



## What is Your Business Worth?

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In order to find out the current value of an investment portfolio, most people simply need to check the latest stock or mutual fund quotes, or peruse a monthly 401(k) statement.

For private business owners, however, determining the value of what is likely their most valuable investment is much more difficult. And while business owners have little need to track the value of their company on a daily or monthly basis, at some point an owner will need to know how much their asset is worth.

Because the value of a business is primarily based on what the market will bear, it helps business owners to look at their company from the perspective of a buyer. Instead of asking, "How much is my business worth?" ask yourself, "What will a highly interested, prospective buyer *actually pay* for my business?"

### **Private vs. public companies:**

In one sense, buying a company is similar to any other investment, so buyers will typically follow the same guidelines in looking at public stock, real estate, and similar investments. However, there are some key differences between investing in a public company and buying a private company.

**Risk:** All investors want an extraordinary return with no risk. However, the marketplace prevents that from happening, and forces investors to balance risks and rewards. Buying a privately held company is inherently a high-risk situation because the investment is almost totally illiquid and because there are so many intangibles and unknowns. By contrast, buying shares of stock in a large public company is a relatively low risk scenario because there is typically full disclosure of financial reports and total liquidity available. If things "head south", one can bail out immediately. Not so with a private company.

**Price/Earnings ratio:** The P/E ratios of public companies have no relevance to the prices paid for privately held companies. This is primarily because public stock P/E ratios are based on *after-tax* earnings, whereas private company transactions are based on a multiple of *pre-tax* earnings. A buyer of a privately owned company wants to get a very good return on his invested funds; therefore, his offer will be based on some multiple of projected future earnings. He will use his multiple and use his projections. Typically, he will use a low multiple. He has to, because his investment is utterly illiquid and because there is high risk.

**Book Value:** Balance sheet "book value" is of little significance in determining what a private company is worth unless there is the necessity of having to liquidate in the near

future. However, the balance sheet has considerable value in determining the amount a buyer can expect to borrow for the acquisition transaction. The “stronger” the balance sheet, the greater the leveragability -- and in turn the higher the earnings multiple a buyer will use for the valuation. Why? Because the more a buyer can safely borrow against the company’s assets, the less personal equity is needed to do the deal.

### **Business Valuation 101:**

Keeping these differences in mind, business owners can begin to evaluate their companies. The first step in valuation is to calculate the adjusted earnings of the business, or EBIT-DA. This amount is the pre-tax net income plus depreciation, interest, and extraordinary owner-related, non-operating expenses. The second step, and where business valuation becomes more art than science, is determining the appropriate multiple of earnings to use. The normal range of multiples paid for private companies is from three to seven times earnings. The three to seven multiple figures are probably equivalent to P/E ratios of five to twelve on the after-tax earnings on the stock of public companies. However, as stated previously, this isn’t really relevant because of the differences in liquidity. Why three to seven? It has to do with return on investment. If current earnings were totally stable and predictable, the three times EBIT-DA multiple, which translates to a 33.3% rate of return, would provide a highly satisfactory return for a buyer, even for an illiquid investment. The seven times multiple provides a 14.3% return, which is generally regarded as unsatisfactory for an illiquid investment.

A buyer’s willingness to pay seven times current earnings is based on the buyer’s belief that earnings will improve significantly in the near future. In contrast, a buyer’s unwillingness to pay more than three times earnings is based on his belief that earnings growth is highly suspect and that the company may even suffer after the acquisition, or worse, lead to liquidation at a big loss.

Determining the appropriate earnings multiple, and the appropriate sales and earnings projections, is complex because often the most important factors are the intangible assets of a company. The intangible assets that make one company worth more, and command a higher multiple, than other companies include the following:

- Strong growth in sales, earnings, and market share in recent years
- Strong industry growth trends
- Well-known and accepted consumer and trade brand names
- Excellent reputation with customers
- Exclusive franchise and/or territories
- Desirable customer list (and no reliance on one or two customers)
- Patented or proprietary products (vs. custom manufacturing)
- Strong R&D personnel and facilities
- Low cost of production relative to competitors
- Manufacturing “trade secrets”
- Modern and efficient plant
- Nonunion employees and low turnover
- Excellent key management personnel wanting to stay with company after the sale
- No environmental problems or concerns
- Strong, steady, and diverse supplier relationships
- Barriers to entry into marketplace for new competitors

Conversely, companies tending to lack such intangible assets realize a lower multiple.

### **How to Get Help:**

Determining the correct earnings multiple for a private company requires experience in the specific marketplace occupied by a company. A business owner can obtain a good estimate from a merger and acquisition specialist (a business broker, not an appraiser) who (1) spends 100% of his time in the marketplace selling companies, (2) has a track record of success, (3) has an impeccable reputation, (4) specializes in selling companies of similar size and type, (5) understands the industry, and (6) won't charge an appraisal fee. Highly professional business brokers know much more about what a specific company is really worth, because they are out on the firing line on a daily basis. With their market presence, they can be of great benefit in determining your company's market value.

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