

Lesson 5. Series: How to Determine the Value of Your Business

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Course Five: Methods of Income/Benefit used in Analysis.

In the previous sessions we have discussed risk and reward relationships as the basis of value. We have also mentioned some different earnings/benefits that are used in the calculation of small business values. These different basis; such as net income, pre-tax earnings, earnings before interest and taxes (EBIT) and earnings before interest, taxes, depreciation and amortization (EBITDA) are common measures used by small and large businesses alike.

One measure, owner's discretionary income, is unique to small businesses. The method using this approach is called the Multiple of Discretionary Earnings Method. The reason this measure and the market driven data supporting this as a basis of valuation came about is quite simple. Data from most small businesses is heavily skewed by owner's compensation. It is either too high or too low. In most cases it involves benefits that would not be afforded the average manager. As a result most measures did not make sense unless you made adjustments for owners comp and benefits. Therefore why not just use the number before any of the owners consideration is deducted which is called owner's discretionary income. With this approach there became available data from market transactions based upon this income number.

Plus much of the decision about buying small businesses is based more on what you can take out as opposed to a more sophisticated return on investment analysis. Someone might think in terms of valuing a business based on the income they think they can make. So someone might think that they would pay \$300,000 for a business if they can make a \$60,000 income for themselves. On the surface that might look like a 20% return, but if the owner will work in the business and he values his worth (as an employee/manager) at \$60,000; he is not making anything for his \$300,000 investment. That is not a good deal—but buyers, based on such logic, value many businesses.

Some of this is in the area of intangibles. The owner might be willing (assuming he has it!) to pay \$300,000 for a business because he wants the personal satisfaction of owning his own business. Or maybe the owner feels the value of the business will

grow substantially in the future justifying his investment. These are all considerations when placing a value on a business.

Another area that causes some concern with this approach is a lack of standard definitions of the terms used to define the method. The International Business Brokers Association (IBBA) defines some of the related terms as:

Owner: A generic term used in business brokerage to represent the proprietor, general partner, or controlling shareholder (singular or plural as appropriate).

Owner's Salary. The salary or wages paid to the owner, including related payroll tax burden.

Owner's Total Compensation. Total of owner's salary and perquisites.

Perquisites. Expenses incurred at the discretion of the owner, which are unnecessary to the continued operation of the business.

This method evolved from a general "rule-of-thumb" for small businesses that the value could be calculated as "one times owner's cash flow, plus the market value of the tangible assets." Much of the logic for that formula found its basis in asset based businesses, such as retailers with inventory intensive businesses. Service business would tend to be undervalued.

Today there are market based databases that supply market comparisons on the basis of a multiple of owner's discretionary income (or cashflow). This information if used properly can be very useful. However users need to be very careful that they understand the definitions used in the data gathering and also how tangible assets are handled. In some cases some assets (inventory, accounts receivable) are added back to the multiple of discretionary income and sometimes they are not.

The simplicity of this approach makes it attractive but that same simplicity can make the information derived from this approach wrong.

Large publicly held businesses usually do not have that kind of problem. These businesses are valued in the market place by an active market of many investors. This market will place premiums on certain characteristics and punish others. The public market place uses many of the earnings numbers we have discussed, such

as EBIT and EBITDA, to establish values for public companies. For many types of industries a multiple of EBIT or EBITDA has become a “rule of thumb” to establish value.

The most common benchmark that we see with public companies is an Earnings Per Share multiple. These earnings multiple is often quoted as part of the financial data presented for a public company. It is tempting for small business owners to try and make some comparisons about their business and a large public company on the basis of these types of measures. I have had small business owners say to me “if ABC Big Company, Inc. is worth 30 times their earnings why isn’t my company even worth 10 times”?

The most important thing to remember about these various measures is that they are benchmarks. Their only meaning is as a comparison. And each of these measures whether for large public companies or small “mom and pops” needs to be defined very specifically on who they are being calculated. A small business might sell for 3 times EBITDA plus tangible assets or it might sell for 6 times EBITDA including tangible assets; but when the “news” gets into the market place one might have sold for 3 times cash flow and the other 6. But until you have all of the facts you would not know which was the best deal.

Next: Valuing Intangibles