Understanding the Valuation Process

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THE VANT GROUP

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Major Steps Involved in Selling a Business

- Business owner decides to sell business
- Determine the value of your business
- Gather information into a marketing package
- Marketing the business
- Identify potential buyers
- Arrange meetings with buyer and seller
- Offer to Purchase / Letter of Intent – Moving Forward
- Negotiating and deal structure
- Due Diligence
- Closing

Valuation Summary Information

- Business owners usually have **misconceptions concerning the value** of their business normally believing his business is worth more than market value.
- There seem to be two main reasons for this misconception
    - **Listening to and believing unqualified sources**
    - **Owners are too emotionally involved in their business, having spent their career developing it**
- Buyers will make a **decision to purchase** a business based on **potential future upside**, but **establishes a price** based on **past & current financial performance**.
- There are probably as many formulas to develop market value as there are different types of businesses.
- In the final analysis, there is one definitive determinant of business worth:
    - **"The amount a willing and educated buyer is willing to pay for a business."**

Valuation Summary Information

- The worst thing a seller can do is to listen to **others' market value.**
- A broad range of multiples of ODCF in determining a sale price is between **one and ten times ODCF** depending on level of ODCF.
- Once analysis of the financial statements has created a base of value, there are many subjective aspects that will adjust the sale price up or down.
- The **objective (financial)** and **subjective factors** are **intertwined** in establishing the ultimate sale price.

Understanding the valuation process

- **Objective**
  - Owner's Discretionary Cash Flow (ODCF)
  - Asset Value
  - Inventory Value
  - Accounts Receivable (A/R) and Accounts Payable (A/P) – included?
  - Leverage – Financing
  - Asset vs. Stock sale

Owner's Discretionary Cash flow (ODCF)

- When dealing with small businesses, the description of **Owner's Discretionary Cash Flow (ODCF)** will be used in most valuation models. A more detailed description was discussed in the previous chapter.
- Most small business sale prices are determined by using a **multiple of cash flow**. If a prospective buyer cannot receive a good return on his investment for a business purchase, the business price is too high.
- If the business is purchased using leverage and the ODCF cannot cover the debt payment, the business is most likely overpriced and will probably not sell. In real estate, a buyer's main focus is location, while in business transfer it is ODCF.

Owner's Discretionary Cash Flow: Example

Net Income	$ 100,000
Addbacks:	
Depreciation	$ 50,000
Interest	$ 20,000
Owner Salary	$ 80,000
Owner travel (personal)	$ 5,000
Owner auto (personal)	$ 6,000
Owner health insurance	$ 7,000
Owner's Discretionary Cash Flow	$ 268,000

Understanding Asset Value

- Many buyers want to know how much of the business price is **allocated to what they can feel and touch**, or hard assets.
- Normally, the higher the value of the asset, the higher a sale price. Conversely, outdated, non-working duplicate assets do not add value to a company; rather, they detract from it.
- A business owner needs to ensure that his business does not become **"upside-down"** (his asset value is much higher than his ODCF), since that would only yield him a sale price driven primarily by his asset value.
- Assets are essential to the operation of any business, yet if an owner is continually building an asset base and not consequently building the sales and cash flow, he is **hindering the ultimate sale price**.

Understanding Inventory Values

- Inventory value falls under the same heading as assets, which are items a prospective buyer **can feel and touch.**
- Inventory is essential to the operation of a business, yet **too much inventory** can have a **negative effect on sale price** as well.
- A sale price can be determined with or without inventory value, but either method will require an **inventory count** before the closing date.
- Dead and obsolete inventory will not add proportionate value since it will not be counted in the sale price.

Accounts Receivable & Accounts Payable

- When a small business is valued, it is normally based from a multiple of ODCF with hard assets and inventory included in the sale price.
- When **A/R and/or AP are included** in a business sale, the price derived from the earning multiple will be **adjusted up or down** based on the net values of the A/R and A/P.
- When a buyer purchases the accounts receivable, the sale price increases dollar for dollar above the predetermined sale price from a multiple of ODCF.
- Normally, there are provisions in the contract for any **uncollectible A/R** that either affects the seller carry-back note or a refund of a portion of the sale price.

Effects of Financing On Value

The terms of payment on a business sale will have a major impact on both the sale price and how long it takes to sell. A business that can be purchased using a high leverage factor generally will be worth more than one that requires all cash.

- SBA Loan
- Owner Financing
- All Cash
- Earn out/Contingency
- Conventional Loan
- Private Equity Funding

Asset vs. Stock Sale

- The two types of business transfer are the purchase of a company's assets or the sale of its stock.
- In the small business arena, a **stock sale** is usually most beneficial for a **seller**, while an **asset sale** is most beneficial for a **buyer**.
- Determining the type of sale will have a direct impact on the sale price with an asset sale usually commanding a higher sale price than a stock sale.
- **Asset Sale**
  - **In an asset sale**, the buyer primarily **buys the assets** of a corporation only (fixed asset, goodwill, noncompete, etc.).
  - The advantage to a buyer is the ability to **allocate the sale price** with a high asset base that will allow for a higher future deprecation schedule.
  - In addition, by purchasing only the assets, the buyer does not assume any of the **corporation's legal liabilities.**

Asset vs. Stock Sale

- In a stock sale, the buyer primarily purchases the **stock of the corporation.**
- The advantage to the buyer is the ability to buy the total package including **contracts leases, permits, and licenses** that are in the corporate name.
- The **disadvantages** as previously mentioned are the **legal liabilities and lack of depreciable asset base**.
- The tax advantages to the seller in a stock sale are usually significant, which is why most business sellers prefer this method of sale.
- The most difficult part of convincing a prospective buyer to pay for the goodwill (subjective) portion of the business can be validated by placing economic values on intangibles such as: employees, company longevity, patents, customer base, and of course, cash flow.

Understanding the Valuation Process

- **Subjective**
  - Years in business
  - Employees
  - Reason for selling
  - Length of training
  - Customer and supplier base allocation
  - Business Type
  - Other factors:
    - Market strength, Industry growth, Appearance, Location, Owner's involvement

Employees

- The old adage, **"Employees are a company's most important asset"** could not apply more than during a business transfer Quality, quantity, and tenure of employees has a direct effect on not only the value of a company, but also on the probability of it business being sold.
- The strength of the employee pool starts at the top with a **solid management team** and/or right-hand person.
- Buyers will be keenly interested in determining which employees will be able to help him **learn the business and survive the transition period.**
- Businesses that have the owner as, "chief, cook, and bottle washer" will **not command the price & attention** of a company with a solid management team.

Years in Business

- Longevity equals less risk.
- We have observed that after ODCF and fixed assets, the number of years in business is the **second most important** factor for buyers.
- All things being equal, a fifteen year-old firm will sell quicker and for more money than a five-year-old firm with similar financials.

Reason for Selling

- A difficult psychological obstacle for a buyer to understand and believe is the **seller's reason for selling**.
- A justifiable, acceptable reason for sale will **increase the probability** of sale for the highest justifiable price.
- The top reasons for buyers are retirement, fatigue, and sickness with the most common reason is probably fatigue, which usually occurs between **7-12 years of ownership**.
- The **least acceptable** and most problematic reasons for buyers include: inability to handle the business, preference for another business, or problems with employees.

Length of Training

- It is standard procedure that a seller will be required to remain with a company for a period of time to train the new owner in the operation of the business.
- As previously stated, if the seller is the "**chief, cook and bottle washer**" then it is a safe bet that the **transition period will be longer** since the seller is the only one with the important knowledge.
- Similarly, if the business is technical and dependent upon the owner in the operation, the training will likely last for an extended period. Unless the aforementioned circumstance characterizes your situation, **the training period will likely be only a month or two.**

Length of Training (cont.)

- Usually, this short period is at no cost to the new owner. It is important to remember that some buyers will want the seller out of the operation as soon as possible to be able to fully assert themselves in their new roll.
- Conversely, other buyers will want to keep the seller around for as long as possible as a safety net. It is good procedure to structure additional time after the original period for phone consultation or monthly meetings. This additional consultation period adds a comfort level to the new owner and as such, will often shorten the time the seller might otherwise be required to stay.
- The length of this period will vary in part on **how well the owner has distanced himself from** the business in the years before the sale.

Customer and Supplier Concentration

- The expression, "Don't put all your eggs in one basket" applies similarly to the customer and supplier base.
- Having one or two customers account for a majority of the business might make it easier to operate, but it could definitely have a **negative effect on the sale price**.
- As a general rule, business owners should not have a customer represent more than **20% of the company's total sales.**
- Buyers are concerned with the possibility of losing one or two large customers and perceive this as an inherent company weakness they would rather not risk.

Customer and Supplier Concentration

- Having a limited base of suppliers not only poses an inherent risk, but it also limits the ability to provide a wide range of products and services.
- Buyers are aware that a large supplier may be tied to the company based largely on the supplier's relationship with the owner who is leaving.
- A **diversified customer and supplier base spreads out the risk** and eliminates the concern of losing those all-important one or two customers and/or suppliers.

Business Type

- Different types of businesses are more attractive than others to prospective buyers.
- There is a **well-defined hierarchy** of desirability in the different types of businesses. The four primary types of businesses listed in order of desirability are: Manufacturing, Wholesale, Service and Retail.
- Some people prefer a Ford to Dodge or a two-story home to a ranch style home.
- There are different buyer preferences for business types as well.

Additional Factors that Affect Value

- **Market Strength** – Does the business have a strong market share in the industry?
- **Industry Growth** – Is the business in a growing industry?
- **Appearance** – Does the business show well? Is it clean? Is there enough space? What would it cost to remodel or redefine the business?
- **Location** – Is the business in a major city? Is it easy to get to?
- **Owner's involvement** – Is the owner the whole business? Does the owner work 100 hours per week?

Our Services

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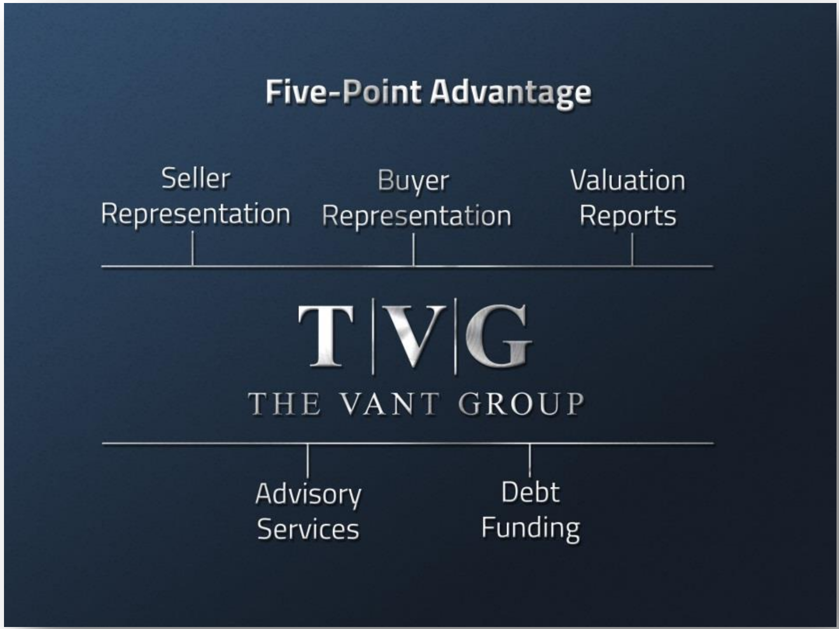
- Selling a Business
- Buying a Business
- Business Valuation
- Business Debt Funding
- Business Advisory Services



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- Closed 80% of the businesses we listed vs. 40% Industry average
- Consistently sold business within 95% of the asking prices
- Closed 500+ business transactions for diverse businesses; including manufacturing, technology, energy, healthcare and service industries
- Established industry best practices as basis for two leading books on business transfer
- 20 years of buying and selling businesses for our own portfolio

Exit and Entrance

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