Valuing a Business

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Valuing a small business is often the most challenging part of the process for prospective business buyers. In reality, it doesn't have to be an overwhelming factor. First of all, buyers must keep in mind that the "Asking price" of a business does not necessarily represent what the business is worth. Furthermore, you should realize that a buyer's valuation is usually quite different from what the seller believes and rightfully so; they have their sweat built in to their calculation, most of the time.

You should also know that valuation is an art, not a science. The key to establishing a valuation benchmark is to utilize a variety of formulas. I am not a fan of the "Rule of Thumb" method, since I do not believe that any two businesses are exactly the same. Valuation must be done based upon what you, as the buyer, can reasonably expect to generate in your pocket, so long as the business' future is representative of the past historical financial data.

Having said this, the most viable valuation method for small businesses, is the multiple method. This formula applies a factor to the previous year(s) Owner Benefit figure to arrive at a purchase price. The Owner Benefit figure is a combination of several factors:

Pre Tax Profit + Owner's Salary + Additional Owner Perks + Interest + Depreciation

Typically, small businesses will sell in a one to three times multiple of this figure. Now, this is a wide range so how do you determine what to apply? The best mechanism I have found is that a one time multiple is for those businesses where the seller is "the business". In other words: as out the door goes the seller, so too can go the customers. Consulting businesses, professional practices, and one-man businesses come to mind.

Three times multiples are for businesses that have been around for several years, have shown sustainable growth, have a solid base of clients, assets that will not have to be replaced in the immediate future, are involved in growth industries, etc. Of course, there is a lot more to factor into the equation and you must always keep in mind that value is a personal assessment.

One thing that you should do is to ask the broker or seller to provide you with the rationale for how they established the asking price. You'll be amazed to learn that a logical assessment is not always the case. Usually, it's what the owner "wants" for the business; which again, does not reflect the market or reality. A good business broker will educate the seller regarding the market, and overall valuations and will price the business to generate the greatest amount of interest possible.

You should also know that a study of hundreds of businesses sold last year in the state of Florida indicated that the average multiple was 2.1 times owner benefits. Always keep in mind the inexact nature of valuations. Use a variety of methods. Understand how the price was determined, remember that valuation is a personal formula, consider the potential return on your cash investment, never, ever buy a business just because the price is right - first and foremost be certain that the business itself is right for you!

About The Author

Richard Parker author of: How To Buy A Good Business At A Great Price(TM), the most widely used reference resource and strategy guide for buying a business. He has purchased ten businesses in his career and has helped thousands of prospective buyers worldwide learn how to buy the right business for sale. He is also founder and President of Diomo Corporation - The Business Buyer Resource Center.