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## The Method Behind the Madness: Business Valuation for your Small Business

How much is my business worth? This question may be the most important one that you will ask as you prepare to sell your business, and your answer to it can affect the amount of profit you make from the sale. While an appraisal of your business is not as simple as one on a home, it is an easy to follow process. If you understand the methods, you will be able to avoid common mistakes and set a price that is easily defended, allowing you to negotiate the highest selling price possible.

### Mistakes to Avoid

One of the most common mistakes that many business owners make is misunderstanding the importance of a proper valuation. This misunderstanding can lead to several pitfalls, which can result in a loss of profit. Having a proper valuation will help you set the right asking price and make a better profit.

These are the most common valuation errors:

- **Setting too high or too low of an asking price.** Both of these can have a negative impact on the sale. If your asking price is too high, a buyer may wait until you lower the price and seek a lower, more bargain, selling price, resulting in a loss of profit.
- **Guessing a value.** Many business owners will set a price based on the sale of a similar type of business. While this method may seem logical, in reality, it may be a dangerous way to set a value. Each business has its own dynamics that can affect the value. Your business will be different, and knowing that difference is crucial to making the most profit from the sale.
- **Inability to explain the valuation.** When you are negotiating a selling price, you must be prepared to defend the value of your business. By presenting solid evidence to a buyer, you have a better chance of obtaining a selling price closer to your asking price.

### Who performs the valuation?

A valuation can be completed by the seller, seller's accountant, broker, or outside agency. Many buyers will be wary of a seller's appraisal, including ones completed by the seller's accountant or broker. For this reason many sellers hire an outside agency to form the report and derive the

value. Regardless, the buyer still may have their own accountant value the business during negotiations.

### **What are the factors that set the value of my business?**

The following items are factors that can affect the value of your business.

1. **Earnings:**
  - net assets
  - return on sales
  - return on assets
2. **The risk:**
  - returns on investments
  - stability of cash flow
  - growth rate
  - economic outlook

The items in list one should help you set the value and asking price of your business. The items in the second list tend to affect the negotiation process and the selling price. However, it is wise to look at the items in list two and adjust your asking price accordingly. In that case, be prepared to stand behind your asking price during the negotiations.

### **What is the process?**

To begin the valuation process, you will need to prepare several financial documents. Most buyers will be interested in tax statements, cash flow statements, and profit/loss statements. When you are preparing these documents, use the earnings before interest and tax, the EBIT value. Usually, you will want to prepare 3-5 years worth of statements and you may have to recast your statements to come to these figures. These documents will allow a buyer to estimate a return by projecting growth and revenue.

### **The Discounted Cash Flow Method**

The Discounted Cash Flow method is the most popular method for valuing the business. It is not a perfect formula, but it is what most accountants and brokers are using to determine the value of a business. The DCF formula is basically the EBIT value multiplied by a multiple. The chart below outlines the basic guidelines for determining the multiple; however, these often vary from industry to industry, so this is just to get you started.

Commonly practiced DCF guidelines for valuing your business:

| <u>Type of Business</u> | <u>Business Description</u>  | <u>Multiple To Use</u> |
|-------------------------|--|------------------------|
| Small Service Business  | <ul style="list-style-type: none"><li>• Few assets</li><li>• Heavily dependent on management</li><li>• Single owner</li><li>• Small mom and pop organization</li></ul> | 1x profit              |

|                             |  |               |
|-----------------------------|--|---------------|
|                             | <ul style="list-style-type: none"> <li>• No significant amount of profit or growth</li> </ul>  |               |
| Small Established Business  | <ul style="list-style-type: none"> <li>• Few assets</li> <li>• Heavily dependent on management</li> <li>• No significant competitive advantages</li> <li>• Beginning to grow and increase profits</li> </ul> | 2-4 x profit  |
| Strong Established Business | <ul style="list-style-type: none"> <li>• Good competitive position</li> <li>• Growing and making significant profits</li> <li>• Still some reliance on management</li> </ul>                                 | 5-7 x profit  |
| Well Established Business   | <ul style="list-style-type: none"> <li>• Strong competitive advantage</li> <li>• Strong earnings</li> <li>• Earning power is not contingent on management</li> </ul>   | 8-10 x profit |

### **What about my business' assets?**

Once you have determined the value using the multiple, you can add any assets that add value to the business. Remember to only add in assets that contribute to the earnings. If they do not contribute to the earnings, leave their value out of the amount. For these particular assets, a buyer may be interested in how easily they can be liquidated, and this fact can be a factor in negotiating the selling price. An example of this type of asset might be computer equipment or real estate.

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