

FRB's "Buying Or Selling A Business" Series

Understanding Business Valuation

Front Range Business, Inc.

*Offices In Boulder, Evergreen,
Fort Collins, and Breckenridge*



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Today's Program Topics

- *Setting the Table – General Concepts*
- *Expected Returns - Rationale To Invest*
- *Primary Elements Of A Business Sale*
- *Business Valuation*
- *Financing the Transaction*

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Setting the Table

Defining Small Business

- *Moving target based on industry, employees and revenue per SBA Size Standards*
- *SBA uses < 100-1,500 employees as small*
- *Typically under \$20MM in revenue*
- *90% of all businesses in the US have less than 20 employees*
- *As small business brokers we typically see \$1MM to \$10MM revenue businesses.*

Qualitative vs. Quantitative Value

- *Sellers Often Think Qualitatively*
 - *Community of customers, employees, suppliers*
 - *Years of effort to build, shape and structure*
 - *Brand, reputation and even personal identity*
- *Buyers Always Think Quantitatively*
 - *Show me the numbers*
 - *What are the risks*
 - *Will it support my lifestyle and investment objectives*

Reasons to Sell an Existing Business

- *The Good Reasons (The Wonderful Rs)*
 - *Retirement following a great career*
 - *Relocation for a spouse job or be closer to family*
 - *Reinvest profits into a new venture*
- *The Bad Reasons (The Dreaded Ds)*
 - *Declining Profits*
 - *Divorce*
 - *Disease*
 - *Death*

Which Are True?

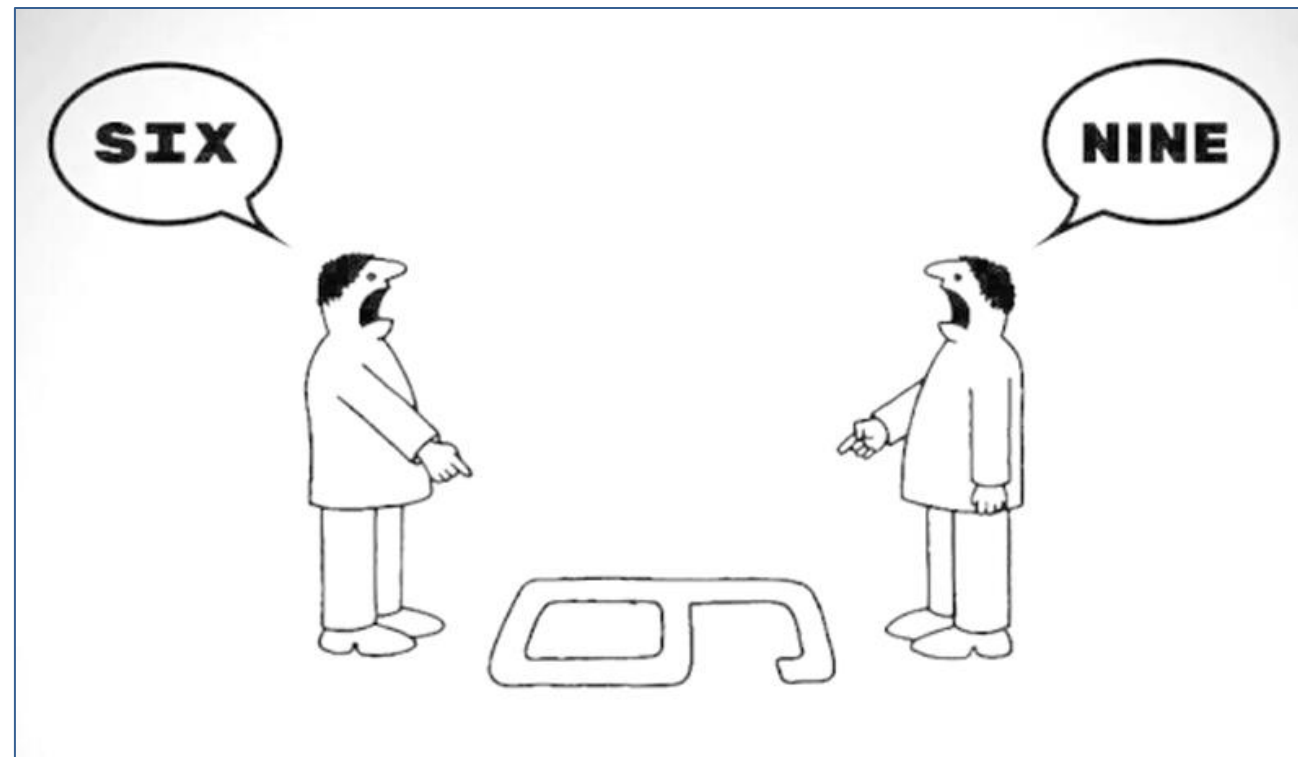
- *Owners, lenders and buyers see the business differently*
- *Traditional valuation rules won't apply to your business because (add rationale here)*
- *Buyers will pay extra for future potential*
- *Strategic buyers pay more*
- *More physical assets means higher value*
- *Value is different from price*
- *Best strategy is to price high, then lower it*

Which Are True?

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Shared Vision

A successful transaction depends on all parties having a shared vision.



Shared Vision



Seller



Buyer



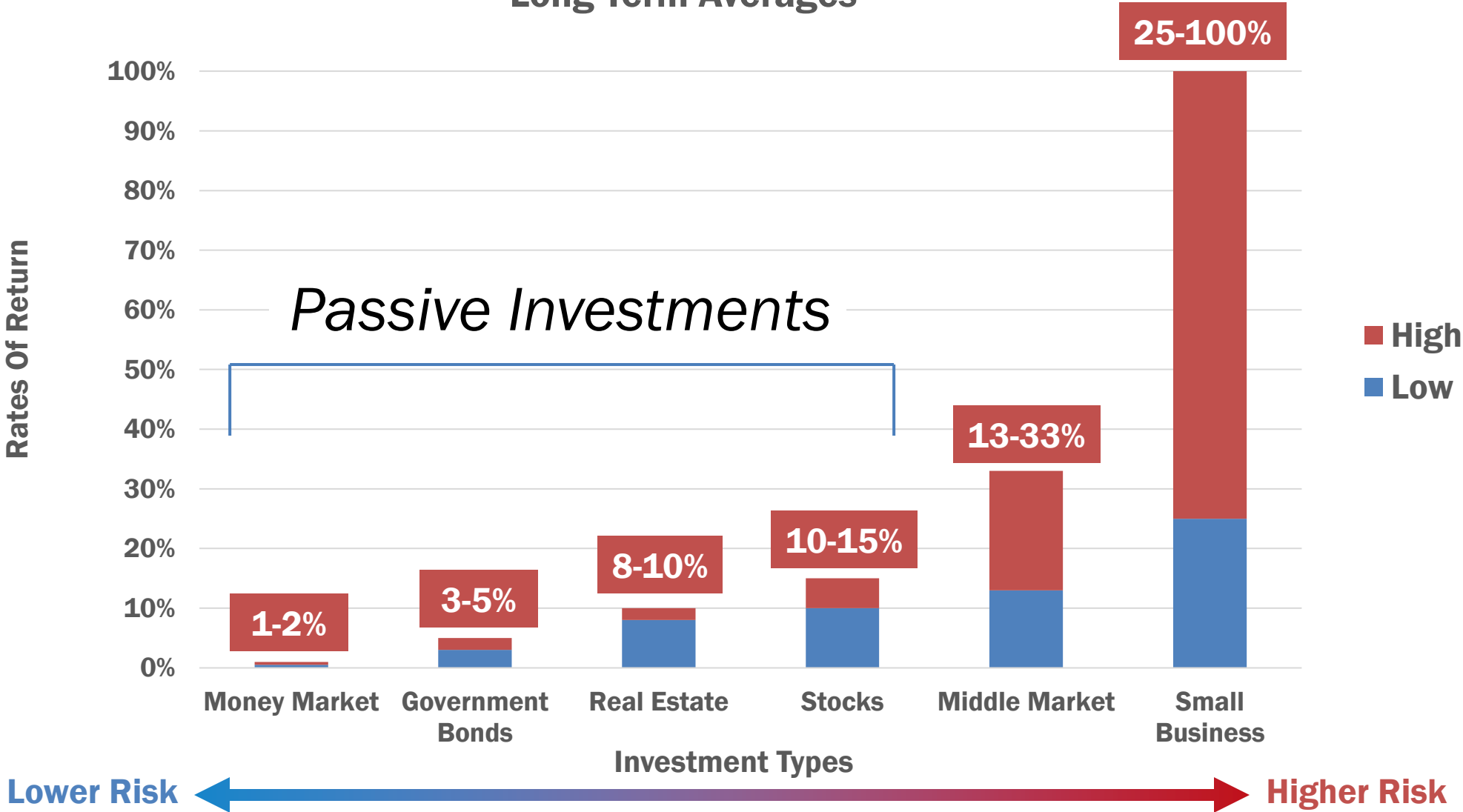
Advisor

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Expected Returns - Rationale To Invest

Annual Investment Returns

Long Term Averages



Business Earnings Must Support...

- *Acquisition Loan Repayment*
- *Working Capital Loan Repayment*
- *Taxes*
- *Business Reinvestment*
- *Owner Lifestyle*

Reasons to Buy an Existing Business

- *Access immediate cash flow*
- *Seller has gone through learning curve*
- *You buy a slice of the pie (existing market)*
- *Business-specific training provided*
- *Risk may be lower and/or quantifiable*
- *Potential to improve the business*
- *Investment leverage through SBA loan*

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Primary Elements Of A Business Sale

Focus on Asset Sales

- *Seller retains possession of the business entity*
- *Buyer creates a new company or uses an existing one to acquire*
- *Some or all assets of the business transfer*
- *Seller retains existing and contingent liabilities such as accounts payable, taxes, pending litigation, etc. (Note: taxes follow the assets!)*
- *Seller retains cash, accounts receivable, etc.*
- *Deposits, gift cards, work in progress negotiated*

4 Elements Of A Business Sale

- *Real Property Interests*
- *Tangible Assets (Personal Property)*
- *Goodwill / Intangible Assets*
- *Working Capital*

Real Property - Seller Owns

- *Sell To Business Buyer*
 - *Separate, concurrent transaction*
- *Retain, Become Landlord*
 - *Lease to business buyer*
 - *Rent may need normalization*
- *Sell To 3rd Party On Open Market*
 - *The most complicated approach*
 - *Timing, additional parties, competing interests,*

Real Property – 3rd Party Owns

- *Buyer Leases Real Property From Landlord*
 - *Assignment or new lease*
 - *Meet SBA loan requirements*
 - *Seller's leasehold improvements belong to landlord*
- *Buyer Purchases Real Property From Landlord*
 - *Separate but simultaneous transaction, can be complicated*
 - *Business and building sellers may not have same objectives*

Tangible Assets

- *Furniture, Fixtures, Equipment (FF&E)*
 - *Machinery, field equipment, tools*
 - *Office furniture, retail fixtures*
 - *Vehicles*
- *Inventory (At cost, usually included in price)*
 - *Saleable*
 - *Appropriate levels*

Assets Exist to Generate Profits!

Working Capital

- *The money a buyer needs in addition to sales price for efficient operation of the business*
- *Unique needs for each business*
 - *Restaurant will cash flow daily*
 - *Manufacturing may need large reserves*
- *Typically NOT included with business price in asset sale*
- *Factors into SBA lending*

Goodwill / Intangible Assets

- *Customer Lists / Contracts*
- *Trade Name / Trademarks*
- *Patents / Intellectual Property*
- *Website / Social Media*
- *Experienced Employees*
- *Quality of Location*
- *Documented Systems and Processes*
- ***PROFITABILITY!!!***

Simply Put...

Goodwill is the difference between the selling price of a business and the value of its physical assets.

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Business Valuation

Can't Be Smarter Than the Market

- *Sellers set price, the market determines value*
- *A business is worth it's TRANSFERABLE value*
- *A business is in competition with all other businesses for sale*
- *Lenders have a say as well*

Value Influencers

- *Industry Desirability*
- *Sales Profile / Concentration*
- *Customer Base / Stickiness / Contracts*
- *Recurring vs. Project Revenue*
- *Competition / Barriers to Entry*
- *Owner Role / Mgmt / Staff / Labor Base*
- *Facility / Capacity / Technology*
- *Location / Lease*
- *Growth Outlook / Scalability / The Economy*
- *Size Matters*

Value By Multiple of Earnings

$$\text{“Earnings”} \times \text{“Multiple”} = \text{Business Value}$$

- *Most common method, provides apples to apples business comparison*
- *“Earnings” types*
 - *EBITDA: Larger, professionally managed business*
 - **Sellers Discretionary Earnings (SDE):** *Smaller, owner-operated business*

Sellers Discretionary Earnings

- *All of the financial benefit that one working owner can derive from the business, assuming “normal” operations and no debt*
- *While valuation calculation is based upon historical performance, value must be transferable to the new owner*
- *All SDE elements must be recorded on financial statements and taxes*

Unreported Income Is Not Included!

Calculating SDE

Begins with a thorough analysis and understanding of the most recent 3-5 years of financials:

- *Business Tax Returns*
- *Profit & Loss (P&L or Income) Statements*
- *Balance Sheets*
- *Monthly Sales*
- *Accrual Based Accounting*

Calculating SDE

Identify the following elements and accurately establish their financial impact:

- + *Net Operating Income*
- + *Owner's W2 Salary & Benefits*
- + *Interest, Taxes Depreciation, Amortization*
- +/- *Non-operating (one time) Expense or Revenue*
- +/- *Normalized Expenses or Revenues*
- + *Reasonable (Provable) Discretionary Expenses*

Net Operating Income

- *“Bottom Line” of P&L*
- *Should “align” with taxes*
- *Often deliberately low as a tax reduction strategy*

ABC Company Net Income \$275,000

Owner's Salary + Benefits

- *Owner W-2 wages (+ company paid payroll tax)*
- *Guaranteed payments*
- *Owner (and family) health, life, and/or disability insurance*
- *Owner retirement plans – IRA, 401K, SEP*
- *Distributions NOT included*

Owner Salary + Benefits \$125,000

SDE Subtotal \$400,000

Financial Adjustments

- *Depreciation (non-cash expense)*
- *Amortization (non-cash expense)*
- *Interest (SDE assumes no debt)*
- *Taxes on P&L*
- *Covid Loans*

Depreciation \$40,000

Interest \$10,000

Covid Loan on P&L \$75,000

SDE Subtotal \$375,000

One Time Expense or Revenue

- *Relocation / Remodel*
- *Legal or Accounting Matter (non typical)*
- *Inventory Adjustment*
- *Specialized Eqpt/Software (not capitalized)*
- *Gain/Loss on sale of assets*

<i>Relocation</i>	<i>\$50,000</i>
<i>Legal Matter / Settlement</i>	<i>\$10,000</i>
<i>Sold Vehicle</i>	<i>\$10,000</i>

<i>SDE Subtotal</i>	<i>\$425,000</i>
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Normalized Expenses

- *To make P&L reflect typical operations*
- *Common adjustments:*
 - *Seller owns real property, rent changes*
 - *Family member salaries change to market rates*
 - *Income & Expenses Accounted for in Other Years*

<i>Spouse Unpaid Accting</i>	<i>\$25,000</i>
<i>Rent Adjust</i>	<i>\$25,000</i>

<i>SDE Subtotal</i>	<i>\$375,000</i>
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Discretionary Expenses

- *Non-Business Travel & Entertainment*
- *Actual Charitable Contributions*
- *Personal Benefit*
 - *Cars, Tuition, New Home Patio(!) and More*
- ***Buyer & lender may have different opinions!***

<i>Personal Vehicle Use</i>	<i>\$10,000</i>
<i>Charitable Giving</i>	<i>\$5,000</i>
<i>Student Tuition</i>	<i>\$10,000</i>

<i>SDE Subtotal</i>	<i>\$400,000</i>
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\$275K Net Income vs. \$400K SDE

<i>Net Income</i>	\$275,000
<i>Owner Salary + Benefits</i>	\$125,000
<i>Depreciation</i>	\$40,000
<i>Interest</i>	\$10,000
<i>Covid Loan on P&L</i>	\$75,000
<i>Relocation</i>	\$50,000
<i>Legal Matter</i>	\$10,000
<i>Sold Vehicle</i>	\$10,000
<i>Spouse Unpaid Accting</i>	\$25,000
<i>Rent Adjust</i>	\$25,000
<i>Personal Vehicles</i>	\$10,000
<i>Charitable Giving</i>	\$5,000
<i>Student Tuition</i>	\$10,000
<i>Sellers Disc Earnings</i>	\$400,000

That's Earnings, Now The Multiple

- *Your business is unique....just like everybody else's business!*
- *Multiple range spans 1X to 4X SDE*
- *Larger business, larger multiple*
- *Remember the Value Influencers?*
- *2.2X is the national average, minimal drift*
- *Rules change for businesses > \$10-20MM revenue, or in certain categories (technology, food products, etc.)*

Valuation Statistics By Size

Level	Median Revenue	Median SDE	Median Sale Price	SDE Multiple
1st Quintile	\$2,323,249	\$345,933	\$1,037,799	3.0
2nd Quintile	\$820,652	\$147,127	\$338,392	2.3
3rd Quintile	\$446,000	\$87,376	\$183,490	2.1
4th Quintile	\$240,192	\$61,282	\$110,306	1.8
5th Quintile	\$112,571	\$36,925	\$62,773	1.7
Average	\$788,533	\$135,728	\$346,522	2.2

Based on 4,287 Business Sale Transactions from Pratt's Stats

Source: Business Valuation Resources

Valuation Statistics By Industry

MULT INDUSTRY

2.0	Health Care and Social Assistance
2.0	Accommodation and Food Services
2.2	Educational Services
2.4	Professional, Scientific and Technical Svcs
2.4	Real Estate, Rental and Leasing
2.4	Construction
2.5	Arts, Entertainment and Recreation
2.6	Retail
2.7	Transportation and Warehousing
2.7	Information
3.0	Manufacturing
3.2	Wholesale Trade
3.6	Finance and Insurance

Note: Multiples are based on a 10 year average with a minimum of 100 transactions in each category.

*From DealStats
Value Index 3Q
2020.*

2.5 ALL SECTORS

Valuation Result

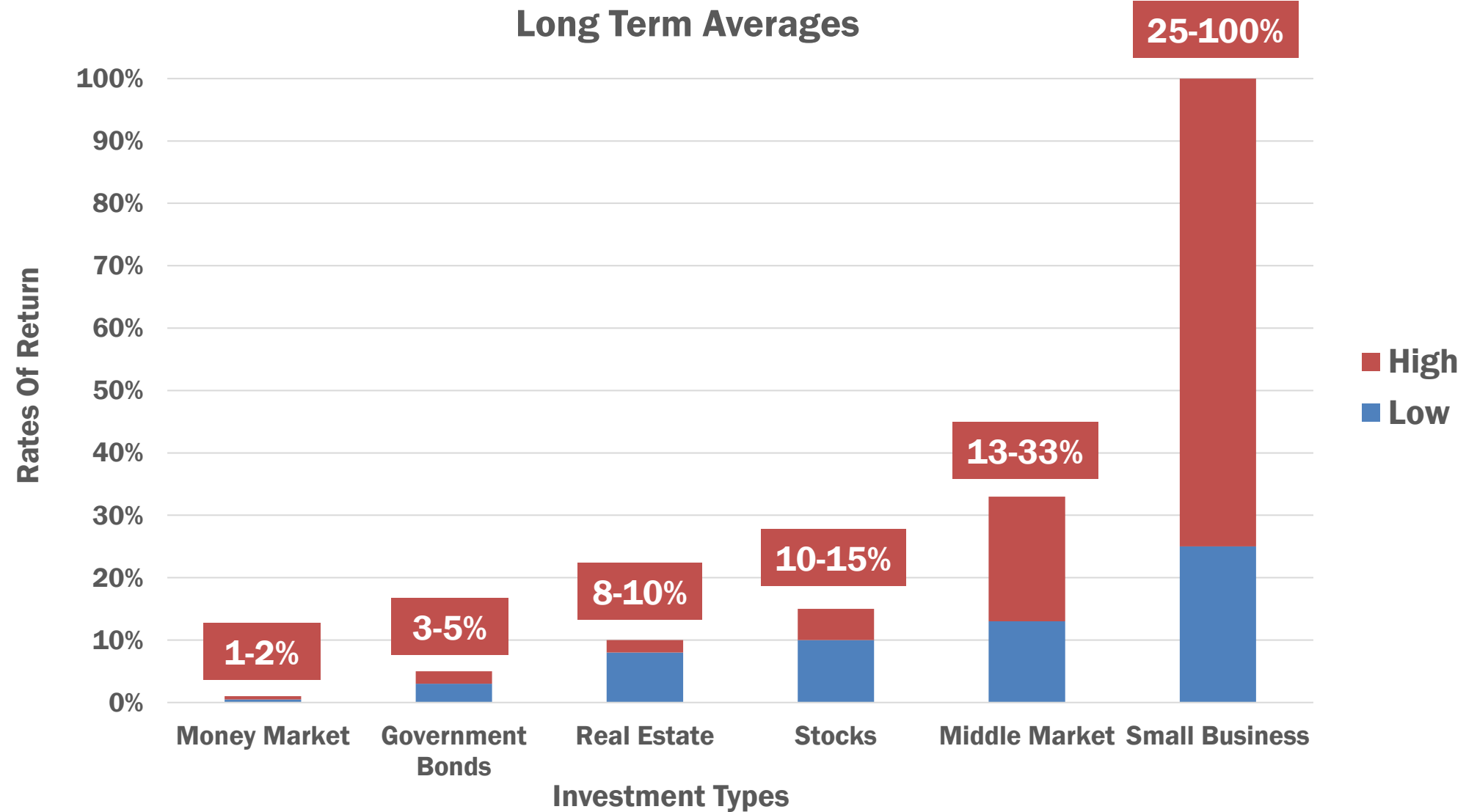
$$\begin{array}{rcl} \text{SDE Earnings} & & \$400,000 \\ & & \\ \text{X Multiple} & & \underline{\text{X } 2.5} \\ \text{= Business Value} & & \$1,000,000 \end{array}$$

**Multiple Assumed for this Example*

Suggestions for Value Increase

- *Increase Profitability*
- *Reduce Reliance on Owner*
- *Systematize & Document*
- *Professionally Prepared Books*
- *Clean Books!!!*
- *Have Customer & Product Diversity*
- *Get Contracts When Possible*
- *No Unreported Income*

Traditional Returns



Lower Risk

Higher Risk

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Financing the Transaction

Only 3 Sources Of Funds

**Buyer
Cash**



**Lender
Financing**



**Seller
Financing**



Buyer Cash (Equity / Down Pmt)

- *Commonly 10% - 25% of Price*
 - *Personal bank accounts*
 - *Liquidate stocks/mutual funds*
 - *Home equity loan*
 - *Liquidate IRA or retirement plan*
 - *Rollovers as Business Startups (ROBS)*
 - *Family & friends (equity or gift)*
- *Will also need working capital!*

SBA Lender

- *Commonly 70% - 90% of Price*
 - *Provide business (8-10 years) and/or real estate loans (20-25 years), or combined*
 - *SDE (cash flow) based lending*
 - *Emphasize debt coverage ratio and lifestyle support*
 - *Independent valuation required*
 - *Look for strong credit & operating qualifications*
 - *First position for repayment and lease*
 - *Personal guarantees & collateralize personal assets*
 - *May also provide working capital*

Seller (Promissory) Note

- *Commonly 0% - 20% of Price*
 - *To supplement Buyer Cash + SBA Loan. SBA may require it given buyer/deal circumstances.*
 - *Can improve the price, provides deferral of taxes.*
 - *Subordinate to SBA loan, payments can be paused.*
 - *2-8 year term, may have standby*
 - *Can be the entire financing if no SBA lender available.*
- *Usually personally guaranteed by the buyer*
- *Reverse earnout structure gaining acceptance*

Buyer's Financial View

SELLERS DISC EARNINGS		\$400,000
SALES PRICE		\$1,000,000
WORKING CAPITAL		\$100,000
ACQUISITION COST (Sales Price + Working Capital)		\$1,100,000
DOWN PAYMENT (As % of Sales Price only)	20%	\$200,000
SELLER NOTE: 5 Yr / 5% (As % of Sales Price only)	10%	\$100,000
SBA LOAN: 10 Yr / 5% (% Sales Price + Working Capital + 3.5% Loan Costs)	70%	\$879,750
TOTAL BUYER INVESTMENT (Price + Working Capital + Fees)		\$1,179,750
SBA LOAN ANNUAL		\$105,387
SELLER NOTE ANNUAL		\$22,645
REMAINING SDE (Lifestyle, Taxes, Reinvest)		\$271,968

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Key Takeaways

Keep These In Mind!

- *Importance of shared buyer/seller/lender vision*
- *Asset sales are the most common type*
- *$SDE = \text{Net Income} + \text{Addbacks} +/- \text{Adjustments}$*
- *$SDE \times \text{Multiple} = \text{Value}$, apples to apples*
- *Multiple driven by size, industry and influencers*
- *Goodwill is difference between price and assets*
- *Only 3 sources of funds: Buyer, Lender, Seller*
- *SBA is critical component, your best friend!*

Business Valuation

Questions?

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*What's My
Business
Worth?*

*Should I
Buy Or
Build?*

*How Can I
Get
Financing?*