

WHITE PAPER

An Alternative Approach to Valuing a Small Business

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There are two basic elements we apply when valuing a small business. First is the value of your personal services. If the business is only generating profits equal to what you could earn as an employee elsewhere than that is all the business is worth. You are simply buying a job and the value is only one times earnings. If the business is generating profits in excess of that then there is additional value based on a return of investment. The values for the return on investment element depend on several factors that we will discuss later.

There are several methods being used to value businesses. There was one software program that used 9 different methods. They all resulted in different values. Also, each industry seems to have a “rule of thumb”. One industry may use 2 times earnings to value a business while another industry may use 3.5 times earnings. What makes the earnings from one industry more valuable than another? Our approach applies the same formula across all industries.

We’ve prepared sample calculations for 4 different industries. The schedule is below. Each uses the same calculation and each assumes the buyer will be involved in the operation of the business. We start with the net income of the business. There’s a separate science involved in reaching that number which is beyond the scope of this article. From net income we have deducted the value of personal services. This will vary based on the level of skill, type of work, effort, hours, etc. We’ve selected \$100,000 for illustrative purposes. In the case of the Hair Salon and Retail Store the net income is less than \$100,000. The calculations stop there. The business is only worth the net income and there is no return on investment element.

The Gas Station and the Wine and Beer Store have net income greater than \$100,000. The greater the excess income the greater the multiplier is. Few businesses ever get to the point of generating serious income above personal services. Those businesses that do are generally very successful and stable. They deserve to be rewarded by a higher multiple. The Gas Station has excess income of \$175,000 and we’ve assigned a multiplier of 2.75 to the excess income. The Wine and Beer Store has excess income of \$125,000 and we’ve assigned a multiplier of 2.25 to the excess income. The additional \$50,000 of excess earnings by the Gas Station results in an additional \$200,000 of value. The multiples continue to increase as the excess earnings increase. A business generating \$300,000 of excess earnings could have a multiplier of 4.00 and could be worth \$1,300,000.

Sample Business Valuation Calculations				
	Hair	Gas	Retail	Wine and
	<u>Salon</u>	<u>Station</u>	<u>Store</u>	<u>Beer Store</u>
Net income	55,000	275,000	75,000	225,000
Net income assigned to personal services	100,000	100,000	100,000	100,000
Excess earnings assigned to return on investment (0 if negative)	0	175,000	0	125,000
Excess earnings multiplier	0	2.75	0	2.25
Value of excess earnings (return on investment)	0	481,250	0	281,250
Valuation of personal services (lesser of net inc or \$100,000)	55,000	100,000	75,000	100,000
Total Value	55,000	581,250	75,000	381,250

These values are for illustration only. The actual values are determined based on many factors and could range greatly. Here's a few of the factors to be considered:

- Age of the business
- Recent trends
- Value of the owner to the business – will it run without the owner?
- How desirable is the industry?
- Location
- What would the cost be to enter the industry?
- Is there significant inventory or equipment?
- Does the owner's reason for selling make sense?
- How heavily is the industry regulated?
- Do lenders like the industry?

The list is not all inclusive but will serve to give the reader a sense of the analysis needed to arrive at realistic values.

While this approach is relatively simple there are many factors that can make it complicated. The strength here is that it can be applied across various industries to provide apples to apples comparisons. If you're a buyer you don't want to over pay. If you're a seller you don't want to underprice.

We here at King and King will be happy to discuss this with you. Call us any time for a no obligation consultation.