

What is My Business Worth?

by Barry Evans

While the title suggests you have discovered the *Oracle of Delphi* and that I will share with you the carefully guarded secret about how businesses are valued, the truth is that there is no one size fits all approach to the topic. However, I will share with you why this is the case, and then I will give you some solid guidelines for understanding the logic and reasoning behind how businesses are valued.

Let's limit the topic to privately owned (as opposed to publicly owned) businesses with annual revenues ranging from under a million to those generating tens of millions each year. Such businesses range from one person businesses to those with numerous employees and structured management in place.

Many people expect the relative simplicity of getting real estate appraisals when it comes to valuing their privately owned businesses. It simply is not the case for the following primary reasons:

* **Comparables** drive most real estate valuations, and there is no comparable data available for privately owned business transactions unless the buyer happens to be a public company that has to publicly disclose data.

* **Replacement cost** is used in real estate valuations, but that is simply not applicable to privately owned business valuations.

* **Businesses are very unique** (even those in the same industry), and that uniqueness, which is generally not found in real estate comparables, can significantly either add or detract from value.

* **Significant tax structuring issues** are a major reality in business transactions, and not in real estate transactions, and those tax implications can have a major impact of the value of a business.

* **Business transactions have unique financing arrangements**, as opposed to most residential real estate sales which are almost always all cash. The various financing arrangements can affect.

* **Business and investment risks:** While commercial and industrial properties entail management and operating risks, those risks are more readily identified/addressed than the mercurial and varied risks associated with the change of ownership in a privately owned business.

Let's define some key terms:

RECASTING is the process by which a business' financial information is 'recast' by adding back into reported earnings: non-cash items (depreciation and amortization); interest expense; income taxes paid; non-recurring expenses, such as moving expenses; and owner discretionary expenses (personal expenses paid for by the business, owner compensation exceeding the cost of a full-time, experienced General Manager, etc.).

STABILIZED EARNING POWER is the net result of recasting. It shows what the business would have earned pre-tax, devoid of the expenses described above. Important: This is **AFTER** management expense.

EBITDA (Earnings before Interest, Taxes, Depreciation and Amortization): This is the same as Stabilized Earning Power; however, most lenders and accountants prefer this acronym.

ODI (Owner's Discretionary Income): This is basically the same as EBITDA; however, it is **BEFORE** management expense. Most small businesses on the market state their earnings this way. Buyers can mistakenly confuse their personal salaried earning power with the business' earning power.

STABILITY OF MARGINS and OTHER RATIOS: Showing the income, expense and recasting data for the last 4 to 5 years allows for an understanding of the historic stability of revenues, expenses and various ratios.

RANGE OF VALUE: Value should always be expressed as a range of value instead of a single number because different buyers have different perceptions of a business' value: a financial buyer gauges value based upon the historic earnings, while a synergistic buyer places a value based upon what his/her synergistic resources can do to increase future earnings. Thus,

FMV (FAIR MARKET VALUE): The price an informed, capable buyer, under no compunction to buy, would pay a seller under no compunction to sell.

The overwhelming importance of the above FMV definition is that the value of a business is determined by what buyers, and their lenders (if any), see as a win-win transaction. Thus, valuations must be approached through an understanding of buyers' minds. Their key components will include:

Suitability of the Business Basically is this a business they feel they can learn to manage and be happy owning? Some businesses have widespread appeal, while others have little curb appeal. That difference clearly impacts the business' value.

Stability of the Business If the margins and trends have been negative or inconsistent, future margins and trends could also be either negative or inconsistent, thus increasing risk and lowering the FMV.

Role of the Former Owner If the current owner is a modern day Superman (putting in 60 hours a week, doing everything, being indispensable), it clearly creates a hard act to follow and negatively impacts the value of the business.

Risk Within the Industry and/or the Business Itself Large or hard to gauge risks scare buyers and lenders and depress FMV. Different businesses (and different industries) have different risk factors that buyers will consider.

Customer or Vendor Concentrations If a single customer is over about 15% of revenues, it represents a major risk that can negatively impact both price and marketability. The same can be said for vendors that provide much over 40% of goods.

Ultimately, buyers arrive at their perception of the potential future Stabilized Earning Power (EBITDA) of the business under their management. In addition, they determine what risks are inherently involved in owning and operating the given business. Buyers use their perception of risk to determine an appropriate Rate of Return (ROI). For example if their ROI objective is 25%, after paying themselves a reasonable salary they expect the business to have EBITDA at approximately 25% of the Purchase Price of the Business. Whether they plan to pay all cash for the business, have a lender involved or have the seller provide seller financing has nothing to do with the ROI calculation: It is future anticipated EBITDA as a percentage of the purchase price (value) of the business. Once ROI is determined, it is divided into 100 to give you the appropriate multiplier, as shown in the example below:

ROI and Multiplier Examples

EBITDA	ROI	Multiple of EBITDA	Buyer's Perception of Probable Value
100,000	25%	4	\$ 400,000
500,000	30%	3.3	\$ 1,650,000
400,000	40%	2.5	\$ 1,000,000
\$2,000,000	20%	5	\$10,000,000
\$4,000,000	18%	5.5	\$22,200,000

While the foregoing is a primary indicator of FMV, another factor is the net asset value (assets minus liabilities) being acquired. You DO NOT add the net asset value to the above probable market values! Buyer and lenders universally expect the purchase price to include whatever stuff it takes to generate

the EBITDA. However, if a business has a probable FMV of X, the ultimate value can/will be influenced by whether the net assets included in the transaction are for example 20% of X or 80% of X. Those calculations are far too involved for this abbreviated summary.

The central issue is that buyers' perceptions of EBITDA, risk and other pertinent issues result in an ROI that determines whether they will invest in a business. To complicate the matter, ROIs are influenced by the overall economic climate, the region where the business is located, interest rates and a host of other issues. With all that being said, we routinely are asked what ROIs apply to a given industry. The above paragraph clearly explains why there is not an intelligent answer to the question. What can be said is that as a general rule: multiples paid for small businesses are greater than those paid for mid-size businesses (due primarily to less sophisticated buyers); there will be some uniformity of opinions for multiples for mid-sized businesses (due to more sophisticated buyers); and businesses with \$1,500,000 or greater EBITDA sell at the highest multiples because the most probable buyers are typically well financed, bring a number of synergies to the transaction, and thus have higher projected EBITDA numbers in mind.

Even with a firm grasp on the above essentials, one must understand that the entire process is very subjective (no cookie cutter approach works very well). To illustrate the types of internal factors within a given company that influence ROIs and the

perceptions of risks and probable rewards, please view the table below. It tracks various characteristics of six different companies (A through F). The X marks indicate various characteristics of each. Your task is to sort through the companies and rank them in the order to which the highest multiple (lowest risk) should be assigned. After completing the exercise, assign actual multiple numbers to each of the companies to show mastery of the subjective phase of the valuation process.

Hopefully by diligently reading this far you will have a good understanding of the subjective nature of the valuation process. My goal is to convey that valuations are best done by professionals involved in the merger/acquisition market who know what ROIs, multiples and other factors exist in the market at any given time. By sharing these insights you will stand less chance of falling prey to the valuation sweatshops that charge unconscionable amounts of money for taking a business' financial data, applying 5 to 15 different formulas, and then averaging them to provide a number that has little if any relevance to the actual FMV.

Internal Factors Influencing Perception of Risks **How would you rank these companies?**

Companies	A	B	C	D	E	F	Required ROI
Largest customer 75% of total revenues		x		x			
No customer over 15% of total revenues	x		x		x	x	
GP %s 50%, 65%, 68% over last 3 years		x	x		x		
GP %s stable between 64% and 65%	x			x		x	
Large competitor opening in their market		x					
No larger competitors identified	x	x		x	x	x	
Owner works 70 hrs/wk; 'does everything'		x				x	
Somewhat absentee owner, has Gen. Mgr.	x	x		x	x		
Revenues declining each of last 5 years	x		x				x
Revenues increasing each of last 5 years		x		x	x		
Losing lease must relocate in 1 year			x				
Key GM employee is 69 years old			x				
Company has cross trained management	x	x		x	x	x	