What is My Business Worth?

“What is my business really worth?” That’s usually the first question a business owner asks, or is thinking?

The most commonly used criteria and methods for estimating the value of a middle market company, or a small, “main street” business, are – income, asset, and market comparison methods.

Income Method**:** This is the most common approach for small, mid-market privately held companies. It utilizes a discounted cash flow methodology which values the income stream created and maintained over time – future income.

Asset Method**:** This approach values the fair market value of the assets minus the liabilities. This method strictly reviews the balance sheet: stated assets and subtracting liabilities. It examines the historical values without any reference to the market or current pricing. Typically, this method understates the value of a business. Often it is used in a liquidation review. A mistake sellers commonly make is to value the cash flow and then add back the assets to get a price. Wrong! These assets, machinery, trucks, etc. are needed in the operation of the business. Without them the business would not exist and hence no cash flow. Think of your business as a machine that prints money. The cost/value of the equipment used is not being valued, but the ability of the business (‘machine’) to generate cash flow.

Market Comparable Method**:** Simply, this method of valuation looks at how similar businesses have sold over the recent past. In addition, comparative ratios or multiples – that have been used in other sales – can be considered in the business being analyzed.

Whatever method is used, just remember the value of your business is what a buyer (the market) is willing to pay and not the seller’s subjective view. The buyer is valuing your business by how much he (not you) can make from its operation, not just tomorrow, but in the years ahead.

Most Commonly Used Approach:

The **most commonly used approach** for valuing a small or lower middle market business is utilizing the **Seller’s Discretionary Cash Flow (‘SDCF’)** and adding back/”adjusting” for all financial benefits an owner, in reality, receives from the business operation.

The **SDCF** approach is a combination of the *Income Method* plus the recognition of all the financial benefits – the real world perks and financial benefits – that inure to the owner. It is the money generating capability of the company.

The SDCF is the company’s profit, as shown on the Tax Returns, plus the owner’s salary, *benefits, any bonuses, distributions or any financial benefit the company pays back to the owner. This identifies all the cash generated by the business that the owner enjoys. It also includes taxes, interest expense, and non-cash expenses such as depreciation or amortization.*

The SDCF is the single most important metric used in selling these types of businesses. It demonstrates to a prospective buyer what money will be available to pay for the new owner's salary, the costs of financing a loan (interest and principal) and a return on his down-payment /investment.

The SDCF or "adjusted cash flow" is now applied to a multiple that discounts time, risk and sustainability. The multiple (1.5, 2.0, 2.5, 3.0 etc.) varies and is driven by industry, company maturity, the management team and the existing management systems. A typical small business may sell between a two and three multiple while a lower middle market may see multiples between three and perhaps as high as five. Again, the market is what someone will pay for the business. Applying a multiple is really more of an art (more subjective) – and the science of a valuation is the actual SDCF.

So to create a hypothetical example, if a business generates $300,000 in SDCF and a buyer applies a 2.5 multiple – the business value would be (plus/minus any adjustments for inventory or other considerations) $750,000 (2.5 x 300,000)

Finally, a valuation is not about determining what a company is worth in the current owner's hands; it is about the company's transferable value in the eyes of a buyer.