Chapter 16: Typical Scenarios Used in Valuing Small Businesses

This chapter discusses the most typical scenarios and problems, which arise when valuing small businesses.

Valuing a Business with Price to Sales Multiples (Actual Transactions)

Many people use price to sales ratios (gross annual sales or revenue, times some multiple) since everyone understands and generally agrees about top line numbers (sales), but not everyone agrees about expenses and bottom line numbers (net income). As a result, people will often look at revenues in order to get a rough idea of the worth of the business. This “price to sales” technique is more relied upon when there is significant “skim” in the business. By skim we mean not reporting income for tax purposes.

Table 16-1: Calculation of Price to Sales Multiples

Item (Restaurant Business)	20X1
Gross Sales	$850,000
Times: Price to Sales Multiple	0.35
Value of Business (before adjusting for working capital)	297,500
Plus: Current Assets	53,000
Less: Current Liabilities	(25,000)
Value of Business (including working capital position)	$325,500

This valuation method tends to be less reliable than a multiple of EBITDA[1] or ODCF[2], since expenses are not taken into consideration in multiples of sales. For example, if the real estate lease is an unfavorable lease, then the value of the

1. EBITDA - Earnings before Interest, Taxes, Depreciation and Amortization
2. ODCF - Owners discretionary cash flow. This is essentially all the pre-tax cash that the owner can take home and utilize.

business will be less or significantly less than what this valuation multiple will indicate.

Take note that when using sales multiples it is common to adjust for working capital positions. The reason for adjusting is that most actual sales for comparables are calculated and published net of the working capital position. As seen in Table 16-1 on page 403, the working capital position needs to be adjusted in order to arrive at the final concluded value of $325,500.

Valuing a Business with Owners' Discretionary Cash Flow Multiples (Actual Transactions)

Most people use multiples of discretionary cash flow multiples as a basis to calculate value. The primary value associated with ODCF figures is that it represents "bottom line" earnings that go to owners. Sales multiples do not always reflect an enterprise's profitability.

Table 16-2: Calculation of Value Based upon ODCF

Item	**20X1**
ODCF	$97,000
Times: ODCF Multiple	2.3
Value of Business (before adjusting for working capital)	223,100
Plus: Current Assets	53,000
Less: Current Liabilities	(25,000)
Value of Business (including working capital)	$251,100

Once again, there needs to be an adjustment for the working capital position because most actual sales comparables of similar businesses calculate their multiples independent of the working capital position. As a result, this working capital position needed to be accounted for in order to obtain the final concluded value of $251,100. Please see "Business Owner has Excess/(Shortfall) Working Capital" on page 417 for more discussion on differences in a company's working capital position.

Valuing a Business with Publicly Traded Comparables

Most small businesses should not use publicly traded comparables, since their size is not comparable. However, in some cases these are the only representative indicators of value for a business in a particular industry.

Financial information regarding comparable publicly traded companies can be gathered from the *Edgar* database and Yahoo Key Statistics on the internet.