

MARKET VALUATION METHODS

Fair Market Value (FMV) is the potential price a business would sell for given a willing buyer and a willing seller, with neither under pressure, and both having reasonable knowledge of the business.

Three Ways Businesses Are Valued

Income-Based Approach

Looks at future earnings potential

- ▶ **Capitalized Cash Flow**
 - $\text{Earnings} \div \text{Capitalization Rate}$
- ▶ **Capitalization Rate**
 - $\text{Net Operating Income} \div \text{Property Value}$
- ▶ **Discounted Cash Flow (DCF)**
 - Projects future cash flow and adjusts for risk

Market-Based Approach

Looks at what similar businesses have sold for

- ▶ Most common method for small businesses
- ▶ Uses real transaction data and valuation multiples

Asset-Based Approach

Looks at what the business owns

- ▶ **Adjusted Net Asset Value**
 - Assets minus liabilities
- ▶ **Liquidation Value**
 - What assets would sell for if the business closed

What Matters Most for Small Businesses

- ▶ Clean, well-documented financials
- ▶ Consistent cash flow
- ▶ Reduced owner dependency
- ▶ Comparable sales in your industry

Tip: A professional valuation or a broker's opinion of value can help you set realistic expectations and prepare for a successful exit.

Two Common Earnings Measures

Seller's Discretionary Earnings (SDE) Multiples

Most common for owner-operated businesses with under \$2M in revenue

SDE = Net Profit + owner salary & benefits + personal expenses + interest + taxes + depreciation + amortization + one-time expenses

Seller's Discretionary Earnings shows the total income available to one owner. A multiple is used with Seller's Discretionary Earnings calculations to provide a practical, common way to standardize a business's value. These multiples are normally industry or deal specific and help brokers, lenders and potential new owners compare opportunities consistently. A typical range for most business valuations is 1.5 to 3.5 times SDE, however the most common middle of the market range is 1.5 to 2.5 times SDE.

Most micro and small businesses transact below 3x SDE (typically 1 or 2x)

EBITDA Multiples

Used for larger or management-run businesses with \$1.5M + in revenue

EBITDA = Net Profit + interest + taxes + depreciation + amortization + excess owner compensation + personal expenses + one-time expenses

EBITDA shows the total earnings independent of the owner's salary and expenses. A valuation multiple for EBITDA shows how much buyers are willing to pay for each dollar of EBITDA, based on what similar companies are selling for in the market. Factors affecting the multiple include things like industry growth potential, company size, recurring revenue streams, diversified customer base, and overall market conditions.

Typical characteristics of businesses include:

- ▶ 1.5x – 2.5x SDE
 - High owner dependency
 - Weak systems or documentation
 - Smaller concentration of customers
 - Inconsistent earnings
- ▶ 2.5x – 3.0x SDE
 - Stable cash flow
 - Clean financials
 - Reasonable owner involvement
 - Average risk
- ▶ 3.0x – 3.5x+ SDE
 - Low owner dependency
 - Strong systems and team
 - Diversified customers
 - Predictable, repeat revenue

Typical characteristics of businesses include:

- ▶ 3.0x – 3.5x EBITDA
 - Still owner-influenced
 - Limited management depth
 - Smaller scale
- ▶ 4.0x – 5.0x EBITDA
 - Professionalized operations
 - Management in place
 - Scalable model
- ▶ 5.5x – 6.0x+ EBITDA
 - Strong growth/scalable model
 - Low risk
 - Value-added business model