How to Value My Business: The Ultimate Guide for 2021

Learning how to value a business is the process of calculating what a business is worth and could potentially sell for. The most common method used to value small businesses is based on using the seller's discretionary earnings (SDE) for the trailing 12 months of operations and then leveraging an industry multiplier. So, if a marketing service business generating an SDE of $125,000 in 2020 and the assigned industry multiplier was 3, the valuation would be $375,000.

Keep reading, there are some factors to consider in this simple equation!

How to Value a Business Yourself

You can calculate the value of your business manually by following the 2 steps below, taking seller's discretionary earnings (SDE) and applying an industry multiple. This is a simple method that can be applied when learning how to value a small business, and is appropriate for many small businesses. Other valuation methods exist, and may be more appropriate depending upon the complexity and structure of the target business.

The 2 basic steps to determine the value of a business are:

1) Calculate Seller's Discretionary Earnings (SDE)

Most experts agree that the starting point for valuing a small business is to normalize or recast the business' earnings to get a number called seller's discretionary earnings (SDE). SDE is the pretax income of your business before non-cash expenses, owner's compensation, interest expense and income, and one-time expenses that aren't expected to continue in the future.

Small businesses report expenses on their tax returns with an eye toward reducing their tax burden. This means you likely claim many deductions that lower your business income on your tax return. For this reason, using income numbers from a business' tax return can underestimate how much revenue the business actually produces.

Why Seller's Discretionary Earnings Matters

SDE gives you a better idea of the business' true profit potential by calculating what the business' earnings would be with a new buyer. This is done by adding back in expenses listed on your tax return that aren't necessary to run your business. This includes your salary as the business owner and any one-time expenses that aren't expected to recur in the future.

Items that are added to net income to calculate SDE include:

- Your salary, or total salary of all owners
- Any perks you or other owners receive (like personal travel or personal vehicle payments)
- Family members on payroll holding non-essential positions
- Non-cash expenses such as depreciation and amortization
- Leisure activities, such as business golf outings
- Charitable donations
- Any personal expenses, like the purchase of a personal vehicle, that were noted as expenses on the business tax return
- Business travel that's not essential to running the business

- One-time expenses that are unlikely to recur after the sale of the business, such as the settlement of a lawsuit

2) Find Out Your SDE Multiplier

Businesses typically sell for somewhere between 1X and 4.5X their SDE. This is called the "SDE multiple" or "multiplier." Think of the industry standard multiplier and the specific business multiplier as two separate numbers, one giving you a general value based on industry averages and another giving you a more specific value based on variable factors of each individual business.

Some of the factors that make finding the right SDE multiple difficult are:

- Industry
- Geographic trends (market risk)
- Company size
- The business' tangible and intangible assets
- Independence from the owner (owner risk)
- And many other variables.

The biggest factors influencing the SDE multiple are usually owner risk and industry outlook. If the business is highly dependent on you or another owner, it cannot be easily transferred to new ownership and the business' valuation will suffer. The more infrastructure and turnkey the business is, the higher the multiple. If you're selling a business in an industry or area that is expected to grow in the near future, the SDE multiple will also be higher. Conversely, if the business model is very much owner operator, where he or she is involved in every facet of the business, the multiple will be lower.

Factors That Influence the Multiplier/Base Value

In most cases, small businesses are given a business-specific multiplier of between one and four. The multiplier can be impacted by your geographic location, the risk of your industry, or a number of things related to your business. Generally, many small businesses are purchased for their ability to generate current cash flow, with a plan to expand the existing customer base. The value of the business assets and liabilities must also be taken into consideration. The legal structure of most small business sales will generally be that of an asset sale, which means the purchaser is buying the tangible and intangible things that make the business what it is. Typically the seller retains liabilities, but deal terms will vary from sale to sale.

Here are the main factors that influence a specific business' multiplier/business value:

*<u>*Assets*</u>

Assets add value to a business. The more assets a business has, the more it will be worth on the market and the higher the multiplier that will be used for the valuation. Assets generally include items that can be sold and converted to cash. Generally, equipment being financed with a capital lease are considered assets, while equipment financed through an operating lease are not.

Tangible Assets

Tangible assets refer to all of a business' material assets, and won't typically have a major effect on your multiplier. However, you might get a higher multiplier if you have recently purchased new equipment. Let's say a restaurant has just purchased a new set of fryers and stoves. That means that equipment will not have to be updated in the near future, cutting down on future costs and which can raise the current value.

This includes but is not limited to:

- Furniture
- Fixtures
- Equipment

- Real estate
- Inventory (sometimes included in the asking price, and sometimes priced separately)
- Company vehicles

It is important to take into account the asset’s depreciation when assessing the value of many of these physical assets. Equipment that is near the end of its economic life may be worth very little to the buyer. In some cases, assets may be seen as a liability that the new owner does not want to take on, like damaged or outdated furniture, fixtures, and equipment that require replacement.

Intangible Assets

Intangible assets are all of the positive aspects of the business that are not material in nature and are the biggest influencer of a business’ individual SDE multiplier. A wealth of intangible assets means a much higher multiple. A lack of non-physical assets means a much lower multiple. This is because the value of intangible assets often determines whether or not your business transitions successfully to a new owner.

The following are some examples of a business’ intangible assets:

- Brand
- Reputation
- Independence from the current owner
- Recipes
- Trademarks
- Copyrights

- Patents

In many industries, buying a franchise is considered a much safer bet than buying an independent restaurant because of the wealth of non-physical assets that inherently come with a franchise. You get credit for the brand, for example, which could be recognized nationwide, like Subway.

******Liabilities***

A business' current liabilities are debt or other obligations the business must pay in the future. When determining the value of a business, it's important to factor whether the business' liabilities will transfer with the sale or be settled by the selling owner. (typically any liabilities will remain with the seller)

An asset sale is typically structured so that the seller pays off the business liabilities with proceeds from the sale. However, it gets more complicated when discussing things like an open line of credit facility that the business needs in order to continue operations

****Real Estate & Lease Terms***

The property or land that your business occupies or owns has a large impact on a business' value. If your business leases a building, the amount of time remaining on the lease is an important factor. If your lease ends in less than three years, it could lower the multiple of your business because the new owner will have to renegotiate the lease.

If a business actually owns its own property and building, then the value of that real estate is estimated separately and added to the SDE value of the business. Some small business owners hold on to the ownership of real estate when they sell their business and agree to lease the property back to the new owner on a long-term lease agreement.

****Other Factors That Affect the Multiplier***

The factors we've covered above are a list of the most common things that can affect the SDE multiplier. Any number of things, from the business being in a desirable or undesirable location to the business having a diverse or narrow customer base, can affect the multiple. This is why it's important to consult experienced professionals like ***Royal Business Consultants*** to help you get an accurate determination of what your business is worth in today's market.

Financing Eligibility

The availability of seller financing also has an impact on the sales price multiplier. In nearly 80% of cases, a business has some kind of seller financing option available to the buyer. This is typically around 30% to 60% of the overall business value or purchase price. If a small business doesn't offer seller financing, it will take longer to sell and its value is typically decreased. Bank Financing via the Small Business Administration is a also commonly used as a form of 3rd party financing. Buyers will also leverage their 401k /Retirement account (ROBS Plan) to help fund a business purchase or for working capital. Please contact ***Royal Commercial Lending*** for a free business financing consultation

Is the Client base portable to the new owner?

Many times, local customers choose one establishment over another because they have a personal relationship with the owner. One way to measure this risk is by asking customers what brings them back, and if they would still frequent the location if it was under new ownership. Some of this risk can be managed by the exiting owner remaining on in a transitional capacity for a period of time following the sale, or with a certain level of owner financing part of the deal terms.

Are current employees willing to stay with the new owner?

Employees who were hired by the seller and are loyal to him may decide to leave when he does. If they agree to stay, however, it may only be for a short period of time (less than one year). If these employees hold crucial positions in the business, such as manager or head cook, the buyer could lose some of the most valuable team members that made the business such a success.

What are the current owner's responsibilities? The more infrastructure and layers of management a business has, the more of a positive effect on the multiplier. If an owner is involved in every operational aspect of the business each day, and has less time to grow sales and perform other CEO type of activities, this will make the business less desirable. Most buyers do not want to simply "buy a job". They realize that "wearing many hats" is necessary, but do not want that to come at the expense of growing sales or focusing on a long term strategy.

The Bottom Line

Approaching the question of how to value a business is often seen as a blend of art and science. Many business valuation experts take a multifaceted approach, combining two or more methods to arrive at the most accurate valuation. For small businesses, starting with SDE, assigning an industry multiplier, and factoring in additional analysis based on cash flow and comparable sales should return a reasonably accurate estimate of a business' worth.

When pricing your business for sale, it's important to get it right. Price too high, and you risk scaring away buyers. Price too low, and you're leaving part of your nest egg on the table.

Call the experts at ***Royal Business Consulting*** for a free consult and get a sense of what your business is worth in today's market!