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# AN IN-DEPTH LOOK AT HOW TO **VALUE A COMPANY**

# Overview

Everything has a value, and your business is no exception. To determine if your current business practices are positively impacting your profitability, or to choose the right listing price before a sale, a business valuation is imperative. That said, a business valuation is more complex than profits and revenue. **The worth of your business is determined by both tangible** (i.e., assets, cash flow, profits, etc.) **and intangible** (i.e., goodwill, customer satisfaction, etc.) **assets.**

Here, we will explore not only different business valuation methods but also the unique value of each as well. We will even provide some other information that will help you navigate the business valuation process. The hope is, that by the end, you will be able to determine which method is best for you and your business.

# Introduction

A business valuation is a delicate process – there is no exact formula. There is certainly strategy and expertise involved, as under-valuing can mean you undersell your business while aiming too high can mean you never sell your business. We know that this is understandably a sensitive and emotional process, as a business owner typically believes their business is high-valued, no matter what, as a result of the value they personally give the business. In this situation, it is important to work with an experienced professional who separates personal feelings and focuses on the facts before them.

# Approaches and Methods of Valuation

There are three common approaches to valuation:

**Income Approach**

Most often using either a cap rate or discounted cash flow methods.

**Assets-Based Approach**

Methods to value the assets include Excess Earning Method.

**The Market Approach**

Most often using a comparable sale approach.

To help you choose the best approach for you and your business, let's take a closer look at each method of valuation. The above is hardly an exhaustive list.

## Discounted Cash Flow/Cap Rate

A strategic buyer will likely prefer this method as it forces the business owner to give attention to details like trends in sales and profits and the capitalized value of the company. This method provides insight into the possible income that can be made by the investor in the coming years. The cash flow method allows a more concise view of the possible return on investment. The cap rate method focuses on current earnings and their value in the future.

## Assets-Based Method

This method is often not relied upon when a business has positive cash flow. Unlike the former, it is the most common as it focuses on hard and soft assets. These assets include merchandise, inventory, sales, office supplies, equipment, intellectual properties, brands, and goodwill. An interesting point to note is that goodwill is a very critical asset, although "intangible," as it represents the difference between market value and the value of hard assets. But, what does that mean?

Goodwill refers to customer loyalty, reputation, a good brand, reliability – and several other positive attributes referring to people, products, and recurring shoppers. And the truth is, the value of goodwill is hard to put a number on, but it is incredibly important.

Since no two businesses are the same, no two methods are going to work for every business universally. For example, a restaurant that is at a deficit each quarter is going to benefit more from an assets-based method of calculation as opposed to a cash flow method.

## The Comparable Method

This method is often the most popular and the simplest, almost like a residential home appraisal that compares similar sales. Here you would be comparing businesses sold in your sector and applying percentages to revenues and multiples to earnings compared with the sale price of the comparable. With this method, you analyze the worth of your business based on how much a comparable business has sold for recently. This method takes into account the current state of the market, and bodes well with buyers who may have been in the market for a business like yours, and are aware of comparable sale statistics.

# How to Value a Business

To successfully choose the business valuation method best fit for your specific business, consider these steps you will need to perform.

## STEP ONE: Calculate the Seller's Discretionary Earnings (SDE)

The SDE refers to the pre-tax earnings of the business before the owner's salary and payroll taxes, depreciation, amortization, interest, other discretionary expenses, and any other personal charges (personal cars, health and life insurance, travel, meals, etc.). This number provides an idea of the company's actual income potential.

**How do you determine the SDE?**

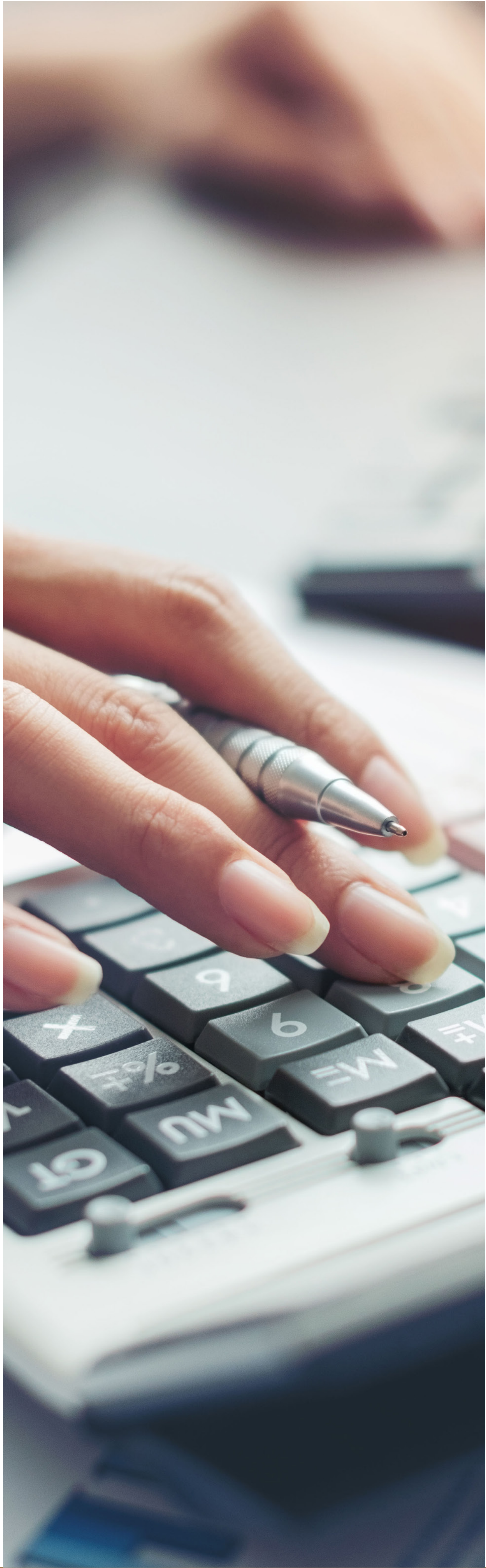
- Begin with the pre-tax earnings
- Adjust interest, depreciation, and amortization expenses to zero
- Adjust out one owner operator's salary and payroll taxes
- Adjust any other perquisites

**Bonus:** If relevant, add one-time charges and subtract non-recurring revenue.

## STEP TWO: Determine the SDE Multiplier

In many cases, a business is valued at one to three times their SDE – this value is called the SDE Multiplier. The SDE Multiplier is directly affected by market trends, company size, industry, owner risk, and company assets, for example.

It is important to note that the most significant variable is the owner's risk. Why? A company whose success is highly attached to the owner means it may not be as successful under new ownership. As you can imagine, this detail affects the overall value of the business – especially in the eyes of a potential buyer.



**STEP THREE:** **Apply the multiplier to the current SDE**

The final step of the process involves applying the current SDE to the multiplier. In the end, the formula looks like this: **SDE x Multiplier = Business Value**

# Reasons for a Business Valuation

As a business owner looking to sell your business soon, there is immeasurable value in understanding business valuations and determining what your business is worth. Without a clear understanding of what your business is worth, you will have a difficult time understanding what price you should list your business for sale at. You will also not know if the amount you are being offered by a potential buyer is a fair price for your business.

## Getting Ready for a Business Valuation

When the time comes to prepare for a business valuation, start by organizing all of your financial documents and records. If you have been organized all along, it will pay off now. If, however, documents have just been tossed in a drawer for years, now is the time to get things in order. You will need to balance your sheets and calculate the profits or depreciation of your assets. You may need to consult with your accountant to have all the financial documents ready for review by interested buyers.

As you work on organizing these documents, it is recommended that you contact an experienced business broker who is not only familiar with your industry but is also familiar with your location. A third-party business broker will want to see you succeed as much as you do but can remove the emotion behind a valuation. The broker will review the financial documents you have gathered and help you identify any missing pieces as they begin the business valuation process in preparation for the sale of your business.

# Experienced Business Brokers Standing by at Transworld Business Advisors

Transworld Business Advisors has been in the business of advising business owners in the purchase and sale of businesses for over 40 years. Whether this is the first business you are trying to sell or the tenth, our experienced team will walk you through the process and make educated recommendations along the way, as needed. To conduct a thorough and accurate business valuation, you will want to work closely with business advisors that have this specific skill set.

At Transworld Business Advisors, our brokers are specifically qualified for this task. Their expertise lies in knowing how to dissect a business, analyze financial statements, determine value drivers, and project future value. Business valuations are a large part of the work done by our brokers as they are well-versed in the buying and selling of businesses. This experience spans years and an endless array of industries in cities across the US. Your CPA and financial advisors may have experience with financials and taxes and have other business-related knowledge, so they can be part of your team but they are not necessarily adept to perform business valuations on their own.

# How to Communicate with Your Business Broker

As a business owner, you understand the importance of preparation and asking the right questions. Before you hire your business broker, we think it is important to write down your questions or concerns so you can bring those up in discussions with potential business brokers. They should be prepared to answer your questions about the business valuation process.

Once you have selected the business broker you will be working with, allow them to do their job. They will ask for some documents related to your business, do some research, and walk you through your valuation options based on their professional expertise. Your business broker will ask you a series of questions to best determine what you need from them – your honesty and transparency will ensure a smooth process. Be transparent about your needs or concerns – Do you need a presentation? A written, contractual appraisal? A Broker Opinion of Value (BOV)? Will you need their assistance beyond the business valuation? What is your timeline? They are now part of your team and you should feel comfortable asking questions; they are here to help you.

Contact Transworld Business Advisors to begin the business valuation process today.