Valuing Your Practice

“Valuation is a difficult and uncertain process. Valuation of a business is even more difficult, and the valuation of a professional practice, with its many intangible factors is more complex still.”

Business valuation is a mix of art and science. The bottom line is, of course, that a business is worth what a buyer will pay for it at a point in time. However, there are ways of estimating a fair price. Several of those methods are described in this section. There are variations of these and there are other methods that apply to specific situations. It is not uncommon to value a business by a number of different methods and use an average (or more likely a weighted average that gives more weight to some methods than to others) of the various methods used.

Valuation Methods

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Note that there are a number of reasons for valuing a business, other than buying or selling it. Businesses are valued for estate and tax purposes, divorce settlements, and for raising capital. In keeping with the purpose of this web site, all valuation discussion here will be limited to valuing for buying and selling.

Basic Method

The Basic or quick estimate is often used as a guide to the valuation of a small business. It is only a useful starting point as few buyers will pay 1 year’s earnings before proprietor’s drawings, interest, tax and depreciation (EBPITD). The type of business that will obtain this type of value in a sale will have a very real goodwill factor and are predominately businesses, which have good long-term contracts that are transferable to the new owner, or the business is a strong nationwide franchise where the demand is high for this product.

Basic Method:

\[
\text{Price of Business} = (\text{Plant & equipment} + 1 \text{ year's EBPITD}) + \text{Stock at Valuation (Cost)}
\]

For Example: Business “Ice Cream’s” which handles a national product and has an exclusive distributorship, produces $86,500 Net Profit (earnings before proprietor’s drawings, interest, tax and depreciation (EBPITD). The type of business that will obtain this type of value in a sale will have a very real goodwill factor and are predominately businesses, which have good long-term contracts that are transferable to the new owner, or the business is a strong nationwide franchise where the demand is high for this product.

Basic Method:

\[
\text{Price of Business} = \$86,500 + \$120,000 = \$206,500 \text{ plus S.A.V } \$45,000 = \text{total price } \$251,500
\]
Rule of Thumb Methods

One of the most common approaches to small business valuation is the use of industry rules of thumb. While most financial analysts cringe at the use of these approaches, they do have their place, to be as adjuncts to other methods.

A Lawn Mowing Business is worth X’s dollars to Y’s dollars per regular customer plus equipment at fair market value. Another says that small news agencies are worth 100% of one year’s gross income. The problem with these and all rule of thumb formulas is that they are statistically derived from the sale of many businesses of their type. That is, an organization might compile statistics on perhaps 100 small newsgagencies that were sold over a two-year period. They will then average all the selling prices and calculate that the average new agency sold for 100% of one year's gross income. The rule of thumb is thus created. However, some news agencies may have sold for twice one year's gross while other may have sold for half of one year's gross.

The rule of thumb averages may be accurate for those businesses whose performances are on par with the average. The business with expenses and profits that are right on target with industry averages may well sell for a price in line with the rule of thumb formula. Others will vary. To apply the rule of thumb to a business that varies significantly from the average is not appropriate.

Nevertheless, industry averages are a good quick and dirty starting point for valuation. Check with your industry associations) for rule of thumb formulas for selling or buying a business. Before taking the formula too seriously, though, check to see how closely your firm's financial performance stacks up to the industry averages. Sources to examine industry averages may also be available from your trade association's), business broker and accountant.

Capitalized Earning Approach

A common method of valuing a business is called the Capitalization of Earnings (or Capitalized Earnings) method. Capitalization refers to the return on investment that is expected by an investor. There are many variations in how this method is applied. However, the basic logic is the same. To demonstrate the capitalization method of valuation, let's look at a mythical and highly oversimplified business. Pretend the business is simply an amusement machine to which people put money. The magic amusement machine with a value of $120,000 has been collecting money at the rate of about $86,600 per year steadily for ten years with very little variation. It is likely to continue to collect money at this rate indefinitely. The only expense for this business is $100 per year rent charged by the landlord were it is located. So the business earns $86,500 per year ($86,600-$100). Because the amusement machine will continue to collect money indefinitely at the same rate and it's magical, it retains its full value. The buyer should be able to sell it at any time and get his initial investment back. A buyer would look at this "minimum risk" business earning $86,500 and compare it to other ways of investing his or her money to earn $86,500 per year. A near no risk investment like a savings account or Bank bill might pay about 4% to 8% a year. At the 8% rate, for someone to earn the same $86,500 per year that the magic amusement machine earns, an investment of $1,081,250 ($1,081,250*8%= $86,500) would be required. Therefore, the amusement machine business value is in the area of $1,081,250. It is an equivalent investment in terms of risk and return to the savings account or bank bill except in the real business world you are taking a risk and you do need to receive or pay a wage to operate the business. Now the real world of business has no magic amusement machine and no "no risk" situations. Business owners take risks and have expenses, and business equipment can break down and usually does depreciate in value. The higher the perceived risk, the higher the capitalization rate (percentage) that the buyer will use...
to estimate value. With the exception of accommodation business like caravan parks and motel capitalization rates of 15% to 25% are common for medium to large businesses while capitalization rates of 20% to 50% are common for a small business calculations. That is, buyers will look for a return on their investment of 10% to 50% (depending on risk) in buying a business after a suitable wage is deducted from the EBPITD. At the 20% (low risk) rate, for someone to earn the same $86,500 per year that the magic amusement machine earns, an investment of $432,500 ($432,500*20%= $86,500) would be required. Therefore, the amusement machine business value is in the area of $432,500. Finally, it is important to point out that the above example does not include a fair salary for the new business owner. If the owner must devote time working to realize a profit, he or she must, in theory, be paid a fair value for that work. The owner's fair and reasonable salary must be separated from the return on investment computations. For example, if the magic amusement machine produced $86,500 per year but required a manager with a fair market salary of $30,000, the income for valuation purposes is $56,500, not $86,500. The fair market value for salary is the important number to use, not the actual salary to the current owner. If a wage of $30,000 (fair salary not the owners drawings) is deducted to run this business we are left with:

**Capitalization Method:**

$86,500 Net Profit (earnings before proprietor’s drawings, interest, tax and $30,000 Wage depreciation (EBPITD)).

$56,500 divided by 20% = $282,500 being the business value.

**Excess Earning Method**

This method is similar to the capitalization method described above. The difference is that it splits off return on assets from other earning (the excess earnings). For example, let's suppose Mr. Owner runs a business that has amusement machines. His company has Tangible Assets (Plant & Equipment etc.) of $120,000. Further let's suppose that Mr Owner pays himself a very reasonable market value salary-- the same amount that he would have to pay a competent manager to do his job say $30,000 per annum. After paying the salary of $30,000 from his $86,500 net (EBPITD) Mr Owner's business has earnings of $56,500 net. The financially rational reason for owning business assets is to produce a financial return. Let's say that a reasonable return on Mr Owner's Tangible Assets is 15% per year. A reasonable number here should be based on industry averages for return on assets adjusted to current economic conditions. For example, Mr Owner or his advisors may have looked up industry standards for amusement machine shops and found that the current average return on assets was 14%. (An alternative approach to finding an industry appropriate return on asset figure is to use a rate 3 to 4 points above the current bank rate for a small business loan, or about 6 points above the current prime rate). So $18,000 of Mr. Owner's profits are derived from the tangible assets of the business ($120,000 x 15%= $18,000) the other $38,500 ($56,500-$18,000=$38,500) in earnings are the excess earnings. This $38,500 excess earning number is typically multiplied by a factor of 2 to 5, based on such factors as the level of risk involved in the business, the attractiveness of the business and the industry, competitiveness, and growth potential. The higher the factor used, the higher the estimate of the business will be. A typical number is 3. That is, a business that is judged to be very average in terms of the level of risk involved, the attractiveness of the business, the industry, competitiveness, and growth potential would use three as a multiplier. The actual factor used is a mix of opinion, comparison to others in the industry, and industry outlook.

Let's suppose that Mr. Owner's business is better than average in these factors and assign a multiplier of 4. Therefore, the value of this business can be determined as follows:
A. Fair market value of tangible equipment (plant & equipment)  
   Equals $120,000
B. Total Earnings  
   Equals $56,500
C. Earnings attributed to Tangible Assets ($120,000*15%)  
   Equals $18,000
D. Excess Earnings (B - C) ($56,500-$18,000=$38,500)  
   Equals $38,500
E. Value of excess earnings (D X multiplier) ($38,500 x 4)  
   Equals $154,000
F. Estimated Total Value (Tangible Assets plus value of excess earnings)  
   Equals $120,000 + $154,000 = $274,000 Being the Business Value

Cash Flow Method

Buyers often look at a business and evaluate it by determining how much of a loan the net profit will support. That is, they will look at the net profit (Earnings before proprietor’s drawings, interest, tax and depreciation (EBPITD) and subtract from this net profit an estimated annual amount for equipment replacement. They will also adjust the net profit by subtracting a fair salary or at least an acceptable salary for the new owner. The adjusted net profit number is used as a benchmark to measure the firm’s ability to service debt. If the adjusted cash flow is, for example, $100,000 and prevailing interest rates are 10%, and the buyer wants to amortize the loan over 5 years, the maximum a buyer is willing to pay for the firm would be about $253,000. This is the loan payment that $100,000 would support over 5 years.

Tangible Assets (Balance Sheet) Method

In some instances, a business is worth no more than the value of its tangible assets. This would be the case for some (not all) businesses that are losing money or paying the owner’s) less than fair market compensation. Selling such a business is often a matter of getting the best possible price for the equipment, inventory, and other assets of the business. It is generally best to approach other firms in the same business that would have direct use for such assets. Also, a company in the same business might be interested in taking over your facility. This would mean your leasehold improvements (modifications to space, etc.) would have value and the equipment would have value as “in place” plant and equipment. In place value is higher than the value on a piece-by-piece basis such as at a sale by auction.

Cost To Create Approach (Leapfrog Start Up)

Sometimes companies or individuals will purchase a company just to avoid the difficulties of starting from scratch. The buyer will calculate his or her start up needs in terms of dollars and time. Next he or she will look at your business and analyze what it has and what it may be missing relative to the buyer’s start up plan. The buyer will calculate value based on his or her projected costs to organize personnel, obtain leases, obtain fixed assets, and cost to develop intangibles such as licenses, copyrights, contracts, etc.)

Value of Specific Intangible Assets

This is an often-overlooked approach to valuation. Yet in some cases it is the only appropriate approach that will result in a sale. The approach is based upon the buyer’s buying a wanted
intangible asset versus creating it. Many times buying can be a cost efficient and time saving alternative, for example, a temporary employment agency. Suppose the agency specialized in placing trade’s people in coal mines and other industries. By approaching firms in the same or related businesses, it is calculated that recruiting a qualified worker cost at least $200 for an agency. The value to a buyer is the value of buying a qualified worker versus recruiting a worker through the more traditional method of advertising, interviewing, etc. This list of trade’s people is valuable and should sell for a price close to the $200 per worker. A common application of this method is the acquisition of a customer base. Customers with a high likelihood of being retained are valuable in most industries. Examples of industries where companies are bought and sold based upon the value of the customer base include insurance agencies, real-estate agencies (property management), advertising agencies, payroll services, and bookkeeping services. In practice the buyer will often ask for a credit for each customer that is not retained for a stated period of time. For example, a firm may offer $100 per customer, with a pro-rated credit for each customer that leaves during the twelve months following the closing of the sale. Pro-rating is based upon when the customer leaves-- if the customer leaves after 6 months, for example, half of the $100 would be returned to the seller.

Conclusion

There is no sure fire way to value a business for buying and selling purposes. The true value is the perceived value to a buyer who is ready, willing, and able to buy it. However, there are a number of approaches to estimate value; some of those are discussed above.
