What's Your Company Worth?

Where Math Meets Emotion

By Bruce McConnell

At the end of your garage door career, valuing your business may be your most important business task. It helps you put a legitimate maximum price tag on your many years of hard work and investment. Buyers, on the other hand, will always want to pay the minimum price possible.

In general, the value of your business is a reflection of its ability to reliably generate profits and cash flow. If you want to build the buyer's confidence that your price tag is justified, you need to understand how you determined its value.

Maximizing Value

Whether done informally or professionally, the basic math and methods used are similar. Typically, valuation methods that are founded in basic cash flow principles (used in the lending and finance industries) are embraced by sellers because they maximize value. The challenge is for the seller to explain and substantiate these cash flow values to a buyer.

Simultaneously, sellers deal with predictable emotions related to the unknown factors of the sale and a deep desire to get maximum value for the company. While nothing will eliminate those emotions, understanding the key elements of valuation math will help control them.

Selling your business to a willing buyer is the ultimate way to unlock its value. Unlike selling a car, however, there is no Kelley Blue Book to determine a fair asking price. The responsibility for establishing a realistic price range falls squarely on the seller's shoulders.

Decide What You Are Selling

Are you selling your stuff (assets) or are you selling profit (cash flow)? There is a big difference.

If you are focused on selling your assets (inventory, trucks, and tools) at a fair market price, then you will overlook the value they generate. By focusing on the profit and cash flow they generate, you can present a much different view to the buyer. The value to the buyer is potentially much higher if the seller can identify the ways that the business can generate sustainable profits.

A Real-Life Example

ASSETS	2011	2012	2013 Projected
Accounts Receivable	170,000	190,000	200,000
Inventory	70,000	50,000	60,000
Net Fixed Assets**	120,000	130,000	120,000
Total Assets	$360,000	$370,000	$380,000

CASH FLOW			
Sales	$1,350,000	$1,500,000	$1,650,000
Gross Profit	485,000	555,000	590,000
Less Expenses	435,000	495,000	510,000
Net Profit	$50,000	$60,000	$80,000
EBITDA* Add-backs	80,000	90,000	100,000
EBITDA*	$130,000	$150,000	$180,000

***Net Fixed Assets = Gross assets minus depreciation.*
**EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization. EBITDA is calculated by adding these four expense items back to net profit. This is a well-established formula for determining a business's cash flow.*

If presented with an asset-oriented valuation, a seller might agree with a buyer's assessment that the business is valued at $370,000 as of the end of 2012. On the other hand, by using a typical range of 3.5 to 4.5 times EBITDA, the valuation ranges from $525,000 (3.5 x 150,000) to $675,000 (4.5 x 150,000).

Justifying a Higher Valuation

To justify a valuation at the higher end of the range, you must include growth, margin trends, and perceived asset quality. Some of the other factors that weigh into the valuation discussion are sales mix, sustainability, owner's compensation, and the depth of the management team.

Regardless of which method you use, the assets will still be sold as items needed to operate the business. But when you place more emphasis on your cash flow, you receive appropriate credit for the company's ability to generate profit from those assets.

The difference between the cash flow-driven value of a business and its simple asset value is referred to as "blue sky" or "goodwill." You could view this as an appropriate bonus for creating a profitable company.

The Valuation Takeaway

Your business is a cash flow engine, and you are entitled to be paid for that engine's output. The challenge is to be able to explain how your business can sustain the cash flow under the buyer's ownership. Once you understand the key metrics involved in valuing your business, you will be able to keep your emotions under control and maximize its value to a potential buyer. ■

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