Bank Trust Wealth Management

Business Valuation

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Your business valuation: what's it worth?

You've worked hard, committed your time and money, and accepted risks as part of your dream to own, operate and build a successful business. Now you're ready to exit and it's time to place a value on your business. How do you do that?

There are many methods of valuating businesses and different approaches depending on the type of business. Pick the method or combination of approaches that fits your unique business.

Your goal is to set the highest, reasonable price for your company. Back up your price with an accepted valuation method and *pro forma* (projected) statements.

Plan well in advance. You want to position yourself to get the best price for your business and the right opportunity might take time to arrange.

TIP

If you hire a business appraiser, contact the appropriate association in your province for a list of registered appraisers. Take time to check the qualifications and industry experience of the appraiser.

Assemble your team

Placing a value on your business is a team effort. Your professional team could include a lawyer, accountant, business appraiser, commercial real estate broker, investors and lenders. Depending on your business and personal situation there may be others who should provide input as well.

A business appraiser can give you a good estimate of value, but input from different perspectives will provide a broader view. You want to give consideration to different factors that are part of the overall value of the business.

Market considerations

There are some overall market factors to take into account when placing a value on your business. Some key considerations are outlined in the section below.

What industry are you in?

Different industries use different methods to establish business value. Find out what method is most commonly used in your business area by seeking an appraiser or a qualified accountant with experience in your industry.

What is the current state of your market and your business?

Market conditions will influence the value of your business. Weak markets can discourage potential buyers and market downturns can weaken your financial performance.

A long track record showing that your business has survived economic fluctuations and continued to grow can help with the perceived value of your business.

Remember that a strong market attracts more potential buyers and can result in a higher asking and sale price. A strong market may also create higher sales and more profit for your business. Both of these factors can influence your decision on when to place your business on the market.

The current condition of your business relative to its historical performance is another factor in establishing its value. If your sales are increasing and you're gaining market share, you may be in a position to add a premium to your asking price. Sales, profit and market growth are very attractive to potential buyers.

How have competitors in your industry valued their businesses?
Find out the most recent purchase price for companies similar to yours. Use your personal network or a business appraiser to identify any recent sales that have happened. Any potential buyers for your business will probably research recent sales of similar businesses and use that information as part of the negotiation process. Investigate prices that are well outside the range to see what factors led to an atypical price. When you eliminate unrepresentative sales, the remaining sales should give you an indication of the value of businesses in your industry and geographic area.

Setting an asking price

Financial methods for valuation

Different industries use different valuation methods and no one method is perfect. We have outlined the most common methods of business valuation to help get you started.

Book value
The book value is equal to the fair market value of assets less liabilities. Book value typically produces the lowest price. Under this method, assets are adjusted to reflect their fair market value or the liquidation value of the business.

Another very simple way of looking at book value is the value of a tangible asset at purchase less the accumulated depreciation.

For example:

You have purchased a piece of equipment for $100,000 that has an allowable depreciation rate of 20% per year. If you've depreciated this asset for 3 years here's the calculation:

Asset value at new:	$100,000
Depreciation rate:	20%
Years depreciated:	3
Annual depreciation	$20,000 ($100,000 x 20%)
Total depreciation	$60,000 ($20,000 x 3 years)
Book value of asset:	$40,000

Book value is suitable method where goodwill is limited or may disappear quickly. Book value does not take into consideration the earnings capacity of the business. Using this method to set the value of your business means you're not considering your business' future value.

Historical earnings

In contrast to the asset-based methods, historical earnings attribute a value to the goodwill of your business over and above the market value of the assets, if it's justified by your earnings.

Savvy buyers will typically be more concerned about the future of your business than its past. However, your history provides a reasonable indication of the amount, predictability, and growth of your future earnings.

If you are in a business strongly affected by external economic factors, showing how your business recovers well from downturns is valuable when negotiating on the purchase price.

Using historical earnings as your method to value your business is not difficult. Each industry is different, of course, and determining a multiplying "factor" for your industry will require some research and input by your valuation team.

A multiplying factor is based on the earnings from your EBIDTA (Earnings Before Interest Taxes Depreciation or Amortization) for a period of anywhere from 1 to 10 or more years. The number of years used as a multiplying factor is industry specific. If your business is hard to break into and has high value, your multiplying factor will be different than that of a business such as a franchise operation. The key people to help you here are an accountant and a business appraiser experienced in your industry.

In this example we will use four years as the multiplying factor for your business. We will also use EBIDTA as your annual earnings figure.

Your average EBIDTA for the past 3 years:	$560,000
Your industry multiplying factor:	4
Your possible asking price	$2,240,000

Potential purchasers may require more years of historical earnings evidence. They may also request historical earning for specific years. This may help provide them with a clearer picture of how your business performs during overall economic downturns or downturns in your particular industry.

Goodwill

Determine your historical annual earnings figure or EBITDA. From this, subtract the portion of earnings that has been earned by your assets alone. Anything left over is the excess earnings. Excess earnings are the portion that can be attributed to the ongoing business volume and value of customer relationships to the business, also referred to as the goodwill.

How do you determine the portion of earnings that are attributable to your assets? One way is to determine how much money you would get if the assets were sold and the money invested at market rates. How much is the market paying for other investments with similar risks?

After you determine the expected returns from your assets, compare the total with your historical earnings figures. If the historical earnings are higher than the return from assets, the difference is your excess earnings.

Let's look at an example:

Let's assume that the book value of your assets is $600,000. Let's also assume that if you sold these assets for $600,000, you would invest these funds at 12% per year (the market rate for investments with a similar level of risk as your business).

Example:

Proceeds if assets were sold	$600,000	
Investment rate for these funds	12%	
Annual return on investment	$72,000	$600,000 x 12%
Average annual historical earnings (EBITDA)	$200,000	
Amount attributable to Goodwill	$128,000	$200,000 - $72,000

This example is for illustration purposes only. Each industry could have variations to this calculation. Your industry may use a different method of valuation. Your accountant and business appraiser will guide you through this process.

About Earnings Before Interest Taxes Depreciation or Amortization (EBITDA)

EBITDA has become one of the most common methods to establish the value of a business. It is a simple calculation process and easy to understand.

The use of EBITDA has spread to a wide range of businesses. Its proponents argue that EBITDA offers a clearer reflection of operations by stripping out expenses that can obscure how the company is really performing.

Interest is excluded because it is largely a function of management's choice of financing. Taxes are left out because they can vary widely depending on acquisitions and losses in prior years and this variation can distort net income. EBITDA also removes the judgments that go into calculating depreciation and amortization, such as useable lifespan and residual values.

EBITDA makes it easier to compare the financial health of companies. It also gives investors a sense of how much money a company might generate before it has to pay interest and taxes.

One of the biggest reasons for EBITDA's popularity is that it shows more profit than just operating profits.

For this example calculation we will use $500,000 as the net annual operating profit.

When you calculated your net profit, you included the following expenses:

Interest	$24,000
Depreciation	$75,000
Taxes	$85,000
Amortization	$10,000
Total	$194,000

These figures will be added back into the $500,000 operating profit for a total of $694,000. This provides a clear indication to a potential purchaser of your equity before interest, depreciation, taxes and amortization.

Although EBITDA can provide a good and simple indication of the performance of a business, it may need to be used in combination with other measures. One other measure is working capital: the funds required to run your business day to day. Fast growing businesses may have to use working capital to purchase inventory. They may also experience a consumption of cash by their receivables as customers have not yet paid for their purchases.

For example:

> Your company has an EBITDA of $1,000,000 for your last fiscal year. You then turn to your cash flow statement and see that you consumed $1,400,000 in additional working capital. You needed to use this cash to support your growth. It helped pay for inventory purchases and regulate your cash flow due to the growth in your accounts receivable.

EBITDA will not show this and savvy investors will want to look at accurate cash flow statements in combination with your EBITDA and your Income Statements.

Increasing your valuation

If you have gone through the valuation process for your business and aren't happy with the result there are some ways to increase the sale value of your company. Planning your exit strategy well in advance will give you time to make changes to increase your business value before you sell.

Increase your operating profits

You can directly impact your valuation by becoming more profitable. Increased efficiency and lower operating expenses can help raise profits and have an impact on your business' valuation.

Reduce inventory and accounts receivable

By reducing your inventory and accounts receivable, you can decrease the amount of capital tied up in your business. The net change directly affects your valuation.

Make targeted capital expenditures

Prioritize your capital expenditures to operations and projects that increase your growth rate or profitability. While capital expenditures reduce your near-term cash flow, effective investment in your business can have a positive impact in your valuation.

Now what?

The examples and methods shown here are common strategies for placing a value on your business.

Plan ahead. Put together your valuation team well in advance of your proposed date to start the process of attempting to sell your business.

Your accountant and a qualified business appraiser will be key to setting the price for your business. They will use their experience to consider all financial and non-financial factors that are used in your industry.

Remember, you've worked hard and committed significant time and effort to make your business successful. Go through the valuation process patiently and thoroughly. Establishing an accurate price for your business can pay off when you put your business on the market. If your business is overvalued, you may have difficulty finding a buyer. Under valuing your business may result in a quick sale but you will walk away with less of your hard earned money.