Business Valuations

After you have owned and operated a small business for a period of time - whether you started it from scratch or purchased it – no doubt you will be wondering how much the business is worth. If you owned stock in a publicly traded company, it would be possible to check the valuation on a daily basis to determine the worth of your investment. With a privately owned company, however, that "public valuation" option is not available. There are a number of other techniques you can utilize to try to place a value on your company.

Many business valuations are based upon various multiples of financial data. In order to use a "Multiples," approach, you need to determine which financial data you wish to review. Some of the standard financial data and terms are as follows:

1. Book Value of Equity – defined as total assets minus total liabilities.
2. Book Value of Invested Capital – defined as (total assets minus total liabilities) plus long term liabilities.
3. Discretionary Earnings – Defined as net income plus taxes plus interest expense plus owners' compensation plus non cash charges.
4. Earnings Before Interest and Taxes (EBIT) – defined as net income plus interest expense plus taxes.
5. Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) – defined as net income plus interest expense plus taxes plus noncash charges.
6. Earnings Before Taxes (EBT) – defined as net income plus taxes.
7. Gross Cash Flow – defined as net income plus noncash charges.
8. Net Income – defined as after tax net income.
9. Net Sales – defined as annual gross sales, net of returns and discounts.

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In order to use a multiples approach, you also need to determine which industry category your business falls into. Commonly recognized categories are:

1. Services
2. Finance, Insurance, and Real Estate
3. Retail Trade
4. Wholesale Trade
5. Transportation, Communications, Electric, Gas, and Sanitary Services
6. Manufacturing
7. Construction
8. Agriculture, Forestry and Fishing
9. Mining

Of course, each of these broad categories can be further broken down into more specific types of businesses. For instance, the "Services," category contains many types of businesses, such as Hotels and Motels, Advertising Agencies, Employment Agencies, Physical Fitness Facilities, Business Services, Data Processing Services, Custom

Computer Programming Services, and many others. Obviously, knowing where you fit within recognized industry categories is essential to determining how your business should compare with others in terms of valuation based upon multiples of financial statistical assessments.

Once you have determined which industry category your business fits into, and which financial statistics to review, you can determine how many multiples (1 year, 3 year, 5 year, 10 years, etc.), to use in your valuation based upon industry standards. There are various sources from which you can glean information pertaining to the appropriate multiple. For instance, an experienced commercial banker often has good information regarding multiples being used, as well as accountants. In addition, various standard industry sources for valuation exist that can be queried to determine what multiples are applying to other businesses in your industry category.

Another common valuation method is the "Discounted Cash Flow Model." In this method, valuation is based upon a projection of the amount of cash a company will be able to generate in future years, and then applies a discount factor to determine a present value for that prediction. Of course, the number of years over which this prediction applies is one of the most important factors in determining the ultimate valuation. Some business experts recommend that the discounted cash flow figure should not be based upon anything more than 5x (five times), especially because in many cases acquisition of a company involves financing approximately 75% (seventy-five percent) of the purchase price with debt. If a purchaser spends five to ten years paying off the debt, there is very little time left to earn profits on the investment if you pay too much.

In order to improve a potential valuation of your Company, it is extremely important to accurately track every dollar made and spent. This is accomplished through the integration of appropriate financial reporting mechanisms throughout the business. Many times it is necessary to involve an accountant to review the day to day operations and make certain that the financial statements have integrity. Any buyer engaged in a due diligence review of a business will drill down into the financial statements to make certain the numbers are reliable. The seller should be comfortable disclosing the numbers to a buyer, without concern that hidden inaccuracies will appear. Of course, disclosure of financial statements should only be made after signing appropriate Confidentiality and Non-Disclosure Agreements.

Some other important considerations to improving the value of your business include:

- Improving the physical appearance of your facilities;

- A Little paint and polish may go a long way toward recouping your investment.

- Know who your customers are, who your best customers are, how long they have been with you, and how much they are likely to buy in the future.

- Know who your suppliers are, keep track of their stability, and know where any doubtful suppliers can be replaced.

- Make sure your arrangements with employees are well documented, appropriate non-competes or other arrangements with key employees have been put in place, and any pension or other retirement obligations will not adversely affect the valuation.

It is also very helpful to have a complete written Operations Manual detailing all aspects of the business that can be passed on to a purchaser in the event the seller does not stay involved with the business for a period of time after the sale.

One of the best ways to improve the valuation of your Business is to do a valuation on a regular basis. In this way, you will learn which areas of the business adversely affect valuation, and where improvements can be made. Ultimately, value of a business boils down to what a purchaser is willing to pay for the business, and what the seller is willing to sell it for. Knowing where you fit within various industry standards is extremely helpful as a starting point. Many business experts recommend that you start the process of valuing your Business no later than 3 (three) years before you intend to sell. But of course, you may always want to be ready for an unsolicited offer.