

# Sell Your Business for Maximum Value: Business Valuation



Every business is unique, and every buyer has different perceptions of value. Value is based on a combination of quantitative and qualitative factors and therefore it is important to have a consistent methodology to establish a baseline of value. The fundamental methodology to arrive at baseline value is easily defined, but the application of assumptions can have a material effect on the calculated output. It is important to have a clear and realistic perspective of the value of your business. A realistic baseline will help drive the right strategy to maximize returns. As a brief tutorial, let's look at some fundamentals of business valuation.

We have heard the phrase "beauty is in the eye of the beholder" and in many ways, business valuation is the same. The value of a business is not simply the value of the assets, or the amount of money invested, or even someone's opinion about potential. At the most fundamental level, basic value is driven and supported by the likelihood of future earnings.

To support the anticipation of future earnings, historical earnings are usually reviewed closely. Typically, financial records of the past 3-5 years are reviewed, to assess the company's historical performance. Growth trends and year-over-year activity can indicate changes in various income or expense categories.

In the historical financial assessment, it is important to understand the definition and application of "earnings". The term "earnings" can be used in

a variety of different ways and can have different meanings, depending on the audience and perspective. We will take a moment to unpack the concept of "earnings" within the context of privately held businesses. Privately held business owners have a considerable amount of autonomy regarding the operational and financial reporting processes. It is not unusual for business owners to run personal expenses and perks through the company, to lower taxable income. Other business decisions

Comparable Company Completed Transactions					
	Sales Price	÷	EBITDA	=	EBITDA Multiple
Company 1	\$25,000,000	÷	\$5,000,000	=	5
Company 2	\$60,000,000	÷	\$10,000,000	=	6
Company 3	\$40,000,000	÷	\$5,000,000	=	8

Application of Multiple					
	EBITDA	x	Selected EBITDA Multiple	=	Estimated Value
Example Business	\$15,000,000	x	6	=	\$90,000,000



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can drive unique expenses into the business. While these expenses may be within legal parameters, the discretionary decisions business owners chose to make are most likely different from similar businesses. In order to communicate the “earnings” of the business appropriately, and in a manner consistent with comparable businesses, expenses should be reviewed and adjusted to account for one-time events, discretionary spending, owner perks, and non-market compensation. These expenses are called “add-backs” and, as the name implies, should be added back into the calculated income for the business. This process is referred to as “stabilizing the cash flows”.

Stabilized financial statements with footnotes explaining the detailed add-backs are recommended as the starting point for calculating value and communicating to potential buyers

when you are ready. Cash flows of a business are typically stated in terms such as 1) Net Income, 2) Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA), or 3) Sellers Discretionary Cash Flow (SDCF). The accounting practices that are applied to the financial reporting should be in compliance with Generally Acceptable Accounting Principles (GAAP). A third party audit is a good way to establish credibility regarding the financial reporting and is usually considered a strong value driver.

Once stabilized earnings are calculated, your business is ready to be compared to other similar businesses that have been sold. In a manner similar to residential home appraisals, information on completed business transactions is reported to databases, for the purpose of providing valuation ratios to business valuation experts. The names of the

businesses are not recorded; however, the industry code and description are provided along with the earnings and sales price. The ratio between the earnings and sales price is referred to as a “multiple”. See the table above. Other typical transaction ratios include Gross Sales to Transaction Value, Gross Profit to Transaction Value, and SDC to Transaction Value. Other deal terms are considered by the business valuation researcher, such as structure and assumed debt.

The multiples paid on a given transaction are impacted by several factors, some easily quantifiable and some subjective, and have a significant impact on value. To summarize, the two key variables in the determination of business value are 1) Earnings, and 2) the Multiple. Any actions that positively influence either of these two key variables will increase the value of your business.