

# How Much is my Business Worth??

This is a popular question posed to our office on frequent occasions. Knowing how much your business is worth is necessary for numerous reasons including:

- a sale to a potential buyer,
- buying out or admitting a partner,
- doing estate planning, including calculating the taxes your estate will owe on your death, and
- marital dissolution.

So how does one go about calculating how much a business is worth? How do you value goodwill? In order to address these questions, let's look at a fictional small business as presented in the financial summary below:

<u>John Doe Consulting - Balance Sheet</u>	
Assets	
Cash & Term Deposits	\$25,000
Accounts receivable	20,000
Equipment, at book value	45,000
<b>Total Assets</b>	<b><u>\$90,000</u></b>
Liabilities	
Accounts payable	\$25,000
Owner's Equity	
Capital	\$65,000
<b>Total Liabilities &amp; Owner's Equity</b>	<b><u>\$90,000</u></b>
<u>John Doe Consulting - Income Statement</u>	
Revenue	\$220,000
Interest Expense	40,000
Depreciation	20,000
Other Expenses	100,000
<b>Total Expenses</b>	<b>\$160,000</b>
<b>Net Income Before Tax</b>	<b><u>\$60,000</u></b>

The term "value" can have different meanings depending on how it is used. The "fair market value" of a business essentially refers to how much a business is worth in an arm's length sale to a knowledgeable buyer where neither seller or buyer are forced to act. The "book value" of a business refers to the carrying value of the assets on the financial statements after depreciation and other provisions are taken into consideration.

When we ask ourselves how much our business is worth, we are generally asking what is the fair market value of the business. A business can be sold for more or less than its fair market value. A premium is possible when a buyer comes along who wants to purchase the business because of special circumstances such as the elimination of competition or economies of scale. Similarly, a discount may be taken in circumstances such as illness where the owner has no choice but to sell quickly.

Calculating the fair market value of a business is both art and science, and involves the following qualitative and quantitative steps:

- 1) separate out investment type assets, which are not required by the business operations (called redundant assets) and their related income. These assets are typically valued separately from business assets,
- 2) determine the selling or liquidation values for each asset group including redundant assets,
- 3) review the income statement over the last few years for unusual and non-recurring items, as well as items subject to management discretion which do not reflect market or business conditions,
- 4) analyze the risk factors and future prospects associated with future profitability of the business in order to select an appropriate multiplier to capitalize profitability,

Possible Risk Considerations	
Proprietary Product Or Service	
Length Of Time Business Has Been Established	
Existence/Possibility Of Competition	
Profit And Revenue Growth History	
Impact Of Owner's Departure	
General Economic And Specific Industry Prospects	
Financial Condition Of Business	
Future Earnings Projections	

- 5) the goodwill of the business is calculated by deducting the value of the tangible net assets of the business from the capitalized value based on profitability,

Selecting An Appropriate Multiplier (Capitalization Rate)	
Rate Of Return On Government Bonds	5%
Anticipated Rate Of Return On Stock Market Investment	10%- 12%
Selling Prices Of Similar Businesses	3X normalized earnings before tax, depreciation and interest charges.

- 6) measure what portion of goodwill is transferable to a purchaser and is therefore saleable, as opposed to personal goodwill which is associated with the seller and is not easily transferable.

To better demonstrate the above points, we will value the John Doe Consulting Business.

In step 1, it is determined that of the \$25,000 cash and term deposits, only \$10,000 is actually required

by the business for working capital while the remainder of \$15,000 is really an investment not required by the business. In valuing the assets of the business for step 2, John determines that the equipment is actually worth \$50,000. All other assets are worth their book values.

Step 3, the review of the income statement of the business, reveals some unusual items that should be adjusted for business valuation purposes

- ◆ \$3,000 of the marketing and business promotion expenses are excessive,
- ◆ the employees require salary increases totaling \$10,000 per annum to reflect prevailing market conditions,
- ◆ John's remuneration package for himself, including expenses, is around \$15,000 higher than it would cost to replace him, and
- ◆ the annual rent on the premises will be increased by \$5,000 in 3 months time when the existing lease comes up for renewal.

John believes that other expenses are accurate. Since his consulting business embraces current technology and given his history of consistent revenue and profit growth, John thinks that business will continue to improve in the future. Therefore, the risk factors associated with continuing profitability are lower than that associated with other similar businesses which may not be as technologically advanced. John thus believes that a fair rate of return for invested capital in his business is 25%. By dividing this percentage into one (1), a capitalization rate of four (4) times is obtained.

We are now ready to calculate the goodwill of the business.

<u>Valuation of John Doe Consulting</u>	
Net Income before taxation, depreciation and interest charges per income statement (\$60,000 + \$20,000+ \$40,000)	\$120,000
Add back excessive marketing expenses	\$ 3,000
Deduct employee salary increases	(\$10,000)
Add back excessive management remuneration	\$ 15,000
Deduct rent increase	(\$ 5,000)
Adjusted Net Income before taxation, depreciation and interest charges	\$123,000
Multiplier	4x
Capitalized value	\$492,000
<u>Deduct Tangible Asset Backing</u>	
Owner's Equity, per balance sheet	\$ 80,000
Add equipment value gain	\$ 5,000
Deduct investment assets	(\$15,000)
Tangible Asset Backing	\$ 70,000
Goodwill of Business	\$422,000

The last step is determining how much of the goodwill is transferable to a potential purchaser. Service oriented businesses tend to have more personal goodwill than businesses that sell a product. Clients of service businesses not only look to the quality of the service, but also the comfort level in dealing with the person(s) providing the service.

Maximizing the transfer of goodwill of a service business normally requires that the vendor cooperate with the purchaser and remain with the business for a period of time after the sale. The purpose is twofold: firstly to reassure existing clients and thereby minimize attrition, and secondly to assist the purchaser in gaining the confidence of clients. Obviously, no knowledgeable purchaser will buy a business if the vendor is likely to compete against him. Thus, it is normal for purchasers to demand a so called "non-compete agreement." It is often difficult to determine client retention and attrition levels in advance. Thus the purchase may be based on an "earn out" formula whereby the ultimate purchase price is based on client retention levels achieved by the purchaser.

If the above steps are followed, John Doe may obtain the \$422,000 value for his goodwill from a prospective purchaser. However, if John intends to sell his business and immediately retire, he may be shocked at how little he gets for his goodwill.