

# Rules of Thumb for Appraising a Business

Business brokers use rules of thumb every day to help sellers put price tags on their businesses. Such "rules" are very useful tools for appraising nearly every small business. They can be used to cut through the confusion.

But, rules of thumb are only rough descriptions of reality. They are gross simplifications. In that sense, they are 'dumb'. When misunderstood and misapplied, they are even dumber!

## Earnings Multiplier is Best

If we are going to use a rule of thumb to value a business, some type of earnings multiplier makes the most sense to prospective buyers. It directly addresses the buyer's motive to make money - to achieve a return on investment. Sales multiples mean nothing unless they can be translated into earnings.

Two areas of confusion are inappropriate comparisons to investment real estate and/or to stock market earnings multiples. Real estate is often priced at 8 to 10 times its net operating income. Stock market prices are often as much as, or even more than, 20 times earnings.

These two comparisons do not work for small businesses primarily because the risk of owning a small closely-held, privately owned business is thought to be much higher than owning either real estate or publicly held stock. Running a small business is also a lot tougher than managing an office building or a stock portfolio.

But, even if we settle on an earnings multiplier, we are not even able to start the valuation process until we decide which earnings figure we are going to multiply. Is it last year's earnings? This year's? Next year's? Is it the last five year's earnings averaged? Is it the next five year's projected?

The next issue is our precise calculation of 'earnings.' Should it include or exclude the owner's pay and perks, interest expenses, depreciation and taxes? What about those one-time expenses that may be on the books?

## But, What's the Right Earnings Multiplier?

After we define which 'earnings' we should use, we still have to choose the right multiplier. How many times are we going to multiply earnings to get to a value of the business? Is it 1, 3, 5, 8, 10 or 20? Based upon what? Figured how? Most people can agree that this multiplier will vary based upon the risk of the business, but how can that be measured?

What about the various tangible and intangible asset values? Do we include the real estate, equipment, vehicles, inventory? Is there a separate value for a seller's agreement to consult with the new owner after the sale? What about non-compete agreements? What about patents, franchises and other extraordinary intangibles?

Finally, how do we define 'value' itself? Do we want 'fair market value?' Or, do we want a specific value for a specific circumstance?

Estimating the market value of a business is difficult when we can't observe a marketplace of buyers and sellers. Sometimes, there aren't many buyer prospects for a given small business.

When no active market seems to exist, buyers pay prices that are unique to their circumstances, sometimes considerably above or below any so-called 'fair market value.'

## Let Common Sense Prevail!

We must allow our common sense to prevail if we are to make our way through these issues. Let's not forget that potential buyers create the market. We have to place ourselves in the positions of would-be buyers for the business we're trying to value.

Let's start with the issue of which earnings to use. It would be easiest to use the most recent year's earnings directly from the latest tax return. But, does that make any sense? Not in my opinion.

A buyer is buying the future, not the past. Projected earnings, therefore, is my answer to which earnings figure to use.

The obvious problem with this is that it is difficult to estimate. But, it's still the right figure to use. It makes sense to most buyers as long as the projection looks realistic.

For most small businesses, I believe a one year 'normalized' earnings projection is in order. But, if one could realistically project five years ahead, I could be persuaded to use such a projection.

## Use Earnings Before Interest & Taxes (EBIT)

The second issue is the specific calculation of what constitutes 'earnings.' I vote for a simple definition here - one used by accountants for businesses large and small. I'm referring to 'Earnings Before Interest and Taxes' (EBIT) as it is known and defined by accountants. Again, I defer to buyer preferences here. Their advisors are often CPAs and EBIT is an understood norm.

What's the right multiple? Well, it depends! For most businesses, it's somewhere between 3 to 5 times 'normalized' EBIT. But, it can be less than that when there are few tangible assets and it can be more than that when the business is uniquely attractive.

The right multiple is, in the eyes of buyers, a matter of assumed risk. Buyers feel better about buying tangible assets that they can appreciate with their five senses - things like real estate and equipment. On the other hand, one can entice them by offering a clearly attractive opportunity to make money, regardless of the tangible assets included, as long as it's believable.

Why is it 3 to 5 times earnings? Well, to buyers, such a multiple represents getting your investment back in 3 to 5 years from profits. That's equivalent to a projected annual return on investment between 20% and 33%. That's the type of return rate that encourages buyers to take the leap of faith to buy an existing business.

## What About Other Assets?

Tangible and intangible assets often seem to have a value separate from the business. The test of whether or not the value of an asset should be included in the multiple-derived price is based upon whether or not it is needed to generate the projected earnings. If it's needed, it's included.

Exceptions to this are most often real estate and inventory for re-sale, because owning real estate and inventory items is theoretically less risky than owning the other assets of a business.

This is especially true for the valuation of businesses which occupy and own buildings which could easily be sold on the open market if the business failed, or businesses which have large amounts of inventory for re-sale which would be easy to liquidate.

The way to treat such assets in this type of pricing analysis is to separate them from the business; value them separately, then add-back these separate values to the multiple-derived value of the business.

Care must be taken, however, not to double-count assets. In the case of real estate, for example, we separate it by making appropriate expense adjustments in the business expenses. If the real estate value is to be added back to the business value, then we must subtract a real estate rent expense when we calculate business earnings. This will lower business earnings and the business entity value. But, we can then add-back the real estate value as a separate figure.

The handling of inventory values can be equally tricky. Inventory is almost always valued at cost, but we have to carefully consider the effect that adding-back inventory value will have on the buy-sell transaction. How inventory is purchased and financed by a buyer has a dramatic effect on the economics of the transaction.

Generally, intangible assets like an owner's agreement not to compete, or to consult during a transition period, are included in the value of the business derived by using a multiple of earnings, even though such assets may well be treated separately at a business closing for tax purposes.

### **How Can You Be Certain?**

After reading and re-reading all the material on business valuation that you can find, you may still wonder how you can be certain that the price you've chosen is correct. Unfortunately, you can't.

Using and applying the multiples described in this article is uncertain and imprecise because buyers are uncertain and imprecise. Most buyers use some type of valuation approach based upon the multiplication of earnings, but they don't all use the same procedures.

Progress is being made at collecting nationwide sales data on small business sales. One of the most interesting results of this new data, so far, is that it confirms the above rules of thumb, if used and applied properly, are fairly accurate.