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PRICING A BUSINESS

Pricing a small business is different from pricing a multi-million dollar enterprise. Large businesses are generally priced at a multiple of EBITDA (**E**arnings **B**efore **I**nterest, **T**axes, **D**epreciation and **A**mortization) with multiples typically ranging from 3.0 to 8.0 times EBITDA. EBITDA is also often referred to as *cash flow*. To arrive at a realistic cash flow multiple, you must take into account the type of industry, financial history, depth of management, leasehold or real estate interest, customer base demographics, asset base, and of course, the cash flow being generated.

Small businesses, on the other hand, often find that the bulk of their cash flow is in the form of the owner's compensation (salary and benefits). Therefore, to accurately determine a small business's true cash flow, the seller's total compensation package must be added to the EBITDA. The corresponding multiple normally ranges between 2.0 and 3.0. In the event this multiple of cash flow produces a value that is less than the current value of the business's assets, the asset value then becomes the true value.

EXAMPLE

ABC, Inc. has a net profit of \$30,000 on sales of \$600,000. Included in the operating expenses are the owner's salary of \$50,000, along with his health insurance premium of \$5,000 per year, profit sharing of \$20,000 and leased company car worth \$7,000 per year. Other cash flow components in the operating expenses include Interest (\$10,000), Depreciation (\$25,000) and Amortization (\$3,000). When added together, the cash flow of this business is a respectable \$150,000...a far more accurate depiction of its financial performance than just the \$30,000 net profit ("earnings") figure.

Based on the above data, this business would be worth between \$300,000 (2.0 multiple) and \$450,000 (3.0 multiple). In order to more closely define the value, the following factors must be addressed:

1. Business Age and History [new or established; reputation; litigation];
2. Revenues [fast growing or shrinking; keeping pace with inflation];
3. Employees [self-directed; long-time; key management; skilled workers];
4. Equipment [age; condition; obsolescence; adequate for growth];
5. Real Estate [long-term, assignable lease at fair market rent or real estate at fair market value];
6. Complexity [easy-to-learn or requiring special training; will seller train];
7. Customer Base [growing or declining; other demographics];
8. Size of cash flow [cash flows under \$50,000 can't provide a living wage and service much debt; a cash flow of \$100,000+ is the most desirable].

It is important to note that the cash flow multiple can be increased somewhat if the cash flow exceeds \$300,000, and even more when it passes \$500,000. This is due to the fact that those cash flows can service a great deal more debt and still provide the buyer with an attractive compensation package.

The key to any business evaluation is being able to decipher the true cash flow. A seller must be able to prove all the cash flow components, i.e., any expense that the seller maintains is not business-related or is personal compensation must have a receipt or other validating document supporting the claim. Tax returns are always considered an essential part of this documentation process because they are signed under penalty of perjury.

There is a sanity test to employ when trying to decide if a business is fairly priced. After a typical down payment (30% to 35%), the business's cash flow should be able to retire the balance of the debt while providing the buyer an adequate living wage. In the above example, if the buyer put down \$150,000 (one-third) on an offer of \$450,000, the debt service would be about \$4,700 per month, on a seven year payout, at 8% annual interest (standard terms). After servicing the \$56,000 annual debt, the buyer would still have about \$94,000 remaining as his compensation package and return on his investment (the \$150,000 down payment).

This cash flow evaluation model assumes a "turnkey" sale, which includes all of the hard assets of the business: inventory, furniture, fixtures and equipment. In retail businesses with large inventories, a carrying cost for the inventory (expressed as annual interest) is deducted from the cash flow, and the value of the inventory (at cost) can then be added to the downwardly adjusted value of the business to arrive at a reasonable price.

If this just sounds like mumbo-jumbo, consider the lyrics of an ancient Harry Belafonte song, "It was clear as mud but it covered the ground and the confusion made the world go 'round.'" It's this confusion that keeps business brokers and CPAs busy.