How Much is Your Business Worth

Sean Rosser
Hearthside Fireplace & Patio

This session will cover how small, privately held businesses are valued by third party, independent buyers. The session will also discuss and define sellers cash flow, purchase multiples, considerations around inventory, real estate, and the value of brands and product lines.
What is My Business Worth?

Sean M. Rosser
Bridge Equity Advisers

Mergers and Acquisitions, Restructuring, Workouts
Family owns Hearthside Fireplace & Patio, 4 Locations in MA and RI
BS Mech Engineering, UC Berkeley
MBA, Harvard University

Overview

• Sellers – what are our options?
  • Buyers – who are they?
  • Value in a Sale – how is it determined?
  • Role of Real Estate – what role does it play?
  • Other Considerations

Sellers: Why does it matter?

<table>
<thead>
<tr>
<th>Wealth Portfolio of Business Owners*</th>
<th>Stocks</th>
<th>Bonds</th>
<th>Cash</th>
<th>Real Estate</th>
<th>Private Business Value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>6%</td>
<td>4%</td>
<td>2%</td>
<td>8%</td>
<td>80%</td>
</tr>
</tbody>
</table>

*2008 Pinnacle Equity Solutions

Sellers: Exit Options

Valuations - Overview

• Definitions
  • Financial Buyer
  • Synergistic Buyer
  • Valuation Methods
  • Valuation Multiples

• Example: AAA Hearth Shop LLC
  • Value to Financial Buyer
  • Value to Synergistic Buyer

• Primer on Exit Strategy
  • If you are thinking about exiting the business, here are some basic things to keep in mind
**Buyers: Financial Buyer**

- Financial Buyer:
  - A buyer who is primarily concerned with ROI & Cash Flow, and is comparing the purchase of one business against another
  - Typically NOT from the industry
  - Business is accepting a "sell"

**Synergistic Buyer**

- A financial buyer is looking to operate and run the business
- A synergistic buyer gets unique benefit and savings
  - Synergistic business - wants to be a retirement as well - looking for strong return on investment
  - Will be financing the purchase with land lease, and possibly a seller note

**Definitions: Valuation Methods**

- There are many different ways to value a business
  - Discounted Cash Flow (DCF) [Accountants]
  - Net Assets/Liquidated Assets [Bankers]
  - Excess Earnings [Financial Advisors]
  - Market Comparison [Business Brokers/M&A]

**Discounted Cash Flow (DCF)**

- A business generates a Cash Flow stream that has value
- DCF is a method that allows us to put a current value of that future cash flow stream
  - Key elements:
    - Future cash flow estimates
    - Revenue, expenses, cash flow
    - Discount rate
    - Reinvestment rate
    - Business life span

**Net Assets: Tangible/Intangible**

- This valuation method evaluates how much it would cost to replace the assets in the business OR what the assets would be worth in a liquidation

<table>
<thead>
<tr>
<th>Tangible Assets</th>
<th>Intangible Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Business Name</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>Web Site</td>
</tr>
<tr>
<td>Inventory</td>
<td>Location</td>
</tr>
<tr>
<td>Fixtures, Furniture, Equipment</td>
<td>Phone Number</td>
</tr>
<tr>
<td>[FFE]</td>
<td>Customer List</td>
</tr>
<tr>
<td>Vehicles</td>
<td>Brands</td>
</tr>
<tr>
<td>Real Estate</td>
<td>Employee industry and product knowledge</td>
</tr>
</tbody>
</table>
**Excess Earnings:**

- This method evaluates the business cash flow as having 2 components:
  - Owner's salary
  - Excess Earnings

- The Owner’s salary is first removed from the cash flow
  - Example: Cash flow of $250,000
  - Owner’s salary of $100,000
  - Excess earnings of $150,000
  - Available to service debt or fund investments

**Value: Market Comparison**

- Market Comparisons are the preferred method for establishing value for a small business

- There are a number of databases and catalogs that tabulate valuations (PrattStats, BizComps, etc.)

- Valuations are based on a MULTIPLE of Sellers Discretionary Cash Flow (Earnings) (SDCF or SDE)

**Value: Sellers Discretionary Cash Flow (SDCF)**

- **SDCF (Cash Flow) =**
  - Tax Return - reported income
  - Add back Depreciation, Amortization, and Interest paid
  - Add back Owner’s salary, and all other DOCUMENTABLE benefits: Phone, car, travel, entertainment, etc.

- **RECAST**
  - Total cash flow that the business generates for the owner’s use and control

**Value: Market Comparison Valuations**

- Market Value is based upon the SDCF and Market Multiple (MM)

- **SDCF X MM**
  - (Cash Flow X Multiplier)

**Value: Market Multiples (MM)**

- Valuation Multiples vary by industry

- **How big is the cash flow today in the future?**

- **How stable is cash flow?**

- **How stable is industry?**

- **How stable is customer base?**

- **How stable are employees?**

- **How secure are supplier relationships?**

**Typical Market Multiples (MM)**

- These Valuation Multiples are typically used by FINANCIAL BUYERS. Synergistic buyers may use higher VMs because of added savings.
Example: AAA Hearth Shop LLC

AAA Hearth Shop LLC - Market Value to FINANCIAL BUYER
- $1,500,000 in revenue, assets of $450,000
  - Reported income: $75,000
  - Depreciation, Amortization: $15,000
  - Interest payments: $5,000
  - Owners Salary: $130,000
  - Other owner benefits: $25,000
- SDE = $250,000
- MM = 2.5
- Financial Value = $625,000

Notice that the ASSETS in the Business are not much less than the value!!

Example: AAA Hearth Shop LLC

AAA Hearth Shop LLC - Market Value to SYNERGISTIC BUYER
- $1,500,000 in revenue, assets of $550,000
  - Reported Income: $75,000
  - Depreciation, Amortization: $15,000
  - Interest payments: $5,000
  - Owners Salary: $130,000
  - Other owner benefits: $25,000
- ADDITIONAL SAVINGS TO SYNERGISTIC BUYER = $75,000
- SDE = $325,000
- MM = 2.75
- Synergistic Value = $894,000

Net Gain of $269K to Seller!

Purchase Structure

- Asset Purchase (95%)
  - All tangible and intangible Assets
- Stock Purchase (5%)
  - Stock in the company, which includes ALL assets and liabilities

What is Included in the Typical Sale?

<table>
<thead>
<tr>
<th>Tangible Assets</th>
<th>Intangible Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Business Name</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>Web Site</td>
</tr>
<tr>
<td>Inventory</td>
<td>Location</td>
</tr>
<tr>
<td>Fixtures, Furniture, Equipment (FFE)</td>
<td>Phone Number</td>
</tr>
<tr>
<td>Vehicles</td>
<td>Customer List</td>
</tr>
<tr>
<td>Real Estate</td>
<td>Brands/Line Card</td>
</tr>
</tbody>
</table>

- Buyers usually don’t want the risk of collecting AR
- Usually it is to the owner’s benefit to offer the AR separately, and structure a lease with the buyer.

Excess Inventory

- NOTE: SDCF does not value “Inventory”...it doesn’t matter whether you have $10,000 or $10,000,000 in Inventory...only that you have enough to generate the CASH FLOW that you are selling
- SDCF is a measure of how much CASH FLOW the owner can realize from whatever inventory they have on hand
- Remember: BUYERS are NOT buying inventory – they are buying CASH FLOW
- So…it makes sense, when selling your business, to SELL excess inventory before the transaction

Real Estate: How it Affects Value

Business:
- Value:
  - SDCF X Market Multiple + Excess Assets/Inventory

Real Estate:
- Value:
  - Cash Flow X RE Market Multiple
  - (RENT – EXPENSES)
How to Maximize Overall Value w/ Real Estate

Example 1:
- **Business Value:**
  - SDCF = $250,000 (after paying rent of $50,000)
  - Market Multiple = 2.5
  - Value = $625,000

- **Building Value:**
  - Net Cash Flow = $200,000
  - RE Market Multiple = 10
  - Value = $2,000,000

Total Value = $2,625,000

Example 2:
- **Business Value:**
  - SDCF = $230,000 (after paying rent of $70,000)
  - Market Multiple = 2.5
  - Value = $575,000

- **Building Value:**
  - Net Cash Flow = $160,000
  - RE Market Multiple = 10
  - Value = $1,600,000

Total Value = $2,175,000

Timing Matters!

The 10 Year Transfer “Cycle”

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Phase</td>
<td>Recession (Buyer’s Market)</td>
<td>Prime Selling Time (Sellers’ Market)</td>
<td>Almost Recession (Neutral Market)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Key Factor: Seller “Readiness”

<table>
<thead>
<tr>
<th>Financial Readiness</th>
<th>Mental Readiness</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td>Low</td>
<td>Low</td>
</tr>
</tbody>
</table>

- **Well-Off, but Want to Continue Working**
- **Stay & Grow**
- **Ready to Retire**
- **Re-Engage or Get Out at Best Price**

Exit Strategies: Plan Ahead

<table>
<thead>
<tr>
<th>Many Ways to Exit</th>
<th>Making it Happen</th>
<th>How to Prepare</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidate</td>
<td>Auctioneer or “Sale”</td>
<td>Prepare the sale</td>
</tr>
<tr>
<td>Transfer</td>
<td>Lawyer</td>
<td>File tax returns</td>
</tr>
<tr>
<td>Sell</td>
<td>M&amp;A Adviser or Business Broker</td>
<td>Generate Unnecessary Inventory</td>
</tr>
</tbody>
</table>

Q&A