GROSS PROFIT MARGIN AND BUSINESS PURCHASE DECISIONS:

- Very often, a business is advertised as being available to purchase.
- Most often, this applies to retail businesses though can also apply to trade businesses such as motor factors, building materials suppliers and similar trade suppliers.
- Typically, the most recent annual turnover (or sales) is made available by the selling agent– this is often referred to as "Certified Turnover".
- A knowledge of the sector is very important before making any decision to purchase a business.
- A key plank in any decision to buy is knowledge of the gross profit margin in the sector.
- It is important to determine whether the certified turnover is sufficient to generate enough gross profit to cover the anticipated annual overheads of the business.
- The annual gross profit should also be sufficient to cover the repayments on any borrowings taken out to purchase the business and also the required annual income of the proprietor should he proceed with the purchase.

DECISION MAKING PROCESS:

1. Set out the annual indirect overheads anticipated to be incurred in running the business. Examples are: wages – rent – rates – insurances –light & heat – maintenance etc
2. Determine the annual amount of loan payments to be made i.e. 12 times the monthly repayment.
3. The question will set for you the annual income required by the proposed purchaser of the business.
4. The sum of the figures set out at 1 2 and 3 is the annual Gross Profit Required to cover these amounts.
5. The gross profit margin for the sector is given in the question.
6. The required annual turnover that must be done is the Gross Profit divided by the gross margin.
7. If the certified turnover exceeds the required turnover, then the business should be purchased. If not, then care about proceeding with the purchase.

LET NOW DO SOME SAMPLE QUESTIONS:

GROSS PROFIT MARGIN:

This is the most important key economic statistic of a trading business.

How is it computed?

Trading businesses measure profit in 2 stages: First state is the measurement of Gross Profit viz. Sales less Direct Costs. The second stage is the measurement of Net Profit viz. Gross Profit less Indirect Costs (costs other than costs of goods acquired for resale e.g. wages, rent, light heat etc).

1. GROSS PROFIT: this is the difference between the sales value of all goods sold and the direct cost of acquiring those goods.

2. SALES: this is the aggregate value of all goods dispatched and invoiced out to customers in the year. There is a paper trail to evidence this figure such as customer order forms, dispatch notes / delivery dockets, sales invoices, customer statements and cash received and banked.

3. DIRECT COSTS: This is the cost of the actual goods dispatched and invoiced out to customers. In order to arrive at this figure, the cost of all unsold stock at the year end must be determined and this give rise to the annual stocktaking viz. a physical count of all goods remaining unsold and still physically on the premises is recorded and then valued at cost using supplier invoices. Direct costs are arrived at as follows:

OPENING STOCK	8000
ADD PURCHASES IN YEAR	56000
TOTAL OF GOOD AVAILABLE FOR SALE	64000
LESS CLOSING STOCK OF GOODS UNSOLD	4000
DIRECT COSTS / COST OF SALES	60000

4. GROSS PROFIT = SALES LESS DIRECT COSTS

5. Using the figures at 3. and assuming sales of EUR 100,000, then the Gross Profit is

SALES	100,000
COST OF SALES	60,000
GROSS PROFIT	40,000

6. GROSS MARGIN: this is the Gross Profit expressed as a percentage of Sales for the year. In the above example, this computes at 40%.

7. The margin tends to be known for most trading sectors, some examples are:

Dublin Pubs	65% to 70%
Rural Pubs	50% to 55%
Petrol / Diesel	8%
Cigarette Vending	10% to 11%
Travel Agents	9% to 12%
Spar Shops (excluding lotto)	23%
Lotto	6%
Freight Forwarding	15%
Vehicle Sales – Dealership	~ 10%
Restaurants	55%-60%
Takeaways	60% to 70%
Retail Hardware	55% to 60%

A retail motor factors shop is on the market for sale as a going concern. Bill Riley is considering bidding for the purchase of the store. Essentially, he will be acquiring the leasehold interest in the property and the goodwill of the business. It is on the market for €700,000. He expects to spend an additional €60,000 on refurbishing the premises and promoting the change of ownership.

Bill intends to borrow the €760,000 required. The repayments over 20 years at 7% will be €5,920 per month.

The auctioneer has indicated that the turnover of the existing business in the last year was €600,000.

The following information on costs has been determined:

Light and Heat	4,800
Telephone and postage	2,600
Printing & Stationery	800
Insurances	9,800
Wages (2 persons)	70,000
Wages (part time)	10,000
Repairs & Maintenance	2,000
Rent & Rates	56,000
Total projected overhead	156,000

The Gross Margin from this sector is 55%.

Bill considers that he requires an income of €60,000 per annum.

a. Determine for Bill whether or not he should go ahead with the purchase of this business. (18 marks)

b. What Profit over and above the €60,000 that he requires would be earned if Bill achieved a Gross Margin of 60%?. (7 marks)

Total 25 Marks.

QUESTION A

- REVIEW OF BUSINESS PURCHASE:

You have been offered an opportunity to purchase a freight agency specialising in long haul groupage freight to Europe. The established Gross Profit Margin in this sector is 26%. You are advised of the following costs:

Wages	300000
Vehicle Leases (annual)	12000
Light and Heat	4000
Telephone and postage	4000
Insurances	12000
Printing & Stationery	4000
Rent & Rates	50000
Repairs & Maintenance	2000
Motor Running Costs	12000
Total projected overhead	400000

Annual sales of the business is €2,240,000 and is being offered to you for €500,000.

The agency agreements have 5 years to run at which point they will be renewed provided the standard of service that has been provided to date is maintained. There is further scope to acquire other agencies on the strength of the good name and reputation of the business.

You have been approved for loan approval should you wish to go ahead with this venture. The term offered is 15 years at 7%. The loan repayment per month on borrowings of €500,000 will therefore be €4,500.

You current annual salary is €80,000 per annum which you would like to retain.

Carry out a Gross Margin sensitivity analysis as a basis to determine whether you should proceed to acquire this business.

Solution A

- Expected Costs:

Wages	300000	
Vehicle Leases (annual)	12000	
Light and Heat	4000	
Telephone and postage	4000	
Insurances	12000	
Printing & Stationery	4000	
Rent & Rates	50000	
Repairs & Maintenance	2000	
Motor Running Costs	12000	400,000

• Required Profit	80,000
• Loan Repayments	54,000
Total Gross Profit Required	534,000
Gross Margin	0.26
Required Turnover	2,053,846
Certified Turnover	2,240,000
Excess of certified turnover over Required Turnover	186,154

REVIEW OF BUSINESS PURCHASE:

Peter Smith is considering the purchase of a retail store. Essentially, he is purchasing the leasehold interest in the property and the goodwill of the business. It is on the market for €500,000. He expects to spend an additional €100,000 on refurbishing the premises and purchasing new equipment.

Should he go ahead with the purchase of this business, Peter will borrow the €600,000 required.
The repayments over 12 years at 7% will be €6,200 per month.

The auctioneer has indicated that the turnover of the exising business in the last year was €800,000.

The following information on costs has been determined:

Wages (2 persons)	60000
Wages (part time)	15000
Light and Heat	6000
Telephone and postage	3600
Insurances	12000
Printing & Stationery	1000
Rent & Rates	50000
Repairs & Maintenance	2000
Total projected overhead	149600

The Gross Margin from this sector is 40%. However, on account of sales promotions and other competitive factors, Peter considers that his margin is likely to be 36%.

Peter also considers that he requires an income of €50,000 per annum.

a. Determine for Peter whether or not he should go ahead with the purchase of this business.

b. What additional profit would arise if the certified turnover figure and 40% margin were achieved?

SOLUTION PETER SMITH

- Expected Costs:

Wages (2 persons)	60,000	
Wages (part time)	15,000	
Light and Heat	6,000	
Telephone and postage	3,600	
Insurances	12,000	
Printing & Stationery	1,000	
Rent & Rates	50,000	
Repairs & Maintenance	2,000	149,600
• Required Profit		50,000
• Loan Repayments		74,400
Total Gross Profit Required		274,000
Gross Margin		0.36
Required Turnover		761,111
Certified Turnover		800,000
Excess of certified turnover over Required Turnover		38,889

Certified Turnover	800,000
Gross Profit at 40%	320,000
Gross Profit Required	274,000
Additional Profit	46,000

BUSINESS PURCHASE :-

An agency business is for sale. It comprises in the main exclusive import & sale to the Hotel / B&B sector of a specialist cleaning solution which is a brand leader.

The margin on this product is set by the manufacturer and is 70%. Annual costs are:

- Rent	€ 70,000
- Rates	15,000
- Insurances	7,500
- Administrative costs	12,500
- Sales & Promotion	25,000
	130,000

The exclusive agency is for sale at €500,000. Repayments on a term loan of €500,000 will be €5200 per month over 12 years.

You are advised the the certified turnover of the agency for the last 12 months trading period was €460,000.

You have been approached to advise a potential buyer of this agency who advises you that he requires annual earnings from this venture of at least €80,000 p.a.

Accepting that the turnover of the agency can be retained, what would your advice be to the potential buyer.

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QUESTION NO. 6

In the recent property supplement of the local newspaper, a retail franchise business is listed for sale in the commercial property listing. The guide price for the business is €280,000. Though the business has traded successfully for many years, it is considered that it still has potential for growth though some promotional expenditure and enhancement costs of an additional €30,000 will be required.

Paul Wall is interested in acquiring the business and intends to borrow the full €310,000 required. The repayments over 20 years at 7% will be €2,368 per month.

The auctioneer has indicated that the turnover of the existing business in the last year was €260,000.

The following information on costs has been determined:

Light and Heat	2,700
Telephone and postage	1,100
Printing & Stationery	900
Insurances	4,400
Wages (2 persons)	38,000
Repairs & Maintenance	1,000
Rent & Rates	30,000
Total projected overhead	78,100

The Gross Margin from this sector is 60%.

Paul considers that he requires an income of €35,000 per annum.

Determine for Paul whether or not he should go ahead with the purchase of this business.

Total 25 Marks