Cashing Out ... What Is Your Business REALLY Worth?

By Elena Fawkner

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Elena Fawkner
jan@ahbbo.com

A Home-Based Business Online http://www.ahbbo.com

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Question: What is your business REALLY worth?
Answer: Whatever someone else is willing to pay for it at the time.

That's a true statement as far as it goes but it doesn't take into account that the way you arrive at a value for your business can give you much-needed ammunition when it comes to justifying your asking price and therefore allow you to influence what the prospective purchaser is willing to pay.

Here's a quick primer of the various methodologies commonly used for valuing businesses (for purposes of imminent sale or otherwise):

1. Asset Valuation

This is used by businesses with predominantly physical assets, especially inventory. Typical businesses that would use this approach are manufacturing and retail. The valuation takes into account the following figures: (a) the fair market value of fixed assets and equipment; (b) the value of leasehold improvements; (c) owner benefit (the seller's discretionary cash for one year - comes from the adjusted income statement); and (d) inventory.

2. Capitalization of Income Valuation

This is used by businesses with predominantly intangible assets. It places no value on physical assets, only intangibles. Typically used by service businesses. Under this method, various factors are given a weighting of 0-5 with 5 being the most positive score. The average of these factors yields the "capitalization rate" which is then multiplied by the buyer's discretionary cash (75% of the

owner benefit defined in 1. above) to arrive at the market value of the business. The factors to be rated are: (a) owner's reason for selling; (b) length of time the company has been in business; (c) length of time the current owner has owned the business; (d) the degree of risk; (e) profitability; (f) location; (g) growth history; (h) competition; (i) barriers to entry; (j) future industry potential; (k) customer base; and (l) technology.

3. Capitalized Earnings

This method is based on the rate of return anticipated by the investor. Small businesses are expected to have a rate of return of 20-25%. So, if your small business has expected earnings of $10,000 for the year, its value may be $40,000 - $50,000.

4. Cash Flow

This method is simply based on how much of a loan the purchaser could get based on the adjusted cash flow of the business. The adjustments to cash flow are for amortization, depreciation and equipment replacement. Obviously, when using this method, the value of the business fluctuates with changing interest rates.

5. Discounted Cash Flow

This method discounts the business's projected earnings to adjust for real growth, inflation and risk. It calculates the value today (i.e., discounted for time) of the business's future earnings.

6. Leapfrog Start-up

This is used when the buyer wants to save him or herself the cost, time and effort of ramping up a new business. The buyer estimates what it would have cost to do the startup less what is missing plus a premium for saved time. The more difficult, expensive or time consuming the start-up would otherwise be, the higher the value that will be arrived at using this method.

7. Excess Earning Method

Similar to the capitalized earnings approach, but the return on assets is separated from other earnings which are deemed "excess" earnings generated. The return on assets is usually determined by industry averages.

8. Owner Benefit Valuation

This method is based on the seller's discretionary cash flow. It is usually used for businesses whose value comes from its ability to generate cash flow and profit. The formula is to simply multiply the the owner benefit by 2.2727.

9. Rule of Thumb Methods

These are rough guides based on industry averages. Many industry organizations have developed methods for their particular industries. They are highly unscientific and hardly rigorous but act as a good "gut-check". You certainly wouldn't use them on their own but they can be useful to check that the value you've arrived at using a more scientific approach is in the ballpark.

10. Tangible Assets (Balance Sheet)

This method is basically a value of the business's current assets and nothing else. Typically used where the business is losing money. This approach will usually be utilized when selling the business is just a matter of getting the best possible price for the equipment, inventory and other assets of the business. A good strategy is to approach other firms in the same business that would have a direct use for such assets.

11. Multiple of Earnings

A multiple of the cash flow of the business is used to calculate its value.

12. Value of Specific Intangible Assets

The value of the business is based on how much it would have cost the buyer to generate the intangible asset. Typically used where specific intangible assets that come with the business are highly valuable such as a customer base. Customers with a high likelihood of being retained are valuable in most industries.

The most appropriate valuation method for you depends very much on the nature of your business. If you manufacture widgets, for example, you'll want to use the asset valuation method. If you offer website design services, on the other hand, you'll want to use the capitalization of income method instead. If you're selling a web-based business where the major asset is your high traffic volume and/or list of ezine subscribers, you will probably want to use the value of specific intangible assets method, such as 10 cents per subscriber (or whatever the going rate is).

Is more than one valuation method applicable to your business? If so, calculate the value of your business in accordance with all of them and see which gives the best result (i.e., highest value). Another good approach is to average your calculations to get a reasonable ballpark figure.

Whichever method you choose, understand it inside out so that when the time comes, you can authoritatively justify your asking price to potential buyers. Pulling a figure out of thin air without any substantiation whatsoever is much less impressive than being able to say, with confidence, "I worked with my advisers using a number of different methodologies to value the

business. We adopted the value of specific intangibles method because the backbone of the business is our large, loyal ezine subscriber database. We also calculated it on the basis of capitalization of income, which yielded a similar value. I can show you the calculations if it will help you see where the number comes from."

By following this approach you may not necessarily get the value you are after (for this reason, many sellers artificially inflate their asking price so they have room to be negotiated down), but at least you have a solid starting point for negotiations and are much more likely to be able to negotiate a price both buyer and seller are able to live with.

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Elena Fawkner is editor of A Home-Based Business Online ... practical home business ideas for the work-from-home entrepreneur.
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