

More to It Than Numbers

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Business owners seek business valuations for many different reasons -- partner buyouts, divorces, estate planning, death of a partner, and, as Randall Lane points out in the July 2003 feature [What's Your Company Worth Now?](#) as a tool to run and improve a business. Another reason business owners seek valuations is to simply sell their companies. But arriving at a sales price isn't a simple process, and often proves to be more complicated than most small-business owners expect.

"For smaller businesses, it's really not rocket science, but for the small business owner it really is rocket science," says John W. Murphy, president of Atlantic Management Company, a Portsmouth, NH-based valuation and financial advisory firm. "A lot of analysis has to go into [pricing a business to sell]," he adds. Even though information on valuation methods abound, using them takes much more than pulling out your financial statements. Pricing a business to sell takes careful consideration of present earnings, future potential, and a slew of factors that business owners quite often don't recognize.

"There are couple of things that small business owners have to be able to do [to value a business], and they stink at both," says Michelle Miles, executive director of the Institute of Business Appraisers (IBA), a professional society based in Plantation, Fla., which provides business appraisal education and professional accreditation. "They have to be able to recognize the money they're taking out of the business and not reporting as income," she says. So, that money you're paying your cousin Chuck to work at your business, even though he's worthless, should be reported. Quite often, owners overlook these resources as less valuable, but still they are applicable to the value of their businesses.

Second, owners need to have a realistic view of the potential of the business. "Owners have to be objective about how strong a performer the business is in the market and the future of the company," Miles says. Where this gets most difficult, according to Miles, is when small family- owned businesses are trying to determine a price. Strong emotional ties to the business often cloud owners' ability to see it in a realistic light.

Beyond owners' characteristic shortcomings, many owners try to oversimplify the process. "Two businesses both netting \$500,000 do not necessarily have the same value," says Jeff Jones, president of Certified Business Appraisers Inc., and chairman of Certified Business Brokers, both based in Houston, Texas. Assuming a business is worth as much, if not more, as a competitor's that recently sold, or determining a price based on an arbitrary number deemed acceptable to retire for the next 20 years are two mistakes Jones sees small-business owners frequently make. "I don't think the seller fully understands the perspective of the buyer," adds Jones. "The seller wants as much as he can get," he says, "but the value has to be supported by the business itself."

All Market Data Is Not Created Equal

Many business owners rely solely on what their competitors received for their companies or other industry data to determine a price. One set of market data that owners frequently use is industry "rules of thumb." Rules of thumb are generally used to get a rough, seat-of-the-pants estimate, according to Miles. Most rules look at an industry and derive an average upon which businesses in that industry are selling. Miles explains the downfall of using a rule of thumb this way: "If the average value of a pizza joint is 25% of gross revenues, why should the value of *your* pizza joint be the same, when the pizza comes hot, the crust is hand-tossed and the joint down the street, which a rule of thumb would say is also worth 25% of gross revenues, was just cited by the Health Department and has employees who never wash?"

According to Jones, the data that many rules of thumb rely on is inconsistent. "Rules of thumb are rules developed in an industry without any supporting empirical evidence," he says. "You're never really sure what the number represents."

The only resources Miles recommends if someone wants to use a rule of thumb to gain a basic perspective on what his or her small business might sell for are Tom West's *2003 Business Reference Guide* (Business Brokerage Press), which contains discussions of value drivers for various businesses as well as the rules. "Tom West is highly qualified and well respected," she adds. And, Glen Desmond's *Small Business Valuation Formulas and Rules of Thumb* (Valuation Press, April 1993). "It discusses commonly used rules, but it also discusses business appraisal," Miles adds.

In contrast, market transaction data maintained in databases by such organizations as the IBA, Pratt's and Bizcomps, uses specific, detailed information on sales of businesses. For instance, the IBA's market database includes ratios that are expressed in terms of Business Selling Price to Annual Revenues (or gross revenues -- this is the P/G ratio), and in terms of Business Selling Price to Annual Earnings (or profits -- this is the P/E ratio). To use this data, an appraiser will plot the universe of transactions, and then place its subject company within that universe. The appraiser then takes the data, does further research on what it would take to set the business apart in the industry, i.e., better technology, strong capital structure, and then compares these value drivers to the subject company. If the drivers exist, the appraiser places the business in that market segment. From there, the appraiser applies the P/G and P/E ratios of the market segment to the company's adjusted earnings to yield the value of the business.

That Magic Number

To derive that magic number for a business, appraisers weigh the outcomes of many valuation methods, which helps explain the, what some might consider, high fees they command (See, [How Much Should an Appraisal Cost?](#)) But the complexity of the job commands professional guidance.

"Everyone looks for magic methodologies to value their unique businesses," says Jones. "The reality is there aren't any."

As an appraiser, Jones never relies on one method to determine a price. In fact, he uses five or six different methods before he arrives at a final figure. For example, Jones use methods within three different valuation approaches: the Asset-based Approach, a Market Approach, and an Earnings Approach. Doing this forces me to look at that company in five or six different ways," Jones.

"The first thing we look at is the balance sheet and what assets go along with the transaction," says Jones. The method he uses here is a method from the Asset-based Approach: the Accumulated-Asset Method. This method sets for the floor for selling price of the business. "At a minimum, a business is going to be worth what the tangible assets are worth," he says. "We're trying to discover what the hurdle needs to be for the earnings to support a value higher than that."

Next, Jones looks at the earnings of the business to determine if it is providing a return on all assets, both tangible and intangible. In specific, Jones uses a popular method for valuing very small businesses (less than \$1 million in revenues), the Multiple of Discretionary Earnings Method (See [Method Examples](#)). Here, Jones looks at the earnings that are available to the owner to pay himself a salary and get a return on both the debt and equity capital in his business. Next, he selects a multiplier derived from his analysis of how the risk factors (See [Risk Factors](#)) might affect the price of the business.

"Risk factors are what make one business different than another," Jones says. Three key risk factors he notes are depth of management, diversity of products or services, and geographic dispersion. Questions he might ask are does all of the company's critical knowledge reside in only one or a few people? How narrow is your marketplace? The answers to the questions help him determine the multiplier that he then applies to the valuation of the business, which either pushes the price up, if the business is deemed less risky, or slides it down, if the questions aren't answered favorably.

Last, a Market Approach, the Direct Market Data Method, offers Jones perspective on how businesses in the company's industry are selling. Based on two data points, Price to Gross (P/G) and Price to Earnings (P/E), Jones evaluates subject companies against industry data. "I adjust the subject company up or down from that, and adjust those ratios based on my whether my company is better than average," he explains. "If my company isn't one of the top players, then I might reduce my value."

After considering all three approaches, Jones selects one or more methods that he deems applicable. "Then based upon my final analysis of the company, I have to correlate those indications of value into my opinion of value," he says. "It's a subjective analysis that may put more weight on one method than another."

It's clear that professionals can certainly help business owners arrive at a selling price more accurately than they could do on their own, but professionals can also help in another way -- by helping an owner determine how to get more for the business.

"If you're going to sell your business, the best thing to do is to get it professionally appraised a least one full economic cycle before you put it on the market," says Miles. That will tell you what your business is worth and you can sit with an appraiser to determine why it isn't worth more. An appraiser will tell you such things as your technology is outdated, you haven't any non-competes, which puts your business at risk, or you have too many eggs in one client's basket. He or she will explain all of these things in a report, and then you'll have a full economic cycle to fix them and make your business a more attractive offering.

SIDEBAR: Choosing an Appraiser

If you're convinced you need an appraiser, make sure they have the following skills to ensure you get the most for your money.

Professional accreditation: There are four organizations in the United States, the [Institute of Business Appraisers](#) (IBA), the [American Society of Appraisers](#) (ASA), [American Institute of Certified Public Accountants](#) (AICPA), [National Association of Certified Valuation Analysts](#) (NACVA), that certify business appraisers, according to Michele Miles, executive director of the IBA. "Everyone's requirements are a bit different based on education and the backgrounds of the founders," she says, but each organization will ensure the appraiser has been trained and tested. These organizations require their designated members to have taken educational courses, attend national conferences, have their appraisal reports reviewed by a peer committee, and subscribe to a code of ethics and professional standards.

Small-business appraisal experience: "Some appraisers tend to specialize in the larger businesses and may not have much experience in valuing small businesses," says Jeff Jones, president of Certified Business Appraisers Inc., and chairman of certified Business Brokers, both based in Houston, Texas. An appraiser who is experienced in appraising smaller business is important, especially when a business value is less than \$500,000.

Ability to conduct in-depth research and financial analysis: An appraiser should be able to create forecasts, conduct thorough research and adjust financial statements. "[You] have to be able to find info about an industry to project the future for the industry and look at financials and do some pretty heavy analysis, and you have to be able to do that with a copy of a word processing program and a financial spreadsheet program and nothing else," Miles suggests. "Everything else has to come from your brain."

Ability to be subjective and to be forthright: Because a lot of owners don't want to hear bad news about business and don't want to report hidden income. You have to be able to be comfortable to deliver bad news and not living for others approval.

Ability to do an appraisal independent of a valuation software program: There's a lot of subjectivity that goes into pricing a business to sell. In most cases, valuation software programs are not flexible enough to make adjustments that are needed for each individual business. And they rarely provide enough disclosure on how it arrived at the number. "Most full-time appraisers don't use computer programs," Jones says. "They use their own templates."

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