Valuation Overview

While there are a number of valuation methods, most small to mid-size businesses are valued using the income capitalization approach. This method assumes a business is valued at a multiple of the discretionary cash flow available to ownership. This cash flow is variously referred to as Seller Discretionary Earnings (SDE), Seller Discretionary Cash Flow (SDCF) or Owner Benefit (OB). We will use the acronym SDE in this overview.

SDE is determined by taking the business's net income before taxes and adding back all forms of owner's compensation, interest expense, depreciation and one-time, non-recurring expenses. The multiple is determined by examining data of actual sales of businesses comparable to the company being valued and computing from this data, a weighted average of the ratios of selling price to SDE for these comparable sales. Comparable sales are generally taken from industry subscription-based databases containing detailed information about sales of closely held businesses. These databases are searchable using a number of different criteria.

Following are the four steps we typically follow to arrive at an estimate of fair market value for a business.

Step One

First, we calculate the SDE. Our approach is generally to apply a weight to the current year's, and each of the two prior years' SDE and compute a three-year weighted average SDE. Higher weights are applied to the more current years.

Step Two

Next, from comparable databases, we select actual transfers of businesses (and active businesses for sale for reference purposes) similar to the company being valued. The following schedule represents an example of the results of a typical search. You will see that we apply a weight (WT) to each selected comparable and calculate a baseline weighted average multiple for all our selected comparables.

BUSINESS TYPE	ANN. REV	SDE	SOLD/ ACTIVE	SALE PRICE	P/SDE	WT
Typical Business	889,000	143,000	Sold	290,000	2.03	15%
Typical Business	2,265,000	351,000	Sold	1,200,000	3.41	15%
Typical Business	1,500,000	250,000	Sold	600,000	2.40	20%
Typical Business	977,000	150,000	Sold	450,000	3.00	20%
Typical Business	1,071,000	336,000	Active	990,000	2.94	10%
Typical Business	1010,000	415,000	Active	1,150,000	2.77	10%
Typical Business	2,367,000	1,242,045	Active	4,620,000	3.72	10%
Weighted Average					**2.85**	100%

Step Three

We then evaluate the weighted average multiple for any positive or negative issues that could affect the value of the business being valued when compared with our database selections. This is performed using a series of criteria that differentiate the quality of earnings of one company from another. We then adjust the baseline weighted average multiple accordingly.

Step Four

In Step Four, we apply the adjusted weighted average multiple determined in Step 3 (let’s assume it’s 2.95) against the company’s three-year weighted average SDE determined in Step 1 (let’s assume it’s $485,000) to arrive at an estimate of fair market value for the company of $1,430,750**,** which generally includes all furniture, fixtures, equipment, goodwill, contractual rights and intellectual property. Inventory may or may not be included in the valuation depending upon various circumstances.

In the vast majority of transactions involving small to mid-size businesses, the selling company retains all cash in bank and accounts receivable but also remains responsible for paying all outstanding liabilities as of the date of closing.