Business Valuation Rules of Thumb

Business brokers and other professional intermediaries use business valuation rules of thumb to help sellers price their businesses for sale. These "rules" are very useful for appraising nearly every small business, however they are gross simplifications and should only provide a general idea of a suitable price range for a particular business.

If a rule of thumb is used to value a business, some type of earnings multiplier makes the most sense to prospective buyers. It directly addresses the buyer's motive to make money to achieve a return on investment. Sales multiples mean nothing unless they can be translated into earnings.

Two areas of confusion are inappropriate comparisons to investment real estate or to stock market earnings multiples. Real estate is often priced at 8 to 10 times its net operating income. Stock market prices are often as much as, or even more than, 20 times earnings. These two comparisons do not work for small businesses primarily because the risk of owning a small, closely-held, privately owned business is thought to be much higher than owning either real estate or publicly held stock. A business has lower liquidity than real estate and stock, and running a small business is also a lot tougher than managing an office building or a stock portfolio.

To determine an appropriate earnings multiplier, the following questions must be taken into consideration:

- How is the business doing in terms of earnings? What are the average earnings per year in the last three to five years? What are the future projected earnings?
- How is earnings calculated? Should it include or exclude the owner's pay and perks, interest expenses, depreciation, and taxes? What about those one-time expenses that may be on the books?
- How do you choose the right earnings multiplier to value the business? What is the multiplier based on? Most people can agree that the multiplier varies based on the risk of the business, but how can risk be measured?
- What about the various tangible and intangible asset values? Do we include the real estate, equipment, vehicles, and inventory? Is there a separate value for a seller's agreement to consult with the new owner after the sale? What about non-compete agreements? What about patents, franchises and other extraordinary intangible assets? Is "value" defined as fair market value or a specific value for a specific circumstance?

As you can see, determining an appropriate earnings multiplier is fairly subjective. The reality is that it is very difficult to estimate the market value of a business because a marketplace of buyers and sellers cannot be easily observed. In fact, there are not many buyer prospects for a given small business and the result is that buyers pay prices that are unique to their circumstances, sometimes considerably above or below any so-called "fair market value".

A buyer must use common sense and remember that potential buyers create the market. Determining an earnings multiplier can be difficult, and the following six guidelines could be used to help calculate earnings:

1. Examine the most recent year's earnings on the seller's latest tax return. It would make sense to look at the last three years, but remember as a buyer you are buying the future and not the past. Use these figures to determine projected annual future earnings with you as the new owner. Do you have experience in this type of business? Can you perform the duties and responsibilities of the seller? Will you be able to maintain sales at their current levels?

2. Look at the tangible and intangible assets. They often seem to have a value separate from the business. Is there real estate and inventory for re-sale included in the sale? Real estate and inventory for re-sale is theoretically less risky than owning the other assets of a business because it is believed that real estate could be easily sold on the open market and inventory for re-sale could be easy to liquidate if the business failed. Generally, inventory is valued at cost. These assets may be valued separately from the business, and then added back to the multiple-derived value of the business. Aside from real estate and inventory for re-sale, other assets should already be included in the multiple-derived business value as they are needed to generate the projected future earnings.
3. If there is real estate involved but it is not for sale, a real estate rent expense must be subtracted from the earnings figure. The seller did not have to pay rent if he or she owned the property where the business is located, but this would not be the case for you as the buyer. You must take future rent expense into consideration.
4. Owner's salary, perks, and certain one-time expenses should be included in the earnings calculation. If these expenses were subtracted from profit on the tax returns, they should be added back in your earnings calculation. Businesses tend to maximize deductible expenses to minimize taxes.
5. Depreciation / amortization is a non-cash expense, meaning the owner does not have to pay out of pocket each year. If these expenses were subtracted from profit on the tax returns, they should be added back to your earnings calculation.
   Earnings = Net Profit before taxes + Owner's Salary + Fringe Benefits + Depreciation / Amortization.
6. Generally, intangible assets such as an owner's agreement to not compete, or to consult during a transition period, are included in the value of the business derived by using a multiple of earnings, even though such assets may well be treated separately at a business closing for tax purposes.

Once you have calculated projected annual future earnings, also known as EBIT (Earnings Before Interest and Taxes) by accountants and is an understood norm, consider the risks involved in owning the business. How much are you willing to pay for the business given the risks involved? The right earnings multiple really depends. For most businesses, it's somewhere between 1 to 5 times EBIT. But, the multiple is less when there are few tangible assets and more when the business is uniquely attractive.

In summary, the rule of thumb to use to value a business is based on an earnings multiple. The right multiple is, in the eyes of buyers, a matter of assumed risk. Buyers feel better about buying tangible assets that they can appreciate with their five senses - things like real estate and equipment. On the other hand, buyers are also enticed when there is a clearly attractive opportunity to make money, regardless of the tangible assets included.