Business Valuation - How a Potential Buyer Will Value Your Business

There are many different methods that are used to value a business. Often, the approach taken will depend on the objective of the valuation. This article will discuss the basics of some of the more common business valuation approaches used by purchasers to estimate the value for small to mid-sized businesses with sales ranging from $1.5 million up to $50 million.

Three of the most common approaches used by buyers are:

- Multiple of Seller's Discretionary Cash Flow (SDCF)
- Multiple of Earnings before Interest and Taxes (EBIT)
- Multiple of Earnings before Interest, Taxes, Depreciation and Amortization (EBITA).

These three approaches are all earnings based methods founded on the general premise that the current value of a business is the present value of all expected future benefits. So just like any other investment, the real value of a business to a buyer is the return on investment that can be generated from the money spent to acquire the business.

The annual return to the buyer is generally the cash flow created by the business on an annual basis. SDCF, EBIT and EBITDA are all methods for determining cash flow. The multiple attached to the cash flow formula is directly related to the return the buyer seeks. For example, a multiple of five attached to cash flow represents to a buyer getting back the investment in five years which is equivalent to an annual return of 20%.

Much of the process of determining SDCF, EBIT and EBITDA is similar. SDCF is most common for smaller businesses while EBIT and EBITDA are more common for larger businesses. The balance of this article will focus on explaining SDCF, EBIT and EBITDA and outlining the factors that make one method more suitable than another for purchasers acquiring larger businesses.

Multiple of Seller's Discretionary Cash Flow (SDCF)

Generally, SDCF is the pre-tax earnings of the business before non-cash expenses (depreciation and amortization), owner compensation, interest expense or income, as well as one time and non-business related income and expense items.

If there are additional owners working in the business, their compensation needs to be adjusted to market rates.

To arrive at a true number for the SDCF the business' financial statements may need to be recast. Some more common items on the Income Statement that may require adjustment include:

- Adjustment of cost of goods sold to historic averages;
- Adjustment of all salaries to market rate (e.g. other owners, family members);
- Adjustment of depreciation expense consistent with the useful life of the underlying assets;
- Adjustment of the business rent to a fair market rate (e.g. if the business owns its real estate premises a fair market rate should be included as a business expense);
- Adjustment to expenses incurred at owner's discretion (e.g. some travel and entertainment, vehicles, memberships, charitable donations, bonus payouts and others); and
- One time extraordinary expenses (e.g. a lawsuit settlement payment).

As mentioned previously, the SDCF approach is most appropriate in the lower range of the small to middle market. It is also most appropriate when the prospective buyer is a person who will replace the owner manager. This buyer can be viewed as an employment buyer meaning he or she will not only be purchasing the business but also will actually be working in the business as the owner operator.

A question that frequently arises when discussing the total price if it is derived by a multiple of SDCF is whether the price includes all the business assets. Generally, the business value determined above only reflects the value of the assets required to operate the business. Other assets such as cash, the net difference between accounts receivable and accounts payable, and inventory are treated as adjustments.

Typically the multiple for businesses in the lower end of the small middle market is in the range of 1 to 3 times SDCF depending upon the business' strengths and weaknesses. Some of the factors that will move the multiple to the higher end of that range include: less specific reliance on the owner; strong growth in financial results (at least over the last 3-5 years); a growing industry, established repeat customers; diversified customers; and exclusive territory.

The use of the EBIT and EBITDA multiple is most common in the mid to upper middle market.

Multiple of Earnings before Interest and Taxes (EBIT)

EBIT like SDCF is also based on the pre-tax earning of the business however unlike SDCF there is no adjustment required for depreciation or the owner's salary. The reason this adjustment is not required is that purchasers of larger businesses tend to be corporate buyers which derive no benefit from salary paid to the manager of the business thus it will deduct from cash flow a reasonable salary to hire somebody to run the business.

Also, in EBIT, depreciation is deducted from cash flow because the corporate buyer views it as a true expense since the equipment will likely need to be replaced at the end of its useful life.

Multiple of Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA)

The EBITDA multiple is calculated in the same way as EBIT with one exception; EBITDA, adds back depreciation and amortization whereas EBIT deducts these items from cash flow.

Often the amount of accounting depreciation is not indicative of the amount required to maintain the level of performance of the capital assets used in the business. The depreciation rates and amounts taken are often much higher than the actual cost of maintaining the assets and replacement of the assets may not be required until well after they have been depreciated to zero. The corporate buyer will add back depreciation in some scenarios because it may feel the true expense is much less than the actual costs based on useful life and residual value of assets.

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