transferred the phones and took care of all of the business aspects. Office Visuals took all of the calls and served the clients from that point on.

Epilogue

More than anything, Sunrise became both a large financial loss and a large learning opportunity for Sarah. In the end, Johnny failed to follow up on Sunrise clients; he just took their calls. Sarah had no way to track the satisfaction of the Sunrise clients as she was totally engaged in her MBA studies. Sarah knew she had to let the company go and move on with her education and her life.

TN 1. Sunrise Presentation Expanded Income Statements and Free Cash Flows

	2017	2016	2015	2014
Total Revenues	$126,402	$146,023	$74,535	$106,746
Expenses				
CGS	$17,889	$59,939		
Advertising	$350	$1,071	$1,521	$1,401
Vehicle	$3,196	$2,138	$1,996	$1,704
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Amortization	$3,477	$580		
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Federal Taxes	$9,573	$5,401	$3,705	$5,193
State Taxes	$1,619	$913	$627	$878
Net Income	$26,691	$15,059	$10,329	$14,478
Foregone Salary	$20,500	$3,333	$4,000	$5,000
Deferred Interest	$2,000			
Rent Covered by DeskTop	$1,500			
Free Cash Flow Calculation				
EBITDA	$45,069	$37,199	$35,421	$56,344
Taxes	$11,192	$6,315	$4,331	$6,071
Unadjusted Free Cash Flow	$33,877	$30,884	$31,090	$50,273
Adjusted Free Cash Flow	$9,877	$27,551	$27,090	$45,273

TN 2. Estimate of the Value of Sunrise Presentations

Value of Business via the Growth Model

Growth Model Assumptions		
Average Free Cash Flow	$27,448	From TN1
2017 Free Cash Flow	$9,877	From TN1
Average Annual Growth in Sales	4.6%	=((2017 Sales-2014 Sales)/2014 Sales)/4
Cost of Outside Financing	10.0%	Assume current borrowing rate
Growth Model (average FCF)	$532,031	=Avg FCF*(1+growth)/(discount rate - growth rate)
Growth Model (2017 FCF)	$191,450	=2017 FCF*(1+growth)/(discount rate - growth rate)

TN 3. Estimate of the Value of Sunrise Presentations by Business Area

Value of Business by Area		
Equipment Rental and Sales		
Gross Revenue	$68,402	=Given Exhibit 3
CGS and Supplies	$42,161	=Given Exhibit 3
Net Revenue	$26,241	
Slides and Design		
Gross Revenue	$58,000	=2017 sales - equipment gross revenue
CGS and Supplies	$25,987	= (2017 CGS + 2017 Sales) - equipment CGS and Supplies
Net Revenue	$32,013	
Percentage of net revenues contributed by Slides and Design area	55%	= $32,013/($32,013+$26,241)
Value of Slide Part of Firm		
Growth Model (2017 FCF)	$105,297	=2017 FCF Value * 55%
Value of Rental Part of Firm		
Growth Model (2017 FCF)	$86,153	=2017 FCF Value * 45%