



Kent Holloway

How and When to Sell Your Business, Part IV

In the final part of this series, Kent Holloway illustrates four methods for calculating the value of your business.

Perhaps there are as many formulas for estimating a company's value as there are accountants. How do you determine a fair price for your business when one formula values your business at \$225,000, while another values the exact same numbers at \$150,000?

One mergers and acquisitions specialist at a big eight accounting firm states that he may use several of over 300 possible formulas to estimate the value of a company. However, most experts agree that all of the possible variations stem from three fundamental systems of analysis: "Asset-Based Valuation," "Earnings Capitalization Valuation" and "Market Comparable Valuation." A fourth common method, "Industry Ratio," is usually some rule of thumb that insiders use to make estimates of value.

Asset-Based Valuation

The Asset-Based Valuation approach assumes the value of a company can be determined by examining the resale value of the underlying assets of the business. If you were to value a wholesale specialty coffee business using this approach, you would list the accounts receivable, green coffee inventory, plant and roasting equipment, and assign a value to each.

The two variations to the approach are:

Replacement or Modified Book Value - This method attempts to determine what it would cost to replace each of the firm's assets or improvements. You would use the value of an asset as shown on the balance sheet and adjust this value to reflect any obvious differences between the historical cost of an asset and its current value. For example, the appreciation of real estate purchased as part of a drive-through business.

Liquidation Value - This method estimates the amount of money that could be received if a firm ended its operations and liquidated the individual assets. The Department of Revenue is famous for this type of forced sale. A buyer might value a company's assets solely on a conservative estimate of the liquidation value of the accounts receivables and inventories. This buyer is interested not so much in paying for the seller's "true value" as he is in acquiring the seller's product at a bargain price. This is considered a worst-case scenario for the seller.

A buyer may hire an accountant to help analyze the number the seller, presents. The accountant may wish to place a book value on the business and will have undoubtedly

read the traditional business valuation techniques taught to aspiring CPAs in business school, such as the following:

Replacement cost is only valid in a very scarce supply situation. Only then would old assets have nearly the value of new assets. Usually the book value is used. This is the original cost less a reasonable depreciation amount. However, you should recognize that marginally useful equipment, equipment that is not useful at all, obsolete inventory or other factors can further depreciate the book value of the asset. The value of intangible assets such as goodwill is negotiable. Usually in total they are priced at 10 to 20 percent of the value of the tangible assets, and almost always 50 percent of the tangible asset value. Don't forget to subtract liabilities in an asset appraisal method of determining price.

Source: William A. Cohen, *The Entrepreneur & Small Business Problem Solver*, 1983.

The problem with Replacement Valuation, Modified Book Value and Liquidation Value is that they fail to place a value on the current and future profits of the business (the book value of an asset was never intended to measure the firm's current value). While Asset-Based Valuation techniques typically place a conservative value on a company's future profits as a going concern, they may be useful in these three scenarios: **1.** A new business is being sold that does not yet show a profit. **2.** A business has been in operation for a long period of time and has never shown a profit. **3.** A business that was once profitable has demonstrated a steady decline in profits.

Earnings Capitalization Valuation (The "Cap" Rate Method)

Different procedures are used in capitalizing a company's earnings to find its value, but the underlying concept is the same. Determine "normalized earnings" and capitalize this amount at some rate of return, called the capitalization rate. Typically, this rate is determined by some rule of thumb based on conventional wisdom and the experience of the person doing the valuation. For instance, if you believe that "normal earnings after tax" for a company are \$40,000 and you use a five-year, 12.5 percent capitalization rate, you could value the firm's equity at \$225,000.

Future Earnings Capitalization is a system in which you estimate future profits over an agreed-upon period, such as five years. There are two essential questions to answer: 1. What earnings should you use? 2. How do you determine the appropriate capitalization rate?

A risk factor (discount based on the anticipated downside potential) is then calculated by comparison with the return for their known risks. The risk factor is divided into the average yearly pretax profits. Consult with your own CPA or valuation expert to determine an accurate "cap" rate.

This valuation method works fine in cash flow situations where the net profits are as predictable as an annuity (commercial rental property, for example). However, we know

that without the owner's careful oversight in an espresso bar, our \$40,000 net profit will turn into a loss virtually overnight. The result of this formula may be an advantageous, yet unrealistic, value to the seller.

Market Comparable Valuation

The Market Comparable Valuation approach uses the market prices of comparable specialty retail operations as the basis of valuing the equity of a given shop that is not publicly traded. After comparable sales of espresso bars are found (which is no easy task), the price-earnings ratios or the market-to-book-value ratios for these shops can be computed. These ratios are then applied to the earnings and equity book value of the store to be valued.

The reliability of this approach depends in part on the frequency of retailers selling their specialty coffee stores in the trading area of the shop being valued. Also, the sale being a clean transaction (not sold to a friend, family member or key employee at a discount). You must look at the market prices of similar companies and then subjectively adjust the price estimate given the uniqueness of the situation. Don't try to value your store based on what you heard Starbucks recently paid (per store) for a specialty coffee chain in the United Kingdom. Starbucks' buying power and reasons for purchasing that company has very little in common with your situation.

The Market Comparable approach can rarely be applied with total confidence. Even in the best of situations, you will probably have difficulty locating the recent sale of a shop that is significantly comparable to your retail operation. It is not enough to simply find another espresso bar that sold recently. You need to find a store that is in a similar type of location, has a comparable financial structure and similar sales, asset ratios and operating profit margins.

Valuation Worksheet

Let's look at an example. Assume the value of tangible assets of the business is \$150,000 and the annual profit forecast is \$40,000 on gross sales of \$300,000. To establish a similar business will take three years and you desire a 10 percent return on your investment (ROI). This means that in addition to your salary (\$38,000), your goal is to net at least \$15,000 per year, although you are forecasting \$40,000.

Step 1 Value the tangible assets. **\$150,000**

Step 2 Forecast annual profit. **\$40,000**

Step 3 Estimate how many years it will take to establish a new and similar business and develop it to a similar level of profitability. **Three years**

Step 4 Determine ROI (this return on investment can be either a return that you desire or a return that you can earn elsewhere). **10 percent**

Step 5 Multiply ROI by the value of tangible assets. **\$15,000** ($\$150,000 \times 10$ percent)

Step 6 Add the ROI amount above to your desired salary to derive the total pretax profit you expect. **\$53,000** ($\$15,000 + \$38,000$)

Step 7 Subtract this sum from the annual profit forecast and multiply this figure times the number of years necessary to achieve a similar profitability if you start a new business from scratch (this is the value of goodwill). **\$13,000** ($\$40,000 - \$53,000$). *If the number is less than zero, as in this case, use zero.*

Step 8 Add this goodwill value to the tangible assets figure calculated in the beginning. This final figure is the amount you should be willing to sell your business. **\$150,000** ($\$0 + \$150,000$)

Valuation Exercise

What if your net profit for the business goal is \$60,500 per year? Then, the business must gross \$1,000 per day (\$365,000 per year) and have net profits of 16.6 percent. Use \$60,500 as the forecast annual profit, \$365,000 as gross sales, \$35,000 as a salary, three years to duplicate, an ROI of 10 percent and tangible assets of \$175,000. Now, using the valuation worksheet, tell me how much your business is worth.

Industry Ratio Valuation

Previously, I discussed a real-life example of an operator selling five espresso bars for a specialty coffee Industry Ratio of two to three times annual net profits plus owner's compensation. In this case, if you use net profits $\times 3$ + owner's compensation, you arrive at a value of \$158,000 (net profits of $\$40,000 \times 3 = \$120,000 + \$38,000 = \$158,000$). The combination of the \$150,000 value calculated previously and the Industry Ratio value (\$158,000) averages out to a sale price of \$154,000.

Even the experts will disagree on what the "right" value should be for your company, but they are unanimous in their view that excellent accounting and profitability consistently brings a higher value. The more work you put into good accounting now, the clearer the picture will be of the true value of your shop and the safer the investment for the potential buyer. I strongly advise you to have an outside accounting firm that you respect and can afford to review your books at least every quarter.

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Please Note: Some pictures or diagrams are only available through the printed media.

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