How to Value a Business

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What's my business worth? As small business owners we ask the question all the time. The problem isn't a lack of answers, it's too many answers. Various formulas and rules of thumb leave of us with too many possibilities. Some simplicity would be appreciated. That's what *Matthew Pohl from The Capitalist Alliance offers us in an article that originally appeared here.*

Take special note of the "When to Use It" sections to understand if the approach applies to your size of business.

How To Value A Business

Have you ever watched Shark Tank™ and wondered, “How did the business owner come up with their business valuation? It makes sense to me – I don’t understand why the sharks aren’t jumping at the opportunity.”

For many business owners, the methodologies used to value their business can be a bit overwhelming and difficult to understand.

The reality is that there are numerous methods of valuing a business based on the financial aspects of a business. It’s worth noting that many of the most common mentions focus exclusively on financial analyses and do not take into account the non-financial components of a business. Therefore, you should think of the results these methods produce as being a guide and not a comprehensive measure of your company's value.

Keep reading to gain an understanding of 3 common business valuation techniques, what they mean, and when it may be appropriate to use in valuing your business.

1. Seller's Discretionary Earnings (SDE) Multiplier

What Is It:

Seller's Discretionary Earnings, or "SDE", calculates the value of the company based on the current owner's earnings from the business. The word "discretionary" is important because SDE includes any expense the company pays that is up to the owner's discretion and directly benefits the owner. These include the typical financial benefits to the owner – wages and distributions. It also includes perks like a cell phone, vehicle, rent payment for a home office, and nonrecurring expenses.

Essentially, this method assumes the new owner (the buyer) will receive the same financial benefits of owning the company as the previous owner (the seller). The higher the SDE amount, the more valuable your company is to the buyer. Once SDE is calculated, a multiplier based on the company's size and industry is used to estimate the company's value.

When to Use It:

The SDE method is most appropriate with smaller businesses (less than $1 million in annual revenue) since buyers of these businesses are often owner/operators who will essentially take the place of the current owner (the seller).

Example:

A construction business has annual revenue of $1M. Let's assume that Bob, the owner, takes out a total of $100,000 a year. This is comprised $80,000 in salary and paid vacation, $8,000 in rent/utilities for his home office, and $12,000 in distributions at the end of the year. This means the Seller's Discretionary Earnings (SDE) equals $100,000, since the amount of salary, rent and utility reimbursement, and distributions are at the discretion of the owner.

This $100,000 in SDE is then multiplied by the average multiplier for similar sized companies and industries. The SDE multiplier for a construction company with $1M in revenue might be 2.5X. So, for Bob's Construction, the estimated value would be $100,000 in SDE times 2.5X multiplier, or $250,000.

2. EBITDA Multiplier

What Is It:

EBITDA, or Earnings Before Interest, Taxes, Depreciation, and Amortization, is a fancy accounting term for "Profit". This valuation method uses EBITDA (Profit) as the starting point for its calculation. This number is then multiplied by an industry standard. The EBITDA Multiplier method is one of the most common techniques used to value businesses.

Because interest, taxes, depreciation, and amortization must be deducted each year for most businesses making over $1M, EBITDA is a good method of evaluating the value of that company.

When to Use It:

The EBITDA Multiplier technique is widely used, regardless of size or industry of the company. Most business brokers will use the EBITDA technique in business valuations.

Example:

A property management company generates $3M in revenue and has $300,000 in EBITDA. The industry multiplier for a company of this size in this industry might be 3X. The EBITDA method would therefore value the company at $300,000 in EBITDA times 3X multiplier, or $900,000.

3. Revenue Multiplier

What Is It:

This valuation method is one of the easiest to understand and calculate.

It starts with the revenue of company – often an average of the past few years or an average that combines recent years with a 1 to 3 year projection. An average multiplier is then applied based on the company's industry. Revenue multiplier data can usually be found online from various companies that track U.S. business transactions.

When to Use It:

The Revenue Multiplier technique is applicable for most companies over the $1M annual revenue mark. It is most commonly used in retail but can be relevant to many industries.

Example:

Imagine a grocery story that over the past three years, has had average revenue of $21M. Assuming a revenue multiplier of 0.33, the Revenue Multiplier technique would value the grocery store at $21M in revenue times 0.33 multiplier, or $7M.

These are three common financial models for valuing a business. Having a basic understanding SDE multiplier, EBITDA multiplier, and Revenue multiplier is incredibly important as a business owner. However, keep in mind that there are many other methods available that incorporate the value of assets and non-financial aspects of a business.

If you've never had your business valued, you should. Not having your business valued periodically is like making deposits into your retirement account and never looking at the balance. Wise business owners know the value of their business.

For a more in-depth understanding of business valuation, watch our webinar here – Make Your Business Worth More.

So, we hope that the next time you're watching Shark Tank, you'll remember this blog and understand why Mr. Wonderful isn't jumping at that opportunity you previously thought was so great.

This article originally appeared at: https://www.capitalistalliance.com/blog-source/2018/5/4/ix9qw2hc3qhglgyrijqnykbtkt9bq5.