BUSINESS VALUATION OVERVIEW

The value of a business is determined by using several methods. The process begins with the current fair market value of the "hard" assets of the business. The fair market value of the equipment, inventory, and real estate provides the lowest value for the business. This is the amount of money the buyer would have to spend if a new business of the same type were started and these assets were purchased. Both the buyer and the seller must realize that these are "used" assets which, in most instances, may be worth considerably less than new assets.

Once the "floor" or lowest value of the business has been determined, the financial history of the business is reviewed to determine if any goodwill or "blue sky" exits. If the business is more profitable than the average business of its type, the owner has done something to create these "excess" earnings and should be compensated for that extra effort. Information is published regularly regarding profit as it relates to sales and assets.

Another method commonly used is the capitalization of earnings at the rate of return required by the buyer. This capitalization of earnings yields a value for the business applicable to one individual buyer. Some buyers require only a return equal to the cost of borrowing (after owner's compensation) while some buyers require more.

A business valuation serves a variety of purposes. For the seller, it provides a range of values based on the assets and earnings of the business. For the buyer, it provides the amount that a specific buyer can afford to pay for the business. Each buyer will have a different amount of cash for down payment, different requirements for cash to be used for personal living expenses, and different ways to operate the business. Although a business might be "worth" $100,000, if the buyer cannot put together cash and cash flow for debt service equal to $100,000, that buyer must offer less for the business. If the buyer pays more for the business than the business can provide, the buyer will not be able to successfully operate that business in the long term.

The business valuation provides the basis for price negotiations. The seller knows the highest supportable price to expect. The buyer knows the highest amount that can be paid. The negotiation process can cover not only the purchase price for the business, but how it will be paid. If the buyer cannot put together cash and cash flow sufficient to pay the asking price, the purchase may be structured differently. For instance, if the buyer cannot purchase the equipment, inventory, and real estate, perhaps the seller will be interested in leasing the real estate with the option to purchase when the original bank loan has been paid. The seller may wish to carry part of the note, subordinated to the bank loan. This means that the seller may receive payments on the note only when the bank agrees that cash flow is sufficient to make bank and seller note payments.

If the valuation process or the negotiations result in a price in excess of the fair market values of the "hard" assets, that excess value is applied to goodwill. It is extremely important to look at the business, the buyer, the seller, and the current laws and/or regulations regarding the allocation of excess values.

The Small Business Development Center provides assistance as you determine the value of the business you wish to buy or sell. This differs from a business appraisal because we provide to the seller a range of values determined by using several different methods, and to the buyer, the amount that can be paid based on the down payment, financing, owner requirements, and how the buyer will operate the business. We do not provide a qualified appraisal of the business or real estate. However, the value determined as a result of your work with our assistance can be used as part of your offer and/or loan proposal. We strongly suggest that the valuation be accompanied by a business plan as we have found the business plan to be an ingredient of long term success for businesses.

In addition to the information requested on the Business Valuation Documents Request Datasheet, a buyer should provide:

1. The amount of cash available for a down payment.
2. The amount of cash required for personal living expenses.
3. The most current personal income tax return.
4. Any changes in the operation of the business that the buyer will make and the dollar amount of those changes.