Capital Source Solutions

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What is the business worth?

Over the past 25 years we have worked with many private business owners who do not have a firm grasp on what their business is worth.

It is understandable why, given that the value can range widely. **There may be little to no value for the business that depends entirely on the company owner's skill and relationships**. Or there may be value beyond expectations, if the company is an attractive acquisition target for a larger business.

It is hard enough to value a publically traded business, where in theory all that there is to know about the company has been shared. In a private business, it can take a fair amount of digging to uncover the company's core cash flow, earnings, and standing in its market.

The most important milestone toward creating "saleable" value occurs when the owner is no longer driving the success of the business. For many small businesses, the founder is often responsible for the lion's share of the income generated, and may even be the brand. In those situations where the owner is the value, it will be difficult to sell that business. It is much better to have solid managers in place performing all of the critical functions.

An exit strategy that includes maximizing the value of the business requires all of the planning you heard that it did. Even before you intend to exit your business, properly valuing your business is critical to strategically managing it.

Preparing several years ahead of a sale gives you time to demonstrate the true earnings power of the business, and to perfect and document all company procedures.

Business Value Drivers

- Strong annual cash flow that is growing
- Diversified customer base
- Timely and accurate financial records
- Documented practices and procedures for all business activities
- Little company debt
- Facility curb appeal
- Strong management team

Common Business Valuation Methodologies

There are three primary methods a professional business appraisal firm will utilize to derive a value for a private business: The Asset Approach, The Income Approach, and The Comparables Approach.

1. **Asset Approach-Adjusted Book Value**

   The least accurate but easiest to use of the 3 methodologies is Adjusted Book Value, which in essence values the business as the value of its assets minus all of its liabilities. **Or in other words, the book value of the business.** The asset approach looks at the approximate value of a business based on the fair market value of its assets, less the fair market value of any liabilities.

   This is often a poor reflection of value, as it gives no weight to the current and future cash flows of the business. It is a good tool to use for the smallest of businesses, where the cash flow is less reliable than is the value of the assets at the time of a sale.

2. **Income Approach-Formulas, Including Multiples of Earnings, Capitalization of Earnings, Discounted Future Cash Flow**

   For many small businesses that are not purchased for Adjusted Book Value or Net Asset Value, a **multiple of cash flow and discretionary earnings, or a discounting of future cash flows**, is used, as part of the Income Approach.

   The income approach will yield an estimate of the value of a business based on the current value of expected future cash flows and/or operating revenues.

   This is the most widely recognized and used approach, but it should not be the only one.

   The more stable and reliable a company's earnings and industry conditions are, the higher the multiple that is applied to earnings to derive a valuation.

   You might see a multiple of less than 2 times earnings for cash flows that are less certain, and up to 10 times earnings for those businesses that reliably and predictability produce a given cash flow stream.

   Only those companies with the most reliable earnings stream, and/or strongest growth possibilities, would get a multiple of 10 or higher.

   Another popular formula capitalizes the business' current earnings by a desired rate of return to arrive at a value. If ABC Flooring reported earnings of

$500,000, and the buyer of the company sought a return of 10%, they would be willing to pay up to $5 million to acquire the company.

The shortfall with this methodology is that it is static, and does not account for how stable earnings are, or if they are growing significantly.

In situations where the business is reporting strong growth, the more complicated formula that is utilized discounts all future cash flows, assumed to grow at various rates, back into today's dollars.

3. **Market Approach-Comparables**

   Much like we do when we purchase real estate and look for data on comparable home sales to determine value, the same approach is used to value private businesses with the Market Approach.

   Here data on the sale of businesses in the region, operating in the same industry, and of like size, is analyzed and applied to the subject company to determine value.

There are a host of other factors (external and internal) that play a part in a company's true value. In due time, a business appraisal should manifest in the form of a written business plan to guide the future direction of the company.

Through our partnership with **Pinnacle Financial Resources** and **The Principal, we can offer those businesses with $500,000 or more in annual revenue a complimentary, professionally prepared informal business appraisal.**

Please note that these appraisals will be performed by a unit of **The Principal**, and will be professionally rendered, but they will be informal, and are not intended to be used where it could be legally contested.

Your business can take advantage of the insights provided by a professionally prepared business appraisal simply by making the request.

Please call us at 314-226-3663 or email David@CapitalSolutionsSTL.com to get started on your business appraisal.

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