How To Value & Buy A Small Business

To be successful every business needs three things; 1) Technical Expertise in the area of the work the business does i.e. If it is a roofing business you need to know how to put roofs on and repair them. 2) Sufficient working capital to run the business. Working capital is current assets (Cash, Accounts Receivable, Inventory etc.) minus current liabilities (Accounts Payable like monthly utility bills, Credit Card Payments, Loan or Lease Payments etc.). Generally 2 to 1 ratio of current assets to current liabilities is considered good. That's twice as many current assets as bills coming due. The third item needed is sufficient Business Acumen to understand financial statements and be able to read them and use them as tools to run the business and make corrective adjustments to maximize the business profits.

Once the business has been selected for purchase, you need to know how much the owner is asking for the business. Next you need to know what is being conveyed in this sale. Often the seller will give you their balance sheet but often some items on the balance sheet are the seller's personal items and won't go to the buyer in the sale. Be sure you know which assets will be conveyed in the sale. This would be a list of assets and their respective values. The value ascribed to these assets is not new value or salvage value or depreciated book value but market value of decent used equipment. This value is often about half of what the item could be purchased for new. Make a list of this equipment and their values and add them up. Pay attention to this list and ask yourself, is this a fair value for that piece of equipment? Do I really need that piece of equipment to run this business? Even if the item is on the seller's balance sheet, will I really get that asset with the sale? Next, list all the debt that the buyer will be assuming, what asset secures this debt, what the monthly payment is, the interest rate, the balance and how many payments remain until it is paid off. Next, you take the total asset values and subtract all the debt balances being assumed to arrive at a net asset value.

Example: if the total amount of assets is $50,000 and the loan balances assumed were $10,000, the net asset value of the business would be $40,000. If there is no debt being assumed, then the net asset value would be $50,000. NOTE: acquisition funding is not considered here. Acquisition funding is the loan the buyer takes out to complete the purchase of the business over the down payment. ***This acquisition funding can be from a bank or other source but 90% of the time it is from the seller.*** Next the buyer looks to the income statement for pre-tax net income for the most current year prior to the sale. Look back about 5 to 6 years of income statements (tax returns) to see how many years showed a profit. We do this to see the consistency of the income stream and to place a relative value on Good Will. Generally, if the business showed a profit in 6 of the last 6 years you would use 3.5 and multiply it by the pre-tax net income to get a good will factor. Then this good will amount would be added to the net asset value to arrive at business value. Example: if the pre-tax net income was $20,000 for the most current year past and the business showed a profit for the last 6 years we would multiply 3.5 X $20,000 = $70,000 in Good Will. To this good will we add the net asset value of $50,000 to get a business value of $120,000. This means that you would pay no more than $120,000 for this business and hopefully less. The coefficients to be multiplied by pre-tax net income for no profitable years in the last 6 is zero for good will; 1 year = 1.0, 2 years = 1.5, 3 years = 2.0, 4 years = 2.5, 5 years = 3.0 and 6 years = 3.5. While this is a simplistic method of valuation, it is relative accurate. It can later be refined with the Excess Earnings Method and the Discounted Cash Flow Method to value.

When making the offer to purchase the business, use a letter of intent that is one page to state the main parts of the deal; price, what you are buying from the financial statements balance sheet, the income you expect from the income statements, how much you are going to put down and how much you expect the seller to carry in purchase loan for the business and for what term and what interest rate and what monthly payment. Remember, the seller is expecting you to believe their figures in buying the business so expect the seller to believe his own figures too and finance the sale himself and always try to get the seller to accept zero cash down, at least to start with as you will be needing your cash for working capital to run the business Start your first offer with a low figure as you can always go up but it is impossible to go down usually. Negotiating technique to remember: they want 10,000 and you want 8,000 so you start your opening bid at 6,000 which is (10,000 – 8,000 = 2,000, then 2,000 x 2 = 4,000 and then 10,000 – 4,000 = 6,000). The seller will usually balk at this lowball figure but if they don't; TAKE IT! If they balk at the figure, ask them for a credible bid back… often they will come down about 10% and tell you 9,000. ***Then you say, OK, you are at 9,000 and I'm at 6,000, why don't we both give equal amounts and split the difference at 7,500?*** This is 6,000 + 9,000 = 15,000 divided by 2 = 7,500. You wanted 8,000 as a selling price and you got 7,500, even better. Try it; IT WORKS!

Always be ready to walk away from the deal. This puts much pressure on the seller to see things your way and you can always go back to negotiations at a later time. Remember too that when you are negotiating with the seller, you are probably the ONLY buyer negotiating with the seller at that time. The other buyer waiting to snatch it up is rarely really there. Also, remember that the buyer controls the deal, the sale and the price. The seller by definition has to sell, the buyer doesn't have to buy and should only buy when his terms are met. There is always another deal coming along so be patient and get what you want and need out of the deal.

Don't let the seller become such a friend to you through the negotiations that you feel awkward asking for the data you need to do the evaluation necessary to formulate a bid or that you feel awkward making a lowball offer; this is business, remember that. Don't allow your fear of irritating the seller lull you into making a bad deal that you will have to live with for many years to come.

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I hope you found this informative.

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