How Much is Your Business Worth

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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.

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What is My Business Worth?

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Overview

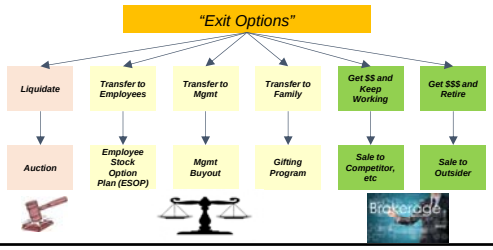
- Sellers – what are our options?
- Buyers – who are they?
- Value in a Sale – how is it determined?
- Role of Real Estate – what role does it play?
- Other Considerations

Sellers: Why does it matter?

Wealth Portfolio of Business Owners*				
Stocks	*Bonds*	*Cash*	*Real Estate*	*Private Business Value*
6%	4%	2%	8%	80%

*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

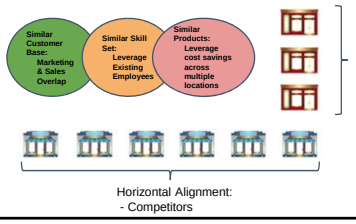
Typically NOT from the industry
- Place high value on current management knowledge transfer
- Typical is 35 - 48 yrs old, male, MBA, with corporate experience

A financial buyer is looking to operate and run the business
- Buying a "job"
- Investing his life savings - needs to build a retirement as well - looking for strong return on investment
- Will be financing the purchase with bank loan, and possibly a seller note

Buyers: Synergistic Buyer

- Synergistic Buyer:
  - A buyer/business who will have a unique benefit from buying the business
  - Typically from the industry or a complimentary industry
    - Adjacent competitors (Hearth dealers)
    - Businesses in other industries that have overlapping/ complementary customer base or technical skills (HVAC, etc.)
  - A synergistic buyer gets unique benefit and savings
    - Elimination of "overhead" - bookkeeping, IT, etc.
    - Leverage marketing across common customers/products, etc.
    - Typically financing the purchase with cash, plus seller note

Synergistic Buyer

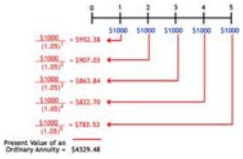


Definitions: Valuation Methods

- There are many different ways to value a business
  - **Discounted Cash Flow (DCF) [Accountants]**
  - **Net Assets/Net 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 variables:
    - Future cash flow estimates
      - Yr 1, yr 2, yr 3, ...etc.
    - "Discount" rate
      - Represents the time value of money...i.e., $1 in hand today is worth more than $1 a year from now, 2 years from now, etc.



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

Tangible Assets	Intangible Assets
• Cash • Accounts Receivable • Inventory • Fixtures, Furniture, Equipment (FFE) • Vehicles • Real Estate	• Business Name • Web Site • Location • Phone Number • Customer List • Brands • Employee industry and product knowledge

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 investements

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

Non-cash Adjustments to Taxable Income: Depr + Amort + Interest

Salary + Health Care + Car + Phone…

SDCF

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 have 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?

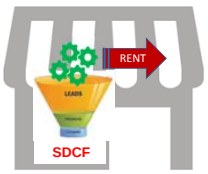
Tangible Assets	Intangible Assets
• ~~Cash~~ • ~~Accounts Receivable~~ • Inventory • Fixtures, Furniture, Equipment (FFE) • Vehicles • ~~Real Estate~~	• Business Name • Web Site • Location • Phone Number • Customer List • Brands/Line Card

- *Buyers usually don't want the risk of collecting AR*
- *Usually it is to the owner's benefit to offer the RE 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

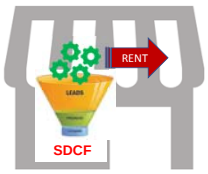
Real Estate: How it Affects Value



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 ($300,000 total)
Market Multiple = 2.5
Value = $625,000

Building Value:
$50,000 less $10,000 in expenses (taxes, etc) = $40,000 cash flow
***RE Market Multiple* = 10 (typical – avg 7 to 12 – set by appraisal)**
Value = $400,000
Total Value = $1,025,000

Example 2:
Business Value:
SDCF = $230,000, after paying rent of $70,000 ($300,000 total)
***Market Multiple* = 2.5**
Value = $575,000

Building Value:
$70,000 less $10,000 in expenses (taxes, etc) = $60,000 cash flow
***RE Market Multiple* = 10 (typical – avg 7 to 12 – set by appraisal)**
Value = $600,000
Total Value = $1,175,000

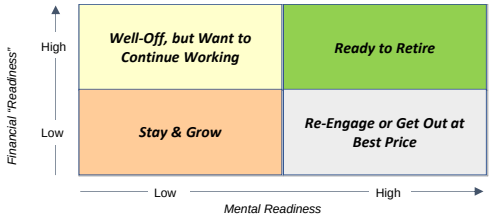
Timing Matters!

The 10 Year Transfer "Cycle"

	Deal Recession (Buyer's Market)		*Prime Selling Time (Seller's Market)*		*Almost Recession (Neutral Market)*	
1980		1983		1988		1990
1990		1993		1998		2000
2000		2003		2008		2010
2010		2013		2018	☆	2020

**Rob Slee, Author and Founder of MidasNation*

Key Factor: Seller "Readiness"



Exit Strategies: Plan Ahead

Many Ways to Exit	Making It Happen	How to Prepare
Liquidate	Auctioneer or "Sale"	• Improve P&L • Eliminate Unnecessary Inventory • File tax returns • Don't take out CASH • Don't stuff expenses into COGS • Document all OWNER benefits • Clean up facility • Make business "independent" of owner • Non-compete for key employees • Good "Prospectus" for business
Transfer	Lawyer	
Sell	M&A Adviser or Business Broker	

Q&A