How To Be A Highly Effective Business Broker

Course Module 3
Understanding, Presenting & Defending Business Values: (Part 1 of 2)

by Glen Cooper

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As with many topics, the more we know about the topic, sometimes, the harder it is to explain it to someone who knows nothing about it. Until, of course, we master it – not only master the *body of knowledge* itself, but master *how to say it* simply and clearly!

To get more details on how to value businesses, brokers can take several courses from both the International Business Brokers Association (IBBA) as well as from various professional appraisal groups. There are also many books and articles about business valuation.

This module will grossly simplify this subject matter, as it is always grossly simplified in the everyday world. To the average person, business values are a mystery!

Let's start with a very basic understanding of small business values, then in Part 2 (Module 4) we will discuss the ins and outs of presenting and defending our thoughts in front of sellers (mostly clients) and buyer prospects (mostly customers, not clients).

Participants: (L-R) Suzanne De Lucia, Michael Marks, Dennis Smith, Glen Cooper, Jim DeShayes, Rogelio Rodriguez and Tom Lindahl.

Basic Concepts of Value (Methods used by appraisers, then reconciled to estimate value):

-Cost Approach – what it costs to duplicate
- Most commonly used to value new construction (not businesses)

-Market Approach – what it costs to buy a substitute
- Most commonly used to value residential real estate (and businesses)

-Income Approach – what's reasonable to pay based upon the profit & risk expectations
- Most commonly used to value income property (and businesses)

Basic Concepts of Valuing a Going Business:

-Only Future Benefits Create Value ("ROL and ROI")
- Buyer is buying a job and a return on investment
- A job is worth just so much of the business profits (Return on Labor)
- Remainder of net profits go to debt and equity (Return on Investment)
- A buyer's "cash invested" is down payment and working capital

-Rules of Thumb Are Dumb
- ***3x SDE or 5x EBITDA*** means nothing if you don't know what SDE and/or EBITDA mean!
- ***40% of annual gross sales*** is meaningless if you don't know the business' profitability
- No rule of thumb makes any sense if you can't define and understand it

-Nobody Really Knows What A Business Is Worth
- It takes in-depth **knowledge** of that specific business
- It takes in-depth **study** of potential markets
- It takes several **long talks** with the current owner
- It takes lots of **numbers-crunching and analysis**

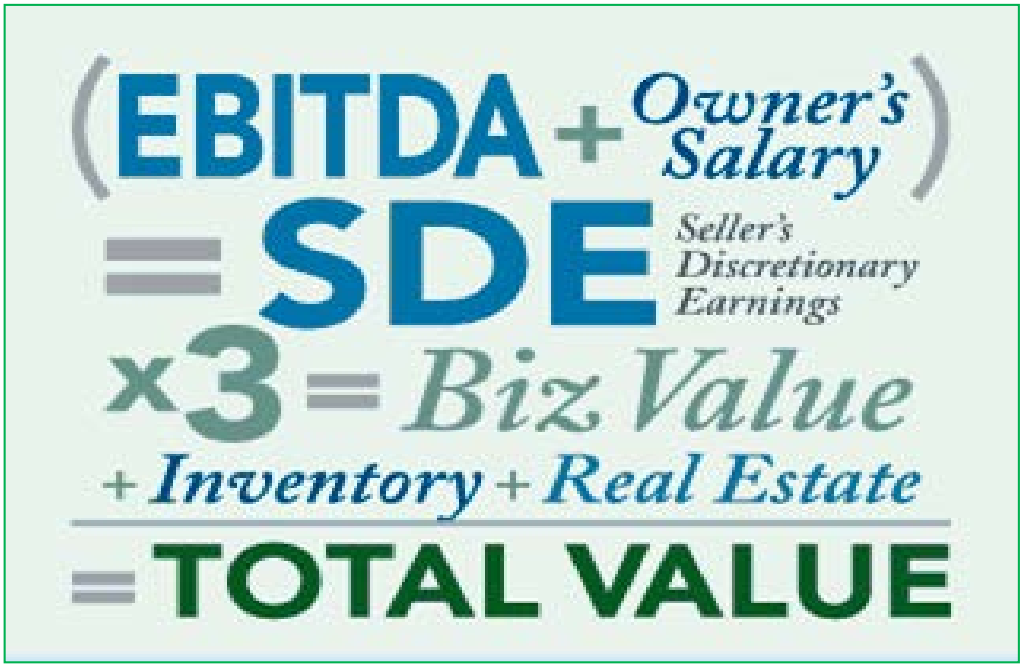
-Whoever Does the Homework Controls the Process
- Whoever understands the fundamentals and sets the assumptions controls the process
- Deciding what cash flow portion is the right "Return on Labor" is critical
- Deciding what investment rate is appropriate as "Return on Investment"
- Determining whether or not it will fit the buyer's lifestyle:
  - Does it utilize the buyer's experience, talents and skills?
  - Will it be what the buyer likes to do: the kind of work he/she finds attractive?
  - Is it where the buyer wants to be?
  - Is it the type of business that other buyers also prefer?

"Rules of thumb are dumb, but we use them anyway. Real-life business buyers – especially individuals – use them all the time." – Glen Cooper

Rules of Thumb Which Are Used (Dumb or Not):

-Ultimately, people like "Rules of Thumb"

- **Sales Multiples** (A business is said to be worth x times annual sales, or a percentage of annual sales.) When this information is available for an industry, it is best used as a sanity check against the results obtained by using "earnings multiples."
- **Earnings Multiples** (A business is said to be worth x times its annual earnings)



Original Windows 3.0 (!) graphic that I first used in 1990. Although it is a gross simplification of the process that appraisers hate, it seems to resonate with clients - Glen Cooper

- "Earnings" can be expressed as EBITDA, EBIT or Cash Flow
  - Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)
  - Earnings Before Interest and Taxes (EBIT)
  - Cash Flow to a Single Owner-Operator (Sometimes CFTO)
    - the same as Seller's Discretionary Earnings (SDE)
  - People also confuse "earnings" with "revenues"
    - For small businesses, a common pricing multiple is an "earnings" multiple of 3 times "Cash Flow to the Owner" or 3 times "SDE" [*1]

Asset Sales Dominate in Small Business Sales. Stock sales are rare. Buyers don't want to assume unknown liabilities. They like starting the depreciation schedules all over again. A stock sale might be best for the seller, but it's a rare buyer who will agree to a stock sale.

[*1] A multiple like "3 times SDE," however, almost never applies to businesses for which the major part of the sale is the underlying real estate value. (i.e. hospitality and/or recreational property). The multiples vary with the buyers' perceptions of investment risk. For many service entities, the multiple might be only 1.5. Historical averages for all business categories have been around 2 – 2.5. Mid-Market size business EBITDA multiples have averaged 5-7.

"To put a little perspective on it . . . because this is scary and someone listening to this might just say, *'Turn it off! I'm heading down the road!'*

. . . what we have here is a motivated seller who wants to sell

. . . and a motivated buyer, who says *'I don't want to work for the 'man' anymore. I like this business. I think I could wake up every morning and get excited about going to work.'*

"So, we have this gap between the value desired by the seller and the value perceived by the buyer and our role, now that we have all of this information, is to put the two together.

"And that now becomes the fun part of the business."

Michael Marks
Business Broker

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