Business Valuation:

Appraising Your Business in 60 Minutes!

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There is a simple method for appraising most businesses. Key terms are important to understand. Major exceptions must be noted.

A short-cut method is useful because it can give you a general idea of what a business might be worth.

Attention must also be paid the non-financial aspects of business valuation (**see also the companion article "*Value Drivers of Business Sales*"**).

Business values are influenced by many factors besides just earnings.

Warning: any figure derived by using a simple method won't be exact.

Also, the method used in this article **doesn't** apply to the larger businesses with annual gross sales over, say, $5-10 million. It also **doesn't** apply to businesses like motels, hotels, golf courses, ranches, campgrounds and marinas, where real estate values are such major elements.

So, What's the Method?

This short-cut method comes from the use of comparable data from businesses that have sold. As messy as this data often is, in its aggregate form, it offers surprising clarity.

In the last 40 years, two large publicly available databases of small business sales have been developed: BizComps® and Pratt's Stats®. The business sales they contain have proven to be reliable barometers for business valuations.

From these sales, earnings multiples can be derived. The most common is a multiple of "cash flow to the owner," an expression of earnings that BizComps® labels "Seller's Discretionary Earnings," or SDE.

SDE is calculated by taking EBITDA and adding owner's salary. EBITDA is "earnings before interest, taxes, depreciation and amortization," a common earnings definition.

Technically, SDE also calls for the adding back of all non-cash, non-operating and non-recurring expenses, as well as income taxes paid, but for most small businesses, these are either obvious, inconsequential, and/or illegal for your CPAs and we brokers to even know about, so we are ignoring them here.

SDE, or owner's cash flow, is thought to be a more appropriate measure of earnings for smaller businesses. EBITDA is used mostly to measure earnings of the so-called "mid market" businesses - those large enough to have a separate layer of professional management separate from ownership.

What the historical sales of businesses show (consistently over many years, believe it or not!) is that small businesses tend to sell for between 1.5 and 3.5 times historical SDE, not including inventory (for resale) and/or real estate.

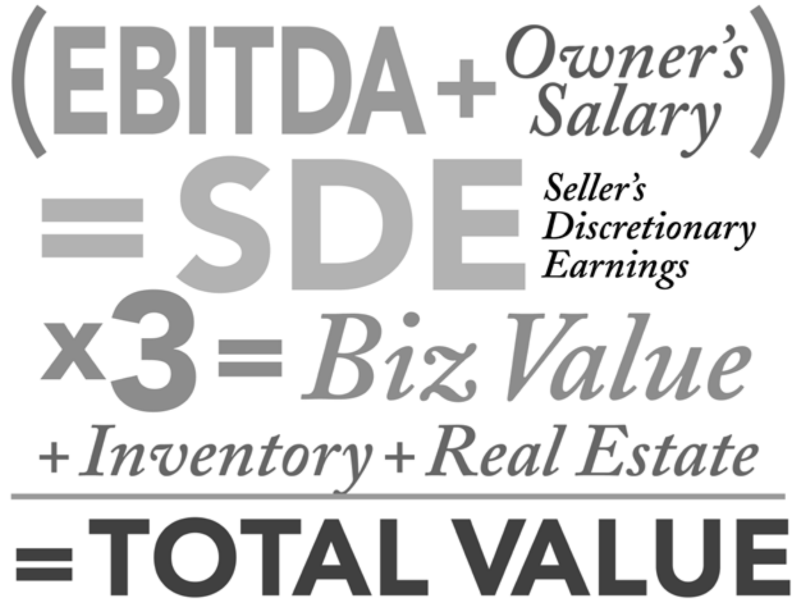
Before we go on, however, let's be clear that we understand that "SDE" is a specific level of earnings, not to be confused with "EBIT," "EBITDA" or other levels.

The multiples are different when applied to different levels of earnings.

The earnings multiple goes higher when using EBITDA, and higher still with EBIT.

Part of the reason this is so confusing is that business publications and Internet writings are often incorrect in their use of this data.

Remember, also, that this DOES NOT apply to the real estate and/or to businesses which are comprised of mostly real estate assets.



Even if we all agree to be consistent about the level of earnings we use, the data is still a bit messy, often giving us a range of data points.

Because of the range of data points that we often get, a simple-to-understand multiple of 3x SDE (3 "times" the annual SDE) is often used as an approximation of value.

This multiple, which might be too high for some businesses and too low for others, is still often seen as a "ballpark" estimate of value.

It is at the higher end of the historic range, so business owners frequently choose it as the "starting point" for their business pricing.

But, What About . . . ?

At this point, nearly everyone asks questions that begin with, "But, what about . . . ?"

Before we can properly answer any of these questions, we need to provide just a little more basic detail.

When calculating EBITDA, the databases use "the most recent reporting period." In actual practice, however, buyer prospects are usually thinking ahead of what the future will hold for them.

What the current owner did last year is not as important as what's happening now, and/or what the buyer estimates future cash flows will be.

For the "owner's salary," there is not only the add-back for the actual “W-2” salary, but also for other owner benefits. And, to obtain uniformity of the data, there is an adjustment back to just one owner salary. If multiple owners run a business, these wage adjustments can get pretty tricky.

Within the multiple-derived price, the business' furniture, fixtures and equipment are included, along with all intangible assets. In most cases, the owner's personal vehicle is not included, even though it is often owned under the business name.

Real Estate Included?

Real estate is not included in the multiple-derived value; so, if real estate is going to be part of the valuation, we need to add it. Inventory and work in process values also need to be added at the lesser of cost or wholesale market price.

Two other major points need to be made about this multiple-derived value: accounts receivable are not included, nor is any accounting made of possible company debt.

Accounts receivable are most often retained by sellers, collected in the transition period following a sale. They are rarely sold.

This formula also assumes a debt-free business. Existing business debt obviously must be subtracted from the value estimate to arrive at a pre-tax net figure for the seller. In addition, if a buyer assumes debt when buying, it is counted as part of the purchase price in this model.

What is, or isn't, included in the formula or multiple-derived value depends, of course, upon the definition of value. To keep this simple, we have chosen to use the BizComps® sales price definition.

BizComps® separates the reported business selling price from the sale of inventory and real estate. If we say, for example, that a business is worth "3 x SDE," it is because there are many comparative transactions to show that businesses often sell for prices which reflect this multiple.

This "3 x SDE" has become the most common “ballpark” estimate of small business value over many years.

Admittedly, a “rule of thumb” like this is grossly simplified and can be misused. Business appraisers are often opposed to their use because they are too simple.

In over three decades of selling businesses, however, I have seen this particular rule of thumb used many times by those who actually buy small businesses. ■