

Valuing a Private Small Business

Valuing small, closely-held businesses can be difficult due to the complexity and the unique nature of each business, industry, and market that the business operates in. Additionally, the private nature of these businesses, their operations, and company sales transactions provide unique challenges. What follows is a discussion of the most commonly used methods for determining the enterprise value of these types of businesses.

The Multiple of Cash Earnings Valuation Approach

The most common way to value a business is by determining the annual cash earnings of a business and then multiplying that by an "earnings multiple" to arrive at a value as follows:

$$\text{Enterprise Value} = \text{Cash Earnings} \times \text{Earnings Multiple}$$

The earnings multiple (or just "multiple") is arrived at in one of two ways.

Comparables Method

The first method for determining the multiple is by using data from comparable transactions to simply compute the average multiple of the comparables based on their similarity to the business and then applying that multiple to the business being valued. The person doing the valuation will attempt to select comparables which closely match the size of the business, the industry it's in, its rate of growth, and other factors. Once this multiple is determined, it is used in the above equation to arrive at a value for the business based on its cash earnings.

For example, if the comparables study shows that an appropriate multiple for the business is 3.3x, and the business being evaluated has cash earnings of \$1 million, then the business would be valued at \$3.3 million dollars.

$$\$3.3\text{M (Enterprise Value)} = \$1\text{M (Cash Earnings)} \times 3.3 \text{ (Earnings Multiple)}$$

Please see the discussion below regarding the limitations of the comparable method.

Highest Multiple Method

The more practical way of determining the multiple is for the buyer to determine the maximum multiple that they can afford to pay based on the cash coming into the business from which they will need to:

- cover the debt payments from the debt used to buy the business
- pay the seller note and/or earnout payments
- increase the working capital to account for growth
- replace aging capital equipment
- realize an acceptable profit

A buyer will make their offer at, or more likely slightly under this maximum to leave a little room for negotiations.

With a little work, the seller should be able to estimate what the buyer's maximum multiple likely is. A good base assumption to use is that the buyer will be purchasing using 5% to 10% cash, 15% to 25% seller carry, and 70% to 80% SBA or conventional (bank) debt.

With this in mind, it's critically important for the seller to realize that there is a maximum amount that a financial buyer can pay for a business and that above that amount the business can't be purchased as it will fail which will result in the seller not receiving the proceeds due them from the seller carry note and/or earnout.

Consistency of the Multiple of Earnings Method

It's interesting to note that though multiples can and do fluctuate somewhat over time, they are remarkably consistent decade to decade. The average multiple across all small business sizes and industries has generally been between 3x and 4x since at least the 1980s.

Determining Cash Earnings

Cash earnings are defined several in different ways, some more accurate than others. These include *Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA)*, *Adjusted EBITDA*, *Free Cash Flow (FCF)*, and *Seller's Discretionary Earnings (SDE)*.

It's important to note that there is no standard definition of these terms and they are often conflated with one another. Below you will find the most common definitions and the ones that we use internally here at East Forty.

EBITDA: Net Income (from your income statement) with interest payments on debt, corporate level income tax expense, and depreciation and amortization expenses added back in.

Adjusted EBITDA: EBITDA less extraordinary / one-time gains, plus extraordinary / one-time losses, plus restructuring charges, less one-time income events, plus one-time expense events, plus excess owner compensation. Other adjustment factors may be appropriate and are handled on a case-by-case basis.

FCF: Adjusted EBITDA less capital expenditures at levels necessary to replace aging Plant, Property, and Equipment (PP&E), and adjusted for changes in working capital. FCF is the most accurate, but requires full financial modeling to determine. In a well run business with consistent working capital requirements, low growth, and that has been adequately replacing PP&E, the difference between FCF and Adjusted EBITDA is usually small.

At East Forty, we perform full financial modeling and use FCF to determine cash earnings.

SDE: Adjusted EBITDA plus all of owner compensation. This measure is commonly used by business brokers who sell smaller, "main street" type businesses. This measure is not used by buyers in the lower middle market and above.

A Note About Using Comparable Data

Due to the confidential nature of private business sale transactions, exact comparables are often difficult to find. Comparable information typically comes from a variety of sources which includes private transaction databases, internal valuation firm data, and the personal experience of the person doing the valuation.

Interpretation of the available comparison data is always required, particularly when choosing comparable transactions and interpreting often incomplete transaction details. Some good guidelines to follow when choosing comparables include:

- closely matching business activities via NAICS industry code(s)
- evaluating companies with similar gross revenues
- excluding unprofitable companies and extreme outliers
- evaluating only transactions involving the acquisition of private companies by private buyers

The ultimate determination of the value of a business can be made only after it's been offered for sale to the marketplace and received a bona fide offer from a qualified buyer.

Other Valuation Methods

Other valuation methods exist, including Discounted Cash Flow (DCF) analysis, Net Book Value (NBV) analysis, etc.. We do not believe that these are generally appropriate for business valuation in this space, however, sometimes they may give a better picture of the value of a company. The DCF method may be used, for example, to value a business with only a few large, long term customer contracts, while the NBV method may be appropriate for a company that is in financial distress. Additionally, if the company has significant assets, sometimes a blended approach is appropriate in a "fair market value of assets + small multiple of earnings" format.