

WHAT'S MY BUSINESS WORTH? THE QUESTION ASKED THE MOST

It's worth what a buyer will pay you for it. Trite but true. The real question then becomes, "How does a buyer determine what to offer for your business?"

No one buys a business because of what it has achieved in the past, or what it consists of now. Your buyer will buy based on anticipated future economic benefits. Past performances and present status can give important clues to let your buyer forecast cash flow. But the economic value is in the future cash flow as perceived by the buyer.

Buying a business is no different than buying a piece of equipment; it must pay for itself and give a reasonable return on the money invested. The money to pay for the business comes from the future cash flow of the business.

Of the twenty-odd methods of valuating businesses as identified by professional appraisers, your buyer will use only one: ROI (Return On Investment). Other appraisal methods may be appropriate for tax, estate, buy/sell agreements or some other purpose, but your buyer will use ROI.

Your buyer will calculate the ROI by forecasting the cash flow and determining how much buyer cash must be invested in the business. The forecasted cash flow (discounted to present value) divided by the buyer cash to be invested gives the ROI. For example, a business cash flowing \$500,000 per year for which the buyer pays \$2,000,000 cash has an ROI of 25% ($500,000/2,000,000$).

The Buyer's ROI Criteria

The ROI criteria your buyer will use will depend upon returns from competitive investments in the marketplace and upon the perceived risk of investing in your business. If practically risk free (and hassle free). Municipals are paying a 10% coupon rate, which is equivalent to 17% pretax, then the

buyer is not going to capitalize your risky, hassle-prone business at 17%. Instead, the buyer will add an allowance for risk, hassle, illiquidity and the burden of management.

Currently, buyers for mid-sized manufacturing companies are targeting 30% to 40% ROI.

Leverage

Does this mean that if you have a company with cash flow of \$500,000 that it is worth only \$1,500,000 to \$1,250,000 ($500,000/30\% = 1,500,000$; $500,000/40\% = 1,250,000$)? No. It depends upon the structure of the transaction.

Remember the buyer calculates ROI cash return on cash invested. If the buyer structures the transaction with borrowed money (leverage), the leverage will allow the buyer to pay more and still achieve the required ROI criteria. The chart on page two shows the

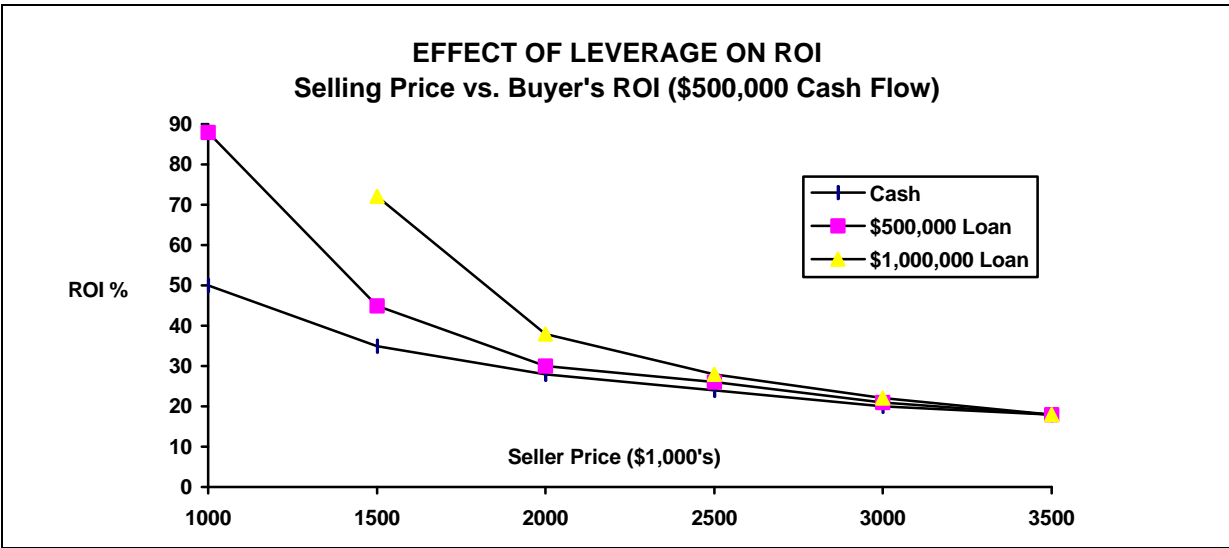
relationship of ROI to purchase price for a company with a forecasted cash flow of \$500,000. The curves represent an all cash case, a case where the buyer borrows \$0.5 million and a case where the buyer borrows \$1 million. Note that for a 30% ROI, the seller price is \$1.7 million for cash vs. \$2.3 million if the buyer borrows \$1,000,000. The buyer could borrow the entire amount from third parties; if so, you would get all cash at the close of the transaction.

Leverage only works when there is cash flow to service the debt and give the buyer an adequate return. Excess leverage could result in negative return on investment and, as such the buyer would not find it attractive to use.

Business Assets--the Effect on Sale Price

Up to now we have talked only about cash flow as the determinant to value of the business. Don't the business assets have any effect on sale price? Yes, they determine how much can be

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borrowed and therefore determine the leverage a buyer can achieve. And, as discussed above, the higher the leverage, the higher the sale price as long as there is cash to service the debt and give the buyer the ROI required.

Business assets also determine the liquidation value of the business. If your asset value is in excess of a price that a buyer will offer, then a partial or total asset liquidation should be studied as an alternative to selling the business.

Cash Flow

Most buyers rely on historical cash flow as a primary predictor of future cash flow. Even if your cash flow has been steady, any information that shows it likely to be higher in the future should be passed onto the potential buyer. (Like a well thought out business plan). It is a trait of buyers to be optimistic about the future. All buyers think that their management skills will substantially improve the selling company's performance.

The sell decision should be made based on the price an investor buyer is likely to pay you.

Synergistic Buyers

Sometimes buyers bring synergy to the transaction. (These buyers are synergistic buyers, in contrast to the investor buyer who merely relies in the return from the business to achieve the ROI criteria.) The synergistic buyer may be merging another business with your business with the result of a much more efficient business

in buying power, sales costs and operating costs. These synergies add cash flow to the buyer's ROI calculations. A stand alone business with \$500,000 cash flow may have an effective cash flow of \$800,000 or higher when the synergies are considered.

The synergistic buyer, with the same ROI criteria that the investor buyer has, can afford to pay more than the investor buyer.

How much more the synergistic buyer will pay is unknown until the synergistic situation is defined. If you know the synergistic buyer's ROI criteria, you can make a pretty good guess as to what the efficiencies might be, and therefore what price might be afforded. But, each synergistic buyer's efficiencies and economies are going to be different. Until you know a specific

synergistic buyer situation, you can't predict the price.

The best situation for the seller is to have two or more synergistic buyers vying for your business.

Value to Use in Making the Sell Decision

If you had perfect information about all the companies that have sold in your industry, you or your professional appraiser could come up with a comparable value for your business.

This comparable value would represent the average value, including both synergistic and investor buyer transactions; it would represent the value of your particular business, because you are not going to sell in an average buyer. You are going to sell to a particular investor buyer or a particular synergistic buyer.

If you take this average value to make your sell decision, you may be disappointed because the offer you get from an investor buyer is likely to be lower. And, if there are no synergistic buyers, you can look for only limited improvement through negotiations.

Since the sell decision represents a large commitment of time and money, the sell decision should be based on the price an investor buyer is likely to pay you. This is the lower limit of what your business is worth. You can hope for a premium, but don't make your sell decision based on hope.

Once you have decided to sell, you should work hard to locate synergistic buyers. You should use your (or your intermediary's) marketing and negotiating skills to assure that synergistic buyer pays the premium they can afford.

Again, "What's My Business Worth?" It's worth what an investor buyer will pay given the leverage that can be achieved with buyer's ROI criteria.

It's also worth a lot more if you can find two synergistic buyers and get them bidding against each other.

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