Business Valuation

Business appraisal also known as business valuation is a fairly complex process that requires much time and effort to master. A very close cousin to “business valuation” is “most probable business selling price” estimation. There is a difference between the two processes and it is important to be aware of that fact. An estimate of a business’s most probable selling price is not the same thing as a business appraisal and should never be represented as such. Along the same lines, one who develops “most probable selling price” estimates for business owners or buyers should not represent him or herself as a “business appraiser.” As we proceed through this section of the seminar, hopefully the distinction between the processes will come into better focus.

Although it is not necessary for a business opportunity broker to be a business appraiser, it is a good idea for business brokers to be aware of the fundamental concepts of business valuation. And, within the context of this reasonable awareness, it is essential that a business opportunity broker possess the skill to advise and assist clients in the determination of a reasonable asking price or purchase price for a business.

The purpose of this section of the business opportunity brokerage seminar is to impart “reasonable” awareness of the fundamental concepts of business valuation and provide detailed instruction in how to establish a reasonable asking price or purchase price, or if you will, “most probable selling price” for a small business.

**Introduction to business valuation concepts**

There are three fundamental business valuation approaches:
- Asset approach (a.k.a. asset accumulation or asset cost approach)
- Income approach
- Market approach

In addition to the three “approaches” to business valuation, there are also four different “standards” of business value:
- Fair Market value
- Investment value
- Fair value
- Liquidation value
- Although not a “standard of value” for the purpose of an appraisal, “Book Value” is the definition of value that appears on a business’s balance sheet, also known as “owners equity.”

There are two basic “premises” of business value:
- Value as a going concern
- Value in liquidation
There are three ownership contexts or business ownership categories within which the preceding approaches, standards and premises may be employed:

- 100% ownership interest
- Majority ownership interest (less than 100% but greater than 50%)
- Minority ownership interest (less than 50%)

And finally, when a business is actually sold, there are two “value” concepts to consider which will almost always differ:

- The estimated value of the business
- The actual transaction price—what the buyer pays the seller

**Implications of the business valuation concepts**

Depending on which premise of value, which standard of value and what ownership percentage of a business is being appraised, the estimated value conclusion for the same business at the same point in time will be substantially different. However, the most common combination of the foregoing elements of business valuation that will come into play in estimating the most probable selling price for a small business will be the fair market value for a 100% ownership interest in a business as a going concern.

**Beware of “fair market value”**

This is not to say that a “fair market value” estimate provided by a business appraiser should be the asking price or offering price for a small business. Indeed, unlike a real property “fair market value” appraisal that puts a cap on how much a lender is generally willing to loan in purchase money and therefore the highest price at which a property is likely to sell, there is widespread agreement in the business appraisal profession that an accurate “fair market value” estimate for a privately owned business is not a prediction of the price at which the business subject to the appraisal is likely to sell. In other words, a professionally developed “fair market value” estimate for a privately owned business is not a “real world” number. However, it is a reliable number from which to make adjustments to develop a reasonable asking price or purchase offer based on the unique circumstances of the owner, the business, a prospective buyer, the proposed financing and other myriad terms and conditions of the transaction and the bundle of assets and liabilities to be included.

**Be on the lookout for “liquidation value”**

The most common combination of business valuation elements notwithstanding, a business opportunity broker must be able to recognize when a business probably has greater value in liquidation than as a going concern. A business opportunity broker should anticipate making listing calls on businesses in this situation on a fairly frequent basis.

**Minority ownership interests are a special case**

Although an extreme rarity (something I have only heard about once and have never experienced), a business broker may encounter a situation where someone wants to sell their minority ownership interest in a business or sell a minority slice of their majority ownership
interest on the open market. If you ever encounter such a situation, be aware that within the business appraisal profession and as a “real world” condition, a minority ownership interest in a privately owned business is not worth a pro rata share of the value of the entire business but something substantially less. Indeed, depending on the circumstances of the business and the minority ownership interest, that interest is probably only worth somewhere between one half and one twentieth of its pro rata share of the entire business. For example, a 30% ownership interest in a business worth $100,000 will probably yield an appraised value of somewhere between $15,000 and $1,500. This means the only way this hypothetical 30% ownership interest can be turned into $30,000 in cash is if a 100% interest in the business is sold. (The one exception to this rule, often cited in valuation texts, is the “swing vote” scenario. That would be the value of a 2% ownership interest in a company where two other working partners each own half of the remaining 98% who, moreover, hate each other’s guts. The 2% ownership interest in this scenario can be worth many times more than it’s pro rata share of the whole business—at least to one or both of the 49% owners).

**Introduction to business valuation methods**

Within each of the three fundamental business valuation approaches, there are various methods that are used to estimate a business’s market value and to establish a reasonable asking price. However, there is no single “best” method. All of the various methods have their strengths and weaknesses. For this reason, within the business appraisal profession, there is a widespread (but not universal) tendency to estimate the value of a business employing two, three and often several different valuation methods and then synthesizing a final value conclusion using a weighted average of all the methods employed.

Some of these methods are quite esoteric and/or labor intensive and probably impractical for small business opportunity brokers to use to assist clients. But there are a few business valuation methods within each valuation approach frequently used by business opportunity brokers and those will be presented here. They are:

**Under the Asset Approach**

The “**Excess Earnings Method.**” This is a “hybrid” method that is something of a blended asset and income approach but is generally categorized an Asset Approach methodology. This method is fairly popular with business brokers and is the only valuation method available developed specifically to directly calculate the “goodwill” portion of a business’s value. In fact, it was developed by the U.S. Treasury Department in the 1920’s to determine how much to compensate the owners of breweries and distilleries for the loss of the goodwill portion of their businesses’ value with enactment of the Eighteenth Amendment to the Constitution—i.e., Prohibition.

**Under the Income Approach**

The “**Multiple of Discretionary Earnings Method.**” Also known as the “Seller’s Discretionary Cash Flow Method.” This method comes from the business opportunity brokerage industry. It is really the outgrowth of a technique developed by Jeff Jones, arguably one of the most successful business brokers in the U.S. This method has been more or less elevated to the status of an accepted appraisal method by virtue of its suggested use by
Practitioners Publishing Company—the leading source of technical reference books for the CPA profession. However, the method is qualified with the advice that it only be used to estimate the value of very small businesses—generally with fewer than twenty employees and/or market values under around $500,000.

The “Rules of Thumb Method.” Although generally avoided by business appraisers, rules of thumb are a very popular valuation or, more appropriately, “pricing” technique among business opportunity brokers. Probably the best reference source for small business pricing rules of thumb is *The Business Reference Guide* published by Tom West. This book will be introduced in the seminar.

The “Capital Asset Pricing Model Method,” also know as “CAPM” (pronounced cap’-em). The CAPM is probably the most popular business valuation method used by business appraisers. It is complex, requires a significant amount of study to master and, in my opinion, it is not a methodology that small business opportunity brokers should use. However, it is a method a business opportunity broker is almost certain to encounter in a formal business appraisal. Moreover, it is a method that charlatans posing as business appraisers butcher with regularity. In fact there is one mail order “business appraisal” company whose work I have reviewed that regularly markets their service to business opportunity brokers across the country that uses the CAPM with such incompetence that, in my opinion, would leave the “appraiser,” the appraisal and value conclusion torn to shreds if subjected to cross examination were it presented in court regarding a litigated business value.

For this reason, a demonstration of a frequently used derivative of the CAPM employed to value small businesses, known as “the build-up method” is included in this manual, so one will be able to distinguish between the real thing and a butchered facsimile going by the same name.

**Under the Market Approach**
The Market Approach is the most commonly encountered approach used to estimate the value of residential real estate. It is the comparison of properties or businesses similar to the subject property or business whose selling prices are known and thereby drawing a conclusion by inference as to the most likely selling price for the property or business under study. The “direct market data method” is used to value small businesses.

There are three databases available containing small business sales information on thousands of small businesses such as those businesses’ selling price, earnings, value of operating equipment, inventory and so forth. The merits of all three databases and how to access them will be presented in this seminar. However, a demonstration of how to use the Bizcomps database to estimate the value or reasonable selling price will be presented. As an added bonus to this portion of the seminar, the only book on the market that explains in detail the many ways to analyze the Bizcomps’ business transaction data will be presented. The title of the book is *Transaction Patterns: Obtaining Maximum Knowledge from the Bizcomps Database*. And, as an extra bonus, this portion of the seminar will be presented by the author of *Transaction Patterns*—namely, me.
Determining a Business's Value:
An introduction to business valuation

The meaning of “fair market value”

Every business appraisal must include a statement indicating the "standard of value" and the "premise of value." Standards of value are "fair market value," "investment value" and "fair value." Premises of value can be either "going concern value" or "liquidation value." Additionally, any of these value conclusions can be rendered for a 100% ownership interest in a company or a partial ownership interest in a company.

Amazingly, these different definitions of value can lead a business appraiser to arrive at different—and sometimes substantially different—value conclusions for the same company as of the same date! However, the most commonly encountered standard of value is "fair market value," and the most commonly encountered premise of value is "going concern value." So just what does the “fair market value for a going concern” mean?

I have seen several variations on the definition of fair market value; however, the International Glossary of Business Valuation Terms defines it as "the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and able seller, acting at arm's length in an open and unrestricted market, when neither is under a compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."

If you are not now perfectly clear on the meaning of "fair market value," don't feel alone. Although the preceding statement, or something similar, is generally all the description one gets in most business valuation reports, it is not nearly enough for the lay reader in my opinion. For this reason, I include an additional section in my business appraisal reports entitled "How to Interpret and Use the Estimated Value Opinion." Here's what I say about "fair market value":

Fair market value does not represent "real world" conditions. The term stands for a theoretical value which is the appraiser's estimate of the most probable price a hypothetical buyer, who represents a consensus of the opinions of all buyers, also known as the "typical buyer," would be willing to offer, and a hypothetical person who represents the "typical seller," would be willing to accept, further provided that:

1. Neither seller nor buyer is under a compulsion to consummate the transaction.
2. Both seller and buyer are knowledgeable of all material facts and conditions of the contemplated transaction.
3. The business has been actively advertised for sale on the open market for a reasonable period of time such that all interested buyers have an equal opportunity to make an offer.
4. The buyer is a "financial buyer." A fair market value estimate assumes that the buyer will operate the business after he has acquired it as a stand-alone enterprise.
This means there is an implicit assumption in the value estimate that the buyer will not benefit from economies of scale in purchasing, administration or advertising by combining the business with a similar enterprise. Neither does a fair market value estimate assume the buyer is motivated by an opportunity to expand market share or otherwise improve a similar business by acquiring the business’s proprietary technologies, patents or key employees.

5. The seller will sign a "non-compete" agreement.

6. The buyer will acquire a 100% ownership interest in the company. In cases where the buyer will acquire a controlling interest, but something less than a 100% interest, the value of the percentage ownership acquired may be somewhat less than a pro rata share of the fair market value for the entire company. In cases where a buyer will acquire a non-controlling, minority ownership interest in a company, the value of the percentage ownership acquired can be substantially less than a pro rata share of the company's fair market value.

7. The total purchase price will be paid in cash at close of escrow.

As a practical matter, there are few business sales where all of the above conditions exist. There are buyers who, for unique strategic reasons, will be able to extract greater earnings from a contemplated transaction than the "typical buyer" would anticipate and for that reason may be willing to pay more for a business. Add to this the fact that many buyers are, for any number of reasons, under a compulsion to buy something or want to buy a seller’s business specifically. They too may be willing to pay more.

On the other hand, occasionally sellers are under some pressure to sell, again for any number of reasons. Under this condition, sellers do not have the luxury of waiting indefinitely for the "right offer" to come along and are compelled to accept whatever offer—perhaps the only offer—that will enable them to get out of the business by a certain time.

And finally, few businesses change hands for all cash at close of escrow. When payment for any portion of the total purchase price is made in the form of a promissory note held by the seller, stock of the purchasing entity or something else of value other than cash, the price at which the deal is consummated is almost always something higher than what would result from an all-cash-at-close transaction.

This last condition—payment in cash at close of escrow—occurs in small business transactions only about 30% of the time. Most business sellers are compelled to finance some portion of the purchase price or accept something of value other than cash typically stock in the acquiring corporation. These terms of payment almost always distort the cash-equivalent value of the transaction, and one should be wary of a heard-on-the-street selling price for a small business if the terms of sale are not also disclosed.

For example, when the seller accepts stock in the acquiring corporation as part of the payment, there is no earthly way to know the cash-equivalent value at which the business traded based on published transaction data. Such transactions are akin to reports of farmer John who purchased Joe the blacksmith's ol' gray mare for $1 million and paid by giving him his two mules they both agreed were worth half a million each.
Similarly, when the seller finances some portion of the transaction with a seller "carry-back" note, the published transaction data clearly shows that this distorts the cash-equivalent value of the transaction. This method of paying for a small business is a subject I examined in my book, Transaction Patterns: Obtaining Maximum Knowledge from the Bizcomps Database.
Business Value & Alternative Purchase Offers

The majority of small business owners who sell their business do not receive the entire selling price in cash at close of escrow. Coupled with this observation is the proposition that receipt of something other than cash for a portion of the selling price usually results in a price greater than what would have been the case had the transaction been consummated for all cash at closing.

The two most common substitutes for cash in small business sales are shares of stock in the acquiring corporation or a promissory note held by the seller - known as a seller "carry-back" note. It is impossible for an outsider to know the cash-equivalent value of a business's selling price when the seller was paid in full or in part with shares of (unlisted) stock of the acquiring corporation. However, when the seller accepts a promissory note from the buyer in lieu of cash for some portion of the selling price, I believe it is possible for an outsider to get a reasonably good idea of the transaction's cash-equivalent value if the terms of the note are known.

Another way to put this notion is that a small business owner who is in the process of selling his business can determine the approximate cash-equivalent value of alternative purchase offers that require him to finance some portion of the transaction via a seller carry-back note. For example, assume for the moment that you are selling a small business and have three offers on the table. Assume the offers (and worthiness of the buyers) are identical in all respects except for the price and payment terms. The varying price and terms are: (1) $440,000 cash at closing, (2) $500,000 with a down payment of $200,000 and the $300,000 balance financed by the seller over five years with 10% interest on the note and (3) $525,000 with $157,500 down and the $367,500 balance financed by the seller over six years with 11% interest on the note. Which of these offers is the best?

I have taken the foregoing example from Transaction Patterns: Obtaining Maximum Knowledge from the Bizcomps Database, a book I published in 2000. Assuming "best" is defined as the offer with the greatest all cash at-closing equivalent value, these three offers are equally acceptable, in my opinion, because they have identical theoretical all-cash values of $440,000 based on my conversion methodology. I need to emphasize the word "theoretical" here because there is no secret formula that all small business buyers somehow know which enables them to convert an all-cash offering price into a partially seller-financed offer that has the same all-cash value. I'm basing my opinion on the central tendency of a large statistical sample of published small business sale data.

In Transaction Patterns I demonstrate that there is a pronounced tendency for the ratios of selling price to owner's discretionary cash flow (SP/ODCF) published in the Bizcomps Database to become progressively higher as the percentage of the selling price financed by the seller increases. I found that the median SP/ODCF was 1.60 for the businesses that traded for all-cash at closing while the median SP/ODCF ratio for partially seller-financed transactions was 1.84. Through this research, I developed a formula to convert a partially seller-financed transaction into an all-cash at closing equivalent value. I applied this formula to a random sample of 100 seller-financed transactions and obtained an adjusted average SP/ODCF ratio equal to the average ratio for the 1,162 transactions that traded for all-cash at closing. I concluded this discussion with the comment that my
conversion formula is intended to serve strictly as a guide to estimating cash-equivalent values. Essentially, the conversion formula represents the central tendency in a large number of transactions.

There is another way to look at the difference between the selling prices of all-cash and partially seller-financed transactions that I did not address in *Transaction Patterns*. What's really going on here is the same thing that takes place when you pay "points" on a home loan. This is to say, there is the interest rate stated in the contract and the real interest rate that is based on the funds actually applied to the purchase of the home. For example, if you borrow $250,000 amortized over 30 years with no points at 6% interest the monthly payment will be $1,498.88, and the entire $250,000 will be applied toward the purchase. However, if you pay two points on the loan, i.e., 2% of $250,000, or $5,000, then only $245,000 is applied towards the purchase of the home, but the monthly payment is the same, $1,498.88. Essentially you are paying 6.19% interest on a $245,000 loan.

Using this logic, let's revisit the two preceding offering price examples that included seller carry-back financing. By changing the offering price to $440,000 and leaving the down payment, the monthly payment and the amortization period the same in both cases, the real interest rate for each note can be computed. In the first example, the amount of the seller carry-back note will be $240,000 (i.e., $440,000 - $200,000), and the monthly payment will be $6,374.11 amortized over five years. The interest rate on such a note is 20.12%. In the second example, the amount financed will be $252,500, and the monthly payment is $6,995.02 for six years. The real interest rate on this note is 21.38%.

The reasons business buyers tend to stick with interest rates around 10% on seller carry-back loans and upwardly adjust the purchase price is probably to circumvent various usury laws and because they can't stomach the idea of paying interest rates north of 20% even though that's exactly what they're doing. However, regardless of the reasons for this phenomenon, the fact that it is occurring is indisputable. This, in turn, has enormous bearing on how published transaction data is employed in business appraisals.
Cash Equivalent Value

The “fair market value” for a business implies that the typical buyer would pay all cash for the business at close of escrow. However, most small business sales are not consummated as all-cash transactions. Approximately 70% of the small business sales reported in the Bizcomps database reflect transactions where the owners received part of the selling price in cash and part in the form of a promissory note held by the seller - known as a seller "carry-back" note.

Moreover, there is a clear tendency in the published transaction data for the selling price/earnings ratio (i.e., selling price divided by annual owner's discretionary cash flow) to increase as the amount of the selling price financed by the seller increases. In essence this means two things. First, it means that the interest rates on seller carry-back notes, generally ranging between 8% and 12%, are well below the appropriate "market" rate for such contracts. Based on the research I presented in Transaction Patterns, the interest rate required on seller carry-back notes necessary for them to have equivalent values in cash would have to be greater than 20% in most cases.

It also means that every business sale consummated for a price paid partly in cash and partly via seller financing at below-market interest rates really has two selling prices: the actual contract price of the transaction and its theoretical all-cash equivalent value.

This second observation has an important implication for business buyers and sellers. It means that one should be careful during price and terms negotiations not to focus all attention on the transaction price. The more important consideration, in my opinion, is the cash-equivalent value of the deal. In theory, any business can support any transaction price - absurd or otherwise - by manipulating the terms of the seller carry-back note. Using an extreme example to make my point, the cash-equivalent value or "present value" of an unsecured promissory note with a face value of $1 million and terms of nothing down, 0% interest and the principal payable at a dollar a year for a million years is less than $10.

This second observation should be important to business appraisers as well. This is because a fair market value estimate for a small business based on published transaction data must somehow be adjusted to reflect the inflationary bias that the seller carry-back financing has on the selling price. Nevertheless, in the few business appraisals performed by others that I have critiqued, the fair market value opinions were formed in whole or in part based on transaction data published in Bizcomps without compensating for the inflation in selling prices caused by seller carry-back financing. In other words, these appraisers' fair market value estimates were too high.

I have no way of knowing how or if most business appraisers adjust published transaction data or a value opinion based on that data to compensate for the cash-equivalent price distortion caused by seller financing even though the need to do this appears repeatedly in the business valuation literature. For example, Z. Christopher Mercer comments in his book that "lenient [seller carry-back financing] terms combined with overstated prices must be discounted to current market rates and terms in order to replicate the cash equivalent concept of fair market value." Interestingly, though, none of the business valuation texts provide any substantive detail on how to adjust published small business selling prices to compensate for the inflationary bias of seller financing - with one notable
exception. That is my book: *Transaction Patterns: Obtaining Maximum Knowledge from the Bizcomps Database.* In Transaction Patterns I provide three different methods to make this adjustment. Each method tends to produce a different adjustment factor to employ in the appraisal. My strong preference, however, is to adjust each transaction to its unique cash-equivalent value first, then perform the statistical analysis on the modified data. This is similar in concept to the way that residential real estate appraisers adjust the selling price of their comps to more accurately reflect the nature of the home being appraised.

If for no other reason than no one else has (to the best of my knowledge) published other empirical research findings, and/or another theory or alternate methodology based on such research to adjust actual business selling prices to their all-cash equivalent value, I suppose that makes me the country's leading authority on this narrow but important subject. To be sure, I have received some criticism of my views and methodology. However, that criticism has been verbal and vague - i.e., "I think you're totally off base here," or "you're on the right track but not exactly right."

I remain undaunted by this kind of criticism. My position is that any criticism of my theory and methodology is without merit until it is published in a business valuation journal. This could conceivably be the position of the court as well in a litigated business appraisal. Now there's a scary thought.

Footnotes


2. Available at BVResources.com and Businessbookpress.com.
Business Purchase Price and Seller Carry-Back Notes

Published small business transaction data indicates that approximately 70% of all small businesses that are sold are partially financed with seller carry-back notes. Figure 1 illustrates the range and frequency of the percentage of a small business’s total purchase price that buyers tend to pay in cash at closing as a down payment as reflected in the Bizcomps database. The remaining unpaid balance in all of these transactions is the amount sellers finance with carry-back notes.

**Figure 1.**

![Distribution of the Percentage of Total Small Business Purchase Prices Paid in Cash Based on 4788 Transactions Between 1989 and 2000 (Source: Bizcomps2001)](image)

Figure 1 tells us that 33% of small business sales transact with down payments between 91% and 100% of the total purchase price. (In fact, 31.5% of the transactions traded for 100% down†). We can also see that among the 70% or so of businesses partially financed by the seller, there is a clear central tendency toward half the price paid in cash and half financed by the seller.

The data on which figure 1 is based represents all businesses in the Bizcomps database. Even though this database reflects small business transactions with annual sales generally under $3 million, "small" is a relative term. Some other questions raised regarding this aspect of business transactions are: (1) Is there a greater or lesser tendency among the smallest of the small businesses to be purchased for all cash relative to the average? (2) Is there a noticeable trend in either direction in the incidence of all-cash at closing transactions as the size of businesses become larger? (3) Among partially seller-financed transactions, is there a trend in the percentage of the deal financed as the businesses become larger?

To answer these questions, I used annual sales revenue as the indication of a business’s size and then sorted the database from the lowest annual sales revenue to the highest. To answer the first question, I divided the 4,788 businesses into ten groups of 479 and looked at the average number of businesses in each group that traded for all cash. Figure 2 demonstrates the results of this analysis.
A very slight downward trend is evident, suggesting that the larger the business, the less tendency there is for it to trade for all-cash at closing. However, the downward slope of the trend line is very slight (less than 1% per decile). This suggests, in my view, that for all practical purposes, there is no meaningful tendency for fewer businesses to trade for all cash as they get larger. The one exception, perhaps, is that it appears the smallest of the small businesses, those with annual sales under $186,000, tend to trade for all cash at closing slightly more often than any of the larger businesses.

The last question is whether or not there is a trend in the percentage of the purchase price sellers tend to carry back in a promissory note as the size of the business sold becomes larger. To answer this question, the 3,356 business transactions partially financed by the seller were sorted from the lowest to the highest annual sales revenue then divided into groups of 336 businesses. The result of this analysis is illustrated in Figure 3.
As with Figure 2, although a very slight downward trend is evident, its slope is extremely slight. This tells me that the average amount of a small business's selling price financed by sellers (in the 68.5% of transactions that include seller financing) is about 45%, regardless of whether the small business is in the tiny, medium or large category.

What all of this boils down to is that for all businesses with annual sales up to around $3 million a year or so, the distribution of the incidence of seller financing depicted in Figure 1 is about the same regardless of the business's size.
Investment Value vs. Fair Market Value

There are other definitions of value besides “fair market value”—known as "the premises of value”—employed by business appraisers. This is to say, a business can theoretically have different values at the same time!

The explanation for this paradox lies in the assumptions one makes about business buyers and sellers. An appraiser's estimate of the "fair market value" of a business assumes a hypothetical seller, known as the "typical seller," and a hypothetical buyer, i.e., the "typical buyer." An estimate of the "fair market value" of a business assumes the typical buyer is a "financial buyer," meaning the buyer intends to acquire the business as a stand-alone enterprise and operate it in pretty much the same fashion as the seller has been doing. Given these "typical" buyer and seller assumptions, an appraiser will develop an opinion of a business's worth known as "fair market value."

However, when an appraiser develops an opinion of what a business is worth to a specific buyer or potential buyer, that value estimate is regarded as that buyer's "investment value" - and this value estimate can be substantially different from a fair market value estimate.

A common reason why a business may have greater value to a specific buyer over the hypothetical "typical buyer" or "average buyer" is because that buyer is already engaged in the same or a similar business. In such a case, the buyer can anticipate realizing various synergies - i.e., making a larger profit off the acquisition's existing gross sales - by combining a prospective acquisition with his or her existing business. For example, the buyer may perceive an ability to eliminate most of the acquisition's historical advertising expenditures and simply include one more locations in his existing media advertising for no increase in cost. It is also likely that most of the acquisition's historical administrative and accounting costs can be saved. There could also be savings in inventory costs because the acquirer may be able to get a larger discount in vendor wholesale prices due to the increased quantity of goods purchased. There are many other ways a specific buyer may perceive a potential to generate more profit from a business than is possible by the current owner or typical buyer, but you get the idea.

Because the "synergistic" or "strategic" buyer can anticipate making a larger profit from a prospective acquisition than the "typical" or "financial" buyer, the prospective acquisition will have greater value to the strategic buyer since it is anticipated future earnings that drive a business's value. Hopefully you now have a reasonably good understanding of the difference between "fair market value" and "investment value" and why a business can be worth two different amounts at the same time.

Now, let me pose a hypothetical proposition. Let's assume for the moment that you are a "strategic buyer" eyeing a possible add-on acquisition to your existing business. Let's further assume that you perceive the ability, via the synergies described above, to generate $50,000 a year greater cash flow from the business than the current owner is making or a financial buyer could make. Assuming you value the prospective acquisition at three times cash flow, this would make the business worth $150,000 more to you than to the typical buyer. Given these assumptions, should you be willing to pay $150,000 more for the acquisition than the next guy? The answer to this question is a qualified "no;" however, it appears that this is not the conclusion of many strategic buyers.
According to Frank Evans and David Bishop in their book Valuation for M&A: Building Value in Private Companies, "frequently [strategic buyers] never ask what the target is worth to its present owners," and this is a mistake. The authors go on to say that "…the value the business creates for the present owners is all they really have to sell. Most, and sometimes all, of the potential synergies in the deal are created by the buyer…so the buyer should not have to pay the seller for value the buyer creates. However, the buyer is likely to do so because his or her company does not know what the target is worth as a stand-alone business. Consequently, the buyer also does not know what the synergies created by his or her company through acquisition are worth, or what the company's initial offer should be." 1

The point being that the correct approach to an acquisition by a strategic buyer should be to determine both the fair market value and his or her investment value in a prospective acquisition and begin price negotiations based on fair market value. Moreover, the prospective acquisition's investment value to the buyer should be regarded as the outside maximum price that would be paid; however, it is a wise buyer who establishes a "walk-away" price closer to the mid-range between fair market value and investment value. To pay more than the mid-range difference is dangerous.

The danger lies in over-estimating the potential synergies that will be created in the acquisition. "The closer the acquisition price gets to the buyer's investment value, the less value the acquisition will create for the buyer, and the smaller the buyer's margin for error. When a seller demands too high a price, the buyer's better option is often to decline that deal and look for one with a better potential to create value." 2

The lesson here for any would-be strategic buyers is to know the difference between a good company and a good investment. This is a lesson that is often missed by overzealous buyers driven more by emotion and their own egos than careful strategic planning.

Footnotes
Frank C. Evans and David Bishop, Valuation for M&A: Building Value in Private Companies, copyright 2001 by John Wiley and Sons, Inc. p. 3.
Ibid., p. 8.
Goodwill Value

I suspect every small business owner understands what the term "goodwill" means within the context of his or her business's value. It is the value of the business's good name and reputation and demonstrated ability to consistently turn a profit. On the asset side of the balance sheet, it is the increment over and above the market value of the tangible assets a buyer should be expected to pay for the business.

The process of determining a business's goodwill value is not simple. Indeed, making such a determination lies at the heart of a formal business appraisal although that fact may not be evident in an appraisal report. This is because the convention within the business appraisal profession is to estimate the fair market value of the business's "equity" or owner's "net worth" which is the pre-tax net amount of cash an owner could realize upon the sale of the business after paying off all of the business's debts.

Obtaining a fair market value estimate of the owner's equity is the ultimate purpose of a business appraisal in the case of a divorce, for example, where that is the amount that needs to be allocated between husband and wife as part of the divorce settlement. However, simply knowing the estimated market value of a business's equity is insufficient information to enable a business owner to establish and/or negotiate a selling price in a typical asset sale. The key to this process is knowing what value the hypothetical average buyer will ascribe to the business's goodwill.

Fortunately, it is an easy process to derive a fair market value estimate of a business's goodwill if the fair market value of the equity is known. For example, suppose the fair market value of the owner's equity has been estimated to be $100,000. Further suppose all of this business's current and long-term liabilities are $50,000. The sum of these two amounts is $150,000. Since total equity plus total liabilities always equals total assets, then the fair market value of the business total assets, including goodwill, is also $150,000. Assuming the market value of all the company's tangible assets is $90,000, then the fair market value of its goodwill is $150,000 minus $90,000 or $60,000.

The estimated goodwill value is the key number one needs to establish a realistic asking price for a business and to facilitate price negotiations in tandem with determining which assets will be included in the transaction and what liabilities the buyer will assume in an asset sale. This is accomplished by simply adding the value of the goodwill to the same value for the fixed assets used in the appraisal that the buyer will acquire plus the value of the current assets the buyer will acquire on the day escrow is to close minus the amount of any liabilities the buyer will assume on that same day.

In the absence of a formal business appraisal, it is left up to the seller to estimate the value of his or her business's goodwill. This is where seller's perceptions often disconnect from reality. It is not at all unusual to see small businesses priced anywhere from two to five times above their likely selling price. Assuming the business owner has a reasonably accurate idea of what the tangible assets to be included in the sale are worth, then the error in the opinion of his business's value is entirely attributable to a misperception of the value embodied in the goodwill.
One method a business owner, broker or appraiser can use to get an idea of how much value buyers tend to ascribe to goodwill generally is through an examination of published small business transaction data. In my opinion, the Bizcomps database is the best source for such information. Following are a couple of analyses using the Bizcomps data with a focus on purchase price allocation.

**Figure 1**

![Total Purchase Price Allocations—All SIC Codes Combined
Based on 3660 Transactions
Total Price = 2.22 Times Tangible Assets](image)

Figure 1 shows the total purchase price allocation for all 3,660 businesses in the database for which this information was available. In Figure 1 we see that approximately 55% of the total purchase price was allocated to goodwill. This means that among all small businesses combined, goodwill value tends to be equal to just slightly more than the value of the fixed assets plus inventory. Thus the median selling price for all businesses included in this study was 2.22 times the value of the equipment and inventory (but excluding any other current assets that may have been purchased).

Although the data analysis presented in Figure 1 is a helpful beginning in an attempt to understand the central tendency in selling price allocations, it is limited in two respects. First, different types of businesses will display different central tendencies in their selling price allocations. Also, widely disparate seller carry-back financing terms, which are very prevalent in small business sales, create significant distortions in selling prices relative to each business's all-cash equivalent value.
This suggests that a more productive approach to estimating the value of a business when using comparative transaction data is to focus on one type of business (or at least on fairly similar businesses) and furthermore, to base it on the all-cash equivalent value of the sample transactions rather than actual selling prices. Figure 2 is just such a study based on 99 deli shop sales drawn from the Bizcomps database. In the case of Deli Shops, the data reveals that the median all-cash equivalent selling price for this type of business's goodwill is almost exactly equal to the fair market value of its inventory and equipment. This is not to say that the value of every deli shop is two times the value of its tangible assets. The value of each business is unique and is generally a function of its earnings, not its assets. Nevertheless, a study like this is helpful in getting a ballpark idea of the cash value for a business’s goodwill.

Footnotes
1. A reasonable estimate for the fair market value for any business's operating equipment is the cost to replace each item with an identical piece of equipment of the same age and in the same condition, delivered and installed.
The significance of a business’s assets in creating market value

A business's value is generally a function of its earnings, not its assets. There is little doubt in my mind that this statement may raise the eyebrows of a few business owners and perhaps be rejected as outright nonsense by some.

Indeed, it was not so long ago that I was discussing this very issue with a business owner who was contemplating selling his printing business. He was convinced that earnings alone can't be the only basis upon which a selling price is determined. I remember the discussion so well, I can quote the print shop owner almost verbatim. He said, "look around. I have thousands of dollars invested in this printing equipment. Do you mean to tell me that a janitorial business, where the owner's only investment is a mop and a bucket, is worth the same as mine if we have the same earnings? That's bull *#$%! All of this equipment has got to count for something."

My objective here is to explore the issue of how much, if any, incremental market value tends to be imparted to a small business based on the value of its assets relative to its earnings. To do this we will compare the selling prices, value of fixed assets and price/earnings ratios of small businesses with a big investment in fixed assets to small businesses with a relatively lower investment in operating equipment.

For businesses with a high investment in fixed assets, I selected as my statistical sample all printing businesses and restaurants in the Bizcomps 2001 database. This sample was comprised of over 900 businesses. For my statistical sample of businesses with a lower investment in fixed assets relative to annual earnings, I selected all property management firms, accounting and bookkeeping practices, advertising agencies, travel agencies, insurance agencies, secretarial services, janitorial and maid services, and employment agencies. All together, this sample contained approximately 325 businesses.

Among the sample of businesses with a large investment in fixed assets, average annual earnings, defined as Owner's Discretionary Cash Flow, were $72,770 and the average value of their assets was $77,860. Among the service businesses, average annual earnings were $90,470 and the average value of their assets was $28,100. Among the restaurants and print shops, the annual earnings to asset value ratio-i.e., the number of times a year the value of the assets are recovered in earnings-was .93. For the service businesses, the average earnings to asset value ratio was 3.22 which is to say that annual earnings equal 322% of those firms' investment in operating equipment.

From this we can see that print shops and restaurants have, on average, three and a half times as much money invested in assets as do service business with similar earnings. Given these facts, let's look at the difference in the selling price/annual earnings ratios between these two groups of businesses.
From this study it is evident there is indeed a difference in the central tendency of price/earnings ratios between the two categories of businesses. The low asset investment category firms tend to sell, on average, for 1.74 times annual earnings whereas the high asset investment category firms tend to sell, on average for 2.03 times annual earnings. Thus there appears to be about a 17% increase in selling prices between businesses with identical earnings for every 350% greater investment in fixed assets. The median differential is only 12%. Another way to express the apparent selling price premium evident in this study is that between two businesses with identical earnings, the business with the greater investment in fixed assets will tend to sell, on average, for an additional three to five cents for every additional dollar the buyer will acquire in fixed assets.

Although there is a measurable difference in the P/E ratios between the two categories of businesses, is not very large. Moreover, among the subset of businesses that sell at the high end of the price/earnings continuum, there appears to be very little, if any difference between the P/E ratios of the two categories. (If there were, the broken line would consistently track to the left of the solid line.)

There is one very important caveat to this presentation. When I speak of the "price/earnings ratio," I am referring to the business's selling price as a going concern. This is the price the business well fetch under the presumption that a buyer will continue to operate the business in a fashion similar to that of the seller with the intent of earning an annual profit for years to come. Under such a presumption, it is very common to find businesses-especially businesses with a big investment in fixed assets-where the liquidation value of the equipment is greater. Such businesses are said to be "worth more dead than alive."

Thus, for the business owner who might exclaim that based on a multiple of approximately two times his discretionary earnings the business would be worth only, say, $100,000 when he knows if he shut his business down, he could sell his equipment today for $150,000. In such a case, his business is worth $150,000 and if he really wants
out, he should do just that: shut his business down and sell his equipment in a going-out-of-business sale.
...And visions of sugarplums danced in their heads:

Dispelling the “wives’ tale that a small business is worth one times annual sales revenue

From time-to-time someone will ask me about the merits of the “rule of thumb” stating that a small business is worth one times annual gross sales revenue.

Although there are business valuation rules of thumb based on multiples of gross revenue, in my opinion, they are generally (but not always) among the least reliable of all business valuation techniques. Show me any business that has filed for bankruptcy and I'll show you a business that was generating some gross revenue at the time of its demise. Just because a business is generating gross revenue does not mean it is earning a profit or that it has any value beyond the liquidation value of its tangible assets. Moreover, even among profitable businesses with identical annual gross revenue, earnings can vary substantially because of dissimilar operating costs which means they will have substantially different market values.

The reason there are valuation rules of thumb based on gross revenue at all is because small businesses within the same industry tend to have similar operating costs expressed as a percent of revenue. This enables a buyer familiar with a particular industry and who therefore knows the average operating cost/revenue ratios for businesses in that industry to estimate what earnings are, or could be, for a particular business just by knowing its annual revenue. Ultimately, buyers are interested in only one thing—a business's expected future earnings.

Because costs as a percent of sales revenue vary from industry to industry, each industry tends to have its own unique gross revenue valuation multiple rule of thumb. There is only one case that I am aware of where it is one times annual gross revenue.

An examination of the Bizcomps database reveals that among all businesses combined, the median selling price, including inventory, is 42% of gross revenue. The same multiple, excluding inventory, is 37% of gross revenue. Thus, if you must have a rough-and-ready "one size fits all" gross revenue valuation multiple for a small business, use .37 times sales revenue plus inventory (although I advise against doing this). Additionally, keep in mind that most small business sales include seller financing, generally ranging between 40% and 60% of the selling price. This means the gross sales valuation multiple of .37 assumes the seller will finance a large portion of the selling price. If we look at only those businesses in the Bizcomps database that sold for all cash at close of escrow, the median selling price is 27% of annual sales revenue.

Let's look at the selling price/revenue ratios for a few industries. The median selling price/revenue ratio for all manufacturing businesses in the Bizcomps database is 51% plus inventory and work in progress. For all types of auto repair combined, the selling price multiple of gross revenue is .37—the same as my "one-size-fits-all" suggestion. In the restaurant industry it is .35. And finally, as one last example, small bookkeeping and accounting practices sell, on average, for one times annual gross sales revenue. This is the only industry I have found where buyers actually tend to pay, on average, one times annual gross sales revenue. (This reminds me of the adage that even a broken clock gives the right time twice a day.) Also keep in mind that in all of these examples, the majority
of the transactions upon which these ratios are based included seller financing. To get an approximate idea of what the most probable all-cash selling price for a small business will be, using any of the above gross sales multipliers, reduce that multiplier by 30%.

Hopefully, I have dispelled any notion you may have had that a small business is worth one times annual gross sales revenue. As I have shown here, businesses in different industries tend to sell for significantly different annual gross sales multiples. In only one industry does this valuation multiple tend to center on one times annual gross sales and, I should also note, that I have not found a single industry category where the median selling price exceeds this ratio. In most cases I have found that selling prices within a given industry tend to range between 25% and 40% of annual gross sales with the exception of the personal service trades where they are generally higher.

I also hope I have succeeded in dissuading you from ever relying on a gross sales multiplier business valuation rule of thumb, except perhaps for the most inconsequential purpose. For that matter, I strongly advise against using any business valuation rule of thumb when actually buying or selling a business without also employing one or more of the formal business valuation methods, ideally with the assistance of a trained (and certified) business appraiser.

If you are still not convinced, consider the words of Glen Desmond in his book Handbook of Small Business Valuation Formulas and Rules of Thumb¹:

"By the act of applying a multiplier to a revenue or cash-flow stream, an appraiser could be deceived into thinking that there must be a value because the arithmetic says so. Nothing could be further from the truth. Relatively few businesses are marketable as going concerns.

"There are millions of small businesses in the United States, and many are offered for sale each year. The vast majority provide little more than a minimal salary for the owner. Others may be very profitable, but depend entirely on unique attributes of the owner or have other elements that limit value. In addition, some types of businesses are easily started anew, so there may be no reason to buy an established one, and thus a business may have no transferable value as a going concern."

The market value of a franchised small business

Buying a franchised business requires additional considerations one need not be concerned about when considering buying a non-franchised small business. In addition to the business itself, the buyer must also investigate the reputation and other circumstances of the franchisor. And it is advisable in so doing that the buyer become more than modestly educated regarding the advantages and disadvantages of the franchising method of doing business. There can be some big advantages to this approach to business ownership but there are also some very noteworthy disadvantages. Anyone considering opening a new franchised location or buying an existing operation should become thoroughly familiar with the differences between being an independent business owner and being a franchisee. Amazon.com advertises 299 books with "franchising" in the title. A cursory glance at this list suggests that there are several books for any would-be franchisee to choose from that would shed light on the subject.

Whenever one is considering purchasing an existing outlet from a current franchisee or opening a new location, the franchisor is required by federal law to provide the prospective buyer with a "Uniform Franchise Offering Circular." This document provides much important information about the franchisor, including the current franchise agreement. Although a good place to begin assessing the merits of a specific franchise business opportunity, it should not be the sum total of a buyer's investigation. It is always a good idea to research articles about various franchise systems. My advice is to be very wary of the hype included in a franchisor's marketing material. It is also wise for any prospective franchise buyer to seek the advice of an attorney who specializes in franchise law and represents the interests of franchisees. There are enormous differences in the terms and conditions of various franchise agreements and a few dollars paid for the advice of an independent expert at the outset of a contemplated investment in a franchise will always be money well spent.

Three good places to begin an investigation of franchising is to read Franchising: Introduction to the Uniform Franchise Offering Circular and the Franchise Agreement on the internet at www.franchise411.com/fpi/UFOC.html, by visiting the website for the American Association of Franchisees and Dealers, a non-profit franchisee support organization, at www.aafd.org and the website for the American Franchise Association at www.franchisee.org. These two organizations provide a number of support functions for potential and current franchisees including connecting them with legal professionals in their part of the country.

As a business broker and business appraiser, I am particularly interested in the prices existing franchised business opportunities fetch when sold. According to the 2001 Business Reference Guide "selling price multiples [of earnings] for the fast food business are a bit above the level for the industry in which the franchise participates." To investigate this proposition, I conducted a couple of studies of the small business transaction data in the Bizcomps database.

My first study was an analysis of the difference in the average selling prices expressed as a multiple of Owner's Discretionary Cash Flow between franchised and non-franchised businesses of all kinds. Figure 1 presents the results of this study.
From this data we can see that the average selling price of franchised businesses as reflected in the sample data is indeed slightly higher than non-franchised businesses. It is also interesting to note that the Bizcomps database includes relatively few franchised business transactions. There were only 93 usable franchised business transactions in my comparison sample as opposed to 4,802 non-franchised businesses. (This is why the line reflecting the distribution of non-franchised businesses is smooth and the one for franchised businesses is jagged). I can only speculate as to the reason for this, but I suspect that many, if not most, franchised business sales are handled outside the traditional business brokerage industry which is the source of the Bizcomps data.

As a second study, I looked at the difference in selling price multiples between franchised and non-franchised restaurants. Again, I had a very small statistical sample of franchised restaurants to work with. There is usable data for only 18 franchised restaurants available in the database compared to 814 non-franchised operations. However, with this caveat notwithstanding, I found that the average selling price multiple of earnings for non-franchised restaurants is 2.03 versus 2.90 for franchised operations.

A more sophisticated statistical test of these two studies indicates that the difference between the two average selling price multiples for all businesses demonstrated in Figure 1 cannot be dismissed as nothing more than a random chance occurrence in the sample data. However, the same is not true for the restaurant businesses. The observed difference in the sample averages for this category strongly indicate that franchised restaurants tend to fetch a higher selling price than non-franchised operations, all else being equal. This bears out the statement appearing in the 2001 Business Reference Guide.

Assessing the wisdom of buying any small business is a complex task and the decision to pursue a franchised business opportunity makes the process even more difficult. Moreover, even though it appears that franchised restaurants tend to fetch higher selling prices than their non-franchised counterparts generally, one should never assume this to be true for every franchised food service operation. The value of any business is a
function of its expected future earnings and the risk that those earnings will or will not materialize. Although some forms of business risk may be reduced when one buys a franchised business opportunity, there are other forms of risk inherent in that form of business ownership that do not exist for independents. For any business buyer, it is essential to be aware of this fact.
Business Valuation Rules of Thumb

"By the act of applying a rule-of-thumb multiplier to a revenue or cash-flow stream, an appraiser could be deceived into thinking that there must be a value because the arithmetic says so. Nothing could be further from the truth. Relatively few businesses are marketable as going concerns."

"There are millions of small businesses in the United States, and many are offered for sale each year. The vast majority provide little more than a minimal salary for the owner. Others may be very profitable, but depend entirely on unique attributes of the owner or have other elements that limit value. In addition, some types of businesses are easily started anew, so there may be no reason to buy an established one, and thus a business may have no transferable value as a going concern."


“...there usually is no credible evidence of how [rules of thumb] were developed...Consequently, Rules of Thumb rarely, if ever, should be used without other, more reliable valuation methods [to estimate the value of a business].”1 Businesses are like snowflakes: every one is different. This being the case, there is no single formula that can be used to determine the value of a business. Rules of Thumb are generally useful as a “sanity check” to see if a contemplated asking price is in the ballpark. However, resorting to a Rule of Thumb pricing technique must be done with the understanding that they are all industry specific. One must be certain that any reliance on a rule of thumb value estimate is based on a rule appropriate for the particular type of business in question.

Shannon Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, p. 249