

Valuing A Small Business For Sale

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Pricing a business correctly is important if you really want to sell it. As a consultant I talk to many business owners, brokers, and agents on a daily basis about valuing businesses. It always amazes me on how some of these individuals come up with the values on small businesses being sold. No wonder only 30% of all businesses sell. In many instances no consideration is given to the total picture—will the available cash flow of the business be able to pay the debt of a loan, will the deal as structured or priced be attractive to financing sources, "cash" price vs. "note" price and how these factors figure into the equation.

I have seen many "professional valuations" where the price just doesn't make sense—and sellers wonder why their business for sale just sits there with no action.

1. Market Approach

There is a solution that is grounded in the fundamentals of economics, and time tested in the marketplace, where the influences of supply and demand ultimately determine where a business belongs on the price scale. One economist explains this market approach by comparing a business to a machine which has the purpose of making money: The more money it makes, the more it's worth. And that explains why, for example, there is a strong demand for a very profitable distribution business with few hard assets; and why it is worth more in the marketplace of available businesses, than a large machine shop that would cost nearly \$1 million to duplicate, but can't make a living for its owner.

2. Adjusted Net Income

The first category of information needed is called adjusted net income, and is the total amount of cash produced by the "money machine." It's a figure that includes the profits, the owner's salary and all of the many cash-related benefits which are enjoyed by the principals of small businesses. Those benefits can include the use of a company car, the company-paid premiums for health, life and auto insurance, plus personal expenditures tucked into travel and entertainment, subscriptions and similar business "expense" categories. Interest expense should be added to adjusted net income, along with accounting entries—such as depreciation and amortization—that can divert money to the owner's pocket so that it never appears on the bottom line of the P&L.

While some of these items vary from business to business, any owner knows which categories of expenses in his or her financial records include sums of money that should be added to adjusted net income. Many business owners also know of cash income that never sees the business records in any way, shape or form. Some owners feel they should get credit for these sums in the calculation of value. But it's a poor policy to collect unreported income and then attempt to have it included in adjusted net income for evaluation purposes. When selling, your buyer prospects want any statements you make about your business to be supported by evidence in the form of accounting records and other reliable sources. To admit that you are doing business "off the books" not only exposes you to problems with the IRS, it also sets a bad tone with prospects who—if they are going to be interested in your business—need to believe your practices and record keeping are above reproach.

Adjusted net income is usually the first thing any buyer wants to know about when investigating a business; and not just the past few months' worth of income. A seller should be prepared to demonstrate a history of earnings, and have the documentation to back it up.

3. Multiplier Method

The next piece of the equation comes from the expectations working in the marketplace to shape the multiplier—a figure which will be computed, along with the cash flow, to calculate a rough value. The validity of the multiple is that it reflects behavior in the market. There is no need to theorize about a proper multiplier. It's calculated by determining what people actually pay for small businesses.

The experience with low risk businesses is that their high market demand is reflected in a fairly strong multiple. A lot of buyers want, for example, a well-established franchise, or a grocery store with a long lease in a densely populated area and little direct competition. Its multiple might be in the range of two to three times annual adjusted net income.

A one or two multiple, on the other hand, would be associated with an enterprise in which the buyer is assuming greater risk. An example is a retail store near a large shopping area, which leaves the buyer of the smaller business vulnerable to the competitive marketing activities of much larger companies. The lower multiple is a consequence of lower market demand. Fewer people want that kind of business.

Since profitable distributorships and manufacturing companies are much sought after, it's not unusual to see them command a price upwards of four times annual adjusted net profit. The company in this category providing adjusted net profit of \$200,000 might realize a selling price in the range of \$800,000, assuming a favorable deal structure (more about that shortly). Also warranting a high multiple are businesses loaded with assets—equipment, trade fixtures and inventory. But remember that a seller must be able to establish the company's "history of earnings" with financial reports and tax returns, before the higher price will be offered.

More commonly available businesses, such as restaurants, are priced with a lower multiple—in the one to two range—to reflect the abundance of this kind of business available for sale at any one time. In this case it's purely a matter of supply and demand.

4. Importance of Deal Structure/Terms

And the final factor thrown into this equation is particularly useful in determining the value of businesses offered for sale. It recognizes that the terms of a transaction—in other words, how a price is paid—are critical in calculating that price. When sellers demand all cash for their businesses, for example, the market tells us that they can expect to receive about 60% to 80% of the sum they would have gotten by taking a down payment and financing the balance.

It's easy to understand why deal structure is such a vital component in the valuation process. For a business to be affordable, the cash flow needs to be substantial enough to support the price at the multiple being used. A deal that requires a lot of cash up front, in relation to the expected amount of adjusted cash flow, will place a greater burden on the buyer. That principle, translated into the language of the marketplace, means the business will only be appealing at a low price. If, on the other hand, the level of adjusted net income supports the buyer's ability to make payments to the seller in order to purchase the business—this opportunity will interest more potential buyers and the result is a higher achievable sales price.

Other ways an attractive deal structure can be used to build market appeal include a delay of a few months—after close of escrow—before monthly payments on the seller's financing are due to begin, a low interest rate, and interest only payments for awhile, until a new owner is able to build the business to more easily meet the loan obligation. Creative deal structures always help sell a business and will usually command a higher market price for the business (remember it has to make sense).

Pricing a business is as much or more of an art than a science. Sellers who take a look at the big picture—looking at both deal structure and price are usually the ones who are successful in selling their business.

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