Valuing & Buying a Small Business

We have been asked several times for a quick way to get a relatively solid market value of a business. We have been appraising businesses coast to coast since the 1980's and have done work for many business brokers, lenders, attorneys, buyers, sellers and even the SBA. While what I'm going to tell you won't pass muster for a formal appraisal, it will give you a good estimate of value. You should keep a few things in the back of your mind throughout this process such as the purpose of a business is to generate cash flow for the owner first and foremost. The first thing I tell start-ups is to concentrate on the income statement and see how much cash flow can be generated if they were to be in this business. The next thing is to go to the balance sheet to see what would be needed equipment wise to capture this income stream and then what it would cost to capture these assets and put them to work generating this cash flow. When buying investment real estate, the building buys the building. When buying an existing business it is relatively the same and bear in mind that the business buys the business. This means that the business will generate enough cash flow to 1) show a return on the capital invested, 2) be able to retire all acquisition debt placed on the business and 3) be able to pay the owner enough to keep them involved in the business.

Let's look at these three items in a little more detail. Whatever amount of cash you put down on a business to buy it could be invested into some other investment vehicle like stocks or bonds or real estate etc. These other investments would generate some kind of a return and by investing in this business you have lost the ability to invest in any other investment. This is the lost opportunity cost. I like to use about 5% as the return on my capital put into a business. So if I invest $20,000 into a business, my capital should receive a return of $1,000 per year as my return on capital. Next, the business has to buy the business. If we paid $100,000 for the business and put $20,000 down and the seller carried the remaining $80,000 at prime interest rate + 5% fully amortized over 60 months, assuming prime interest rate is 3.25% then we would figure 8.25% on our purchase loan. This would produce a monthly payment of $1,631.78. Now the owner is hoping to eventually build this business to make a very handsome income but initially he needs at least $20,000 a year just to keep him working the business. After the purchase loan is paid off and as he builds the business his income is going to go up substantially, he hopes. Let's look at this business again below.

	Monthly	***Yearly***
Return on Capital Invested	$ 83.33	$ 1,000.00
Acquisition Debt to Seller	$1,631.78	$19,581.36
Owner Income 1st 5 years	$1,666.67	$20,000.00
Totals	$3,381.78	$40,581.36

The above figures show what the business should generate as NET income to make the deal work. Generally speaking a small business will show about 20% of the gross business sales as net income so, we divide $40.581.36 by .2 and we get $202,906.80 in gross sales for this business. Always remember that it isn't what the business grosses that is important, it is what the business nets. When I look at a business and assume that I can get owner financing for the purchase amortized over 3 to 5 years, I generally value my initial bid around 2 to maybe 3 times net income. The above example shows a value or purchase price of $100,000 which is 2.46 times the pre-tax net income.

If you are buying a business and you are using invested capital for your down payment the above example would work nicely. If you are borrowing this down payment by putting a second mortgage on your house you would need to factor the monthly payments on the second mortgage into this also. Say you got a $22,000 second on your home (extra $2,000 to cover the cost of the loan etc.) at 6% amortized for 15 years = $185.65 per month or $2,227.78 per year. The above chart of totals would change to $3,484.10 per month and $41,809.14 per year. This would lower the times annual net to 2.39.

All the above is good background info to keep you grounded through the valuation and buying/selling procedures. The more sophisticated approach to value is the tangible net worth of the business and assets conveyed plus a function of the pre-tax net income for good will. That was a mouthful wasn't it. Let's break it down. We start with the business balance sheet which shows current assets & liabilities and fixed or long term assets & liabilities. The net worth is figured by subtracting all liabilities from all assets. So, if the business you are buying has current assets of $2,200 and current liabilities of $1,520 and the business has long term or fixed assets of $35,750 and long term debt of $12,750 that will be assumed by the new owner. If this debt would not have been assumed by the buyer, it would not be subtracted from the fixed assets. Now we have $2,200 - $1,520 = $ 680 in net current assets. Further, we have $35,750 - $12,750 = $23,000 in net fixed assets. Adding the $23,000 + $680 = $23,680 net asset value.

Now we move over to the income statement to figure good will. We notice that last year's net income was $50,000. Further investigation shows the business had been profitable 3 of the last 5 years. Rules of thumb say that all 5 of the last 5 years showing a profit would dictate a figure of 3.0. Also, 4 years = 2.5, 3 years 2.0, 2 years 1.5 and 1 year = 1.0. If none of the last 5 years none showed a profit the factor is 0. In our example 3 of the last 5 years showed a profit, so we use a coefficient of 2.0. We take the pre-tax net income of $50,000 times 2.0 = $100,000 good will. To the good will factor we add the net asset value of $23,680 to get a market value for this business of $123,680.

Things to Look Out For

Often the seller's book value of assets which reflects the asset acquisition price less accumulated depreciation which could be high or low compared to actual asset value. If the business asset is deemed to be serviceable for a couple years into the future at least, I like to use a figure of about half the current new price for that item. Typically good serviceable used equipment can be purchased on the used market for about half the cost of the item new. When listing the assets, list them separately in a column, next to it the purchase price new, next any loan balance on it, next any monthly payment and next for how many months remaining. Current assets like inventory should be entered at book value from the balance sheet.

	New	Used	Loan Balance	Monthly Payment	Months remaining
Big Machine	$25,000	$12,500	$15,269.84	$531.18	33
Counters	$ 3,000	$ 1,500			
4 Desks	$ 2,000	$ 1,000			
4 Chairs	$ 400	$ 200			
	$30,400	$15,200			

The limited list of equipment for this sample business shows an estimate of the cost of this equipment new and we would want to show it at about half that value on our balance sheet as used equipment. Note that we owe more on the equipment than we show as its value but it has a strong remaining life so this should work out in the long run.

It is always best to run a list like this when arriving at the value of the business equipment, fixtures etc. rather than relying on the book value from the balance sheet.

Often a business owner will buy a personal asset and show it as a business asset to take advantage of the additional tax write off. While this asset, say a car or a truck, shows on the balance sheet, the owner has no intention of selling it with the business and as a result should not be part of the assets shown on the balance sheet or used in your list of assets. Many an inexperienced business buyer has had such assets used to calculate the business value but they never received the asset.

Another one I saw recently was a note receivable showing on the seller's balance sheet. A note receivable is created when the owner takes money out of the business and replaces the dollars taken with a note receivable to the business. The note receivable increases the business assets thus increasing the business value. In this case, the seller got the cash AND the increased value of the business. The buyer got screwed here.

In short, the buyer should be sure that they are receiving the assets that they are paying for and only paying fair market value for them.

What Not To Do

Business opportunities are fascinating to me but I've been in this game quite a while and know what to look for to avoid getting taken advantage of or in the everyday parlance; screwed. Often a small business owner gets burned out and wants to sell. He contacts several business brokers to list the business for sale. The restaurant business is worth $100k but the seller insists on a value of $120k. The broker is eager to get the listing so he agrees to take it for $120k hoping to get it reduced later. Before signing the listing papers the owner inquires about the brokerage fee. The broker tells him that the brokerage fee is 10% of the selling price. The owner thinks HE need the whole $120k so he figures if he pays 10% & keeps 90% he needs to list it for a higher price. He also wants to be able to come down 5% on his price and still get his net price of $120k. He calculates $120k divided by 85% which is (10% + 5% = 15% & 100% - 15% = 85%). He takes $120k divided by .85 = $141.18k. The seller will list his business for $141,200. The broker knows its overpriced but he takes the listing anyway.

Now Bob the buyer has worked in corporate middle management for 25 years and has always dreamed of owning his own business. He settles on either a restaurant or a bar basically because those are the only businesses he has ever been in outside of retail and gas stations. He contacts the broker and he's in luck. The broker has just taken a listing for a neighborhood restaurant for $141,200. Bob tells the broker that he could pull about $50k out of his house on a second mortgage and is interested in the restaurant. Bob thinks he's pretty shrewd and offers $135k with $50k down and the seller to carry the balance of $85k on a purchase loan at 6% fully amortized over 5 years. The deal closes, the broker gets paid and the seller is enjoying his $50k less $13.5k in commission and loves his monthly payments of $1,643.29.

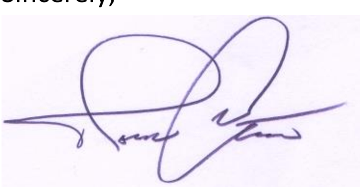
Bob is ecstatic as he finally has his own business. Bob finds the sales are hard to get now, problems with some of the staff, food costs going up and it is really tough to make the new 2nd mortgage payment of $438.81 on top of the seller loan of $1,643.29 and still leave enough for him and his family to scrape by. He figures he needs to spend more time at the business and his home life goes to pot. Try as he might he just can't get the business sales up enough to make a good living. He is never home and his wife and kids are ticked off by his absence and further irritated by the lack of income to do any fun stuff. There is barely enough money to pay the bills and eat. He puts in more and more time in the business and after a while he burns out and the business starts to slip. Things go from bad to worse as the business revenues shrink and he doesn't have enough money to pay the 2nd mortgage and the seller loan and still eat. He stops paying the seller loan and he is in foreclosure on the 2nd mortgage too. He is going to lose the house and he is getting a divorce. Bob could care less about the business now and he just runs it into the ground. The buyer is ruined. The seller takes the business back thinking he has a business worth at least $120k. However, since business values are largely a function of income and with the net income being down now, so is the value. The seller ends up taking back a business that is now worth about $60k. The buyer lost, the seller lost and the broker got paid. The seller again puts the business up for sale at $120k this time and the cycle starts again. Our goal is to never have our clients repeat this scenario.

I remember as a young man working in middle corporate management, a friend and I wanted to buy a bar. We were really excited about having our own business and making a fortune. Then I talked with my attorney about putting the deal together and he started telling me about all the ways our help could steal from us. He went on about how we would have to be there constantly to avoid employee theft. The thought of spending every night there until closing at 2am was not attractive to me or my young wife. I think I dodged a bullet.

If we can help you buy or sell a business, please call so we can discuss how we might be able to help you. We also have other services such as; appraisal, financial analysis, productivity studies, profit development, loans, small business accounting and income tax preparation.

I hope you found this informative and if we can help you in the future, please contact us. We have been serving clients coast to coast since 1980. Business can be fun and profitable if it's done right.

Sincerely,



Tom Stewart