



October 31, 2016 | Financial Integrity, Selling a Business

UNDERSTANDING VALUATION VS. SALE PRICE

The first question a business owner looking to sell will bring to our team is, "What is my business worth?" Despite their desire for a cut and dry answer, the inevitable response is, "It depends." There are a lot of factors that go into determining a business's worth.

One important distinction through this process is understanding the difference between a traditional valuation and a price we can sell the business for. While they sound similar, they're actually light-years apart.

Traditional Valuation

Business owners occasionally seek out a traditional business valuation. Insurance coverage often needs a specific number to write out a policy, which lends itself well to following the standard business valuation formula. Professional firms or

CPA's run your business through one of the approved formulas for valuating a business. There are as many as four different formulas to choose from.

One common formula evaluates earnings before interest, taxes, depreciation and amortization (EBITDA). The valuation starts with the company net income and then adjusts for EBITDA to come up with a revised net income. Then there are often "owner add-backs" where the business has included expenses related to the owner that would not exist if the owner did not work in the company. Finally, there may be some "one-time" expenses or income in the financials that need to be adjusted for. These items might be a lawsuit, selling equipment, bad debt write off, insurance claim, etc. The final EBITDA is then multiplied by predetermined value to come up with a simple and clean value.

If it seems too simple for real life, you're right. While it may work well enough for an insurance agent to mark off a box, these formulas don't go very far in the market place. Unfortunately, many business owners seek out a traditional valuation to identify a potential sale price for their business. The large sticker value is appealing, which makes it easy to apply to their business when it comes time to sale.

The catch is that these figures are based upon a hypothetical buyer without taking market and business risks into consideration. A business is a complex entity that has many moving pieces. Professional valuations do not factor in risk, owner's value, market demands, financing availability and strategic acquisition, which are key components of a successful sale.

Sale Price

Rather than create a valuation for a hypothetical buyer, in order to successfully take a business to market you need to create a price for a real buyer. This starts by attributing value to a lot of the factors overlooked by your traditional valuation. Everything from the ability to renew a lease to market size to competency of the management team to how diversified client base is to business health and more get factored in.

For example, if you are in a hot market, there is a lot more potential for your business to expand. This makes your shop more valuable, which in turn adds to the sale price. A business in an over saturated, and possibly dwindling, market will be a lot less valuable to a potential buyer.

On the other side, if you have a brick and mortar business that attracts foot traffic, the lease is an important asset. A business that negotiated several options to renew for the new owner will be a lot more attractive to a prospective buyer than a business with a costly move on the horizon.

Don't forget to factor in the ability to get financing. In 2009, few buyers could get a loan from a bank. Market conditions play into your overall success as well.

The key takeaway is to understand the buyer's perspective. They are working to mitigate risk. Each of these countless factors weigh into the overall equation of how sound of an investment purchasing this business is. The more sound the investment, the more valuable it is to them. The more valuable the business is to them, the more they are willing to pay for it.

Identifying Your Buyer Type

Once crucial step in setting a sale price is pinpointing your ideal buyer. There are three different types of buyers for a business. Each will want different things from a business, which means we need to cater the business book to the ideal buyer. Additionally, the three buyers will value your business differently, which means a varying sale price based on buyer type.

First, you have a strategic buyer. This is an operational business owner looking to acquire an existing business to either grow their business, eliminate the competition or diversify their revenue streams. This type of buyer will pay the most for the business because it is the most valuable to them. Without the need to hire upper management and other support staff, including a CEO or an HR team, the buyer absorbs the new business into their existing business without additional overhead. All revenue is straight profit.

The second buyer is an individual looking to step in as CEO. In essence, they are purchasing a job. They will still need to support a lot of the overhead, including a lease, HR and accounting. Even though they will be able to keep all the profit, that overhead eats into the overall value of the business.

The third buyer is your financial buyer. Much like a real estate investor, they purchase businesses at a discount with the intent to “flip” and sell later. This often includes pairing with other discounted businesses they buy to create a larger, more lucrative business. This is the least profitable buyer as they will have to hire a CEO and possibly all the support staff to keep the business operational. In short, owning the business costs them more.

Discovering Your Business’s Value

Each and every business is different. At the end of the day, a cut and dry formula cannot truly encapsulate all the moving pieces you’ve built into your business over time.

If you’re looking to identify your business’s sale price and pinpoint your ideal buyer, [contact our team at Exit Consulting Group today](#). Together we can determine a price that a real life buyer would be willing to pay, as well as help you find that specific individual.