ANNEAL
BUSINESS COACHING

How to Think Like Business Buyers

THE VALUE OF A BUSINESS IS WHAT A WILLING BUYER AND SELLER AGREE IT TO BE

HOW TO THINK LIKE BUSINESS BUYERS

The value (price, if we're selling) of a business is what a willing buyer and seller agree it to be. However, assuming both parties are informed and rational, the value of most small businesses is calculated by multiplying annual profit times a "multiple." The multiple is a number that reflects buyer confidence and often falls between one and seven. So, for example, a business with annual profit of $100,000 at a multiple of two would be worth $200,000.

FUTURE PROFIT IS THE BUYER'S RETURN ON INVESTMENT

The price buyers pay for a business is their investment.

The future profit from the business is their return on investment.

Buyers are very interested in the return on their investment, and will adjust their valuations to match their expectations. For that reason they spend a great deal of time trying to understand the true profit potential of a business they're interested in buying.

PROFIT IS CALCULATED DIFFERENTLY FOR BUSINESS VALUATION

When most of us think of profit, we think of the difference between sales and expenses that appears as the bottom line of an income statement. That's the conventional definition, but profit is calculated differently for use in business valuation.

BUT WHY?

Because conventional profit may not be a good measure of the true earning capacity of a business. In order to get a clear picture, buyers adjust conventional profit to estimate the profit potential of the business independent of the current owner, tax rules and special circumstances.

You're may be thinking: "Yada, yada, yada. Why should we care about such abstract concepts?"

Because buyers care. We may get top dollar for our businesses just by asking, but the chances are we won't. Understanding how buyers think gives us the best shot at the best price.

EXPERIENCED BUSINESS BUYERS ESTIMATE TRUE PROFIT POTENTIAL BY:

1.) Calculating EBITDA profit for the business

2.) Increasing EBITDA by adding back certain expenses

3.) Decreasing EBITDA by deducting certain revenue or savings

EBITDA

We won't get far talking valuation before hearing the word EBITDA, an acronym that stands for **Earnings Before Interest, Taxes, Depreciation, and Amortization.**

The word "Earnings" in EBITDA is just another name for profit, so EBITDA is what conventional profit would have been had a business not subtracted interest, taxes, depreciation and amortization expenses on its income statement.

To calculate EBITDA, we begin with our conventional profit and "add back" interest, tax, depreciation and amortization expenses, or, better yet, we have our accountant do it for us. EBITDA will almost always be higher than conventional profit, sometimes a lot higher.

EBITDA is a useful number because interest, taxes, depreciation and amortization expenses - therefore profit - can vary widely for the same business depending on who owns it.

INTEREST AND TAXES DEPEND ON THE OWNER

The amounts of interest and tax expense incurred by a business directly affect profit, but depend heavily on the decisions and position of a particular owner.

INTEREST

A cash-poor owner may borrow heavily and incur significant interest expense to fund the business. A cash-rich owner may not need to borrow money or incur any interest expense to fund the same business. Cash-poor or cash-rich, interest, no interest or combinations of those factors depend on the owner, not the business.

TAXES

The "T" for taxes in EBITDA refers to state and federal income taxes, not to sales tax, property taxes or other taxes a business might encounter. Income taxes, like interest, are added back because the amount of taxes paid depends heavily on current tax law, the owner's tax position and choice of corporate structure, none of which can be blamed on the business itself. Sales taxes, property taxes and other possible taxes are the same no matter who owns the business and are not added back to EBITDA.

Be aware that income taxes are not always deductions on income statements. Don't be surprised if there is no income tax expense on your business income statement, even though you paid taxes.

NON-CASH EXPENSES

Depreciation and amortization expenses are added back not only because they depend on owner's choices, but also because they are "non-cash" expenses.

DEPRECIATION

Depreciation is an expense, a "write-off", that is allowed by tax authorities to acknowledge that tangible assets such as buildings, trucks and equipment wear out or become obsolete. Businesses don't actually pay depreciation as they would a utility bill, but they are allowed to deduct depreciation expense as if they did.

The amount of depreciation expense deducted depends on tax rules and owners' choices, but seldom matches reality. Assets are usually written off either much faster or much more slowly than they really wear out or become obsolete. Therefore depreciation is simply an accounting entry – a non-cash expense - that does not reflect the true cost of wear or obsolescence and distorts the true earning capacity of a business.

AMORTIZATION

Amortization is depreciation for intangible assets. Intangible assets are things a business owns that we can't touch, things like patent rights, good-will, or franchise rights. Our businesses may not have intangible assets, but many do. Amortization, like depreciation, is an accounting entry and a non-cash expense.

OTHER ADD-BACKS

Interest, taxes, depreciation and amortization add-backs are well understood, so we shouldn't expect resistance making the adjustments.

Possibilities include unusual or one-time expenses that are not likely to repeat, or expenses due to the current owner that are really an owner benefit. These adjustments are subject to negotiations, which might go something like this:

Seller: “I paid myself a $200,000 annual salary. I’m leaving, so you won’t have that expense. Let’s add-back my salary to profit!”

Buyer: “Not so fast. I have to pay someone to replace you, so no, no add-back.”

Seller: “But you can easily replace me with someone for $75,000.”

Buyer: “So you say…”

OR

Seller: “And… we need to adjust last year’s travel expense. We made three “business” trips to Europe (wink, wink) and held our annual Board meeting in Bali. Staying here would have reduced travel expenses by $45,000 which would increase last year’s profit by the same amount…. There are also the expenses for the company Escalade I drive, the life insurance the business pays for me and the…”

We get the idea. Sellers make the case to add back expenses to increase profit, buyers resist. Every negotiation is different, so we can’t anticipate specifically how to win each one except say plan for a sale and eliminate such expenses in fact rather than in negotiations.

WOO HOO! GOOD FOR US

Woo Hoo!" we're thinking, "good for us. We like adjustments!" But hold on, there's a flip-side to the coin. Up to this point, we've been doing a lot of adding-back which has all worked in our favor. But we can't expect a buyer to just sit there and take it. Buyers will look for certain types of "deductions" to subtract from profit and lower the valuation. These deductions, like add-backs are subject to negotiations, which might go like this:

Buyer: "You owned your building and didn't pay rent. I'm going to adjust profit down to reflect rent expense."

Seller: "But I'm selling you the building. You won't have rent either."

Buyer: "True, but I'll have interest on the mortgage."

Seller: "It's not my fault you have to borrow to buy the building... "

OR

Buyer: "A big chunk of last year's profit came from that one sale to your brother-in-law. That's not likely to happen again, so I'm going to reduce profit by..."

Seller: "True, but we have three big sales in the pipeline, all ready to go..."

Buyers will continue to make their case by arguing, for example, that our stated profit is too high because we neglected maintenance, or didn't replace obsolete equipment, or reduced our marketing budget to inflate profits and so on.

HOLD ON A MINUTE

"Hold on a minute," you're thinking. "I've looked at my profit and likely adjustments, and even if I win all the negotiations, my business is worth a lot more than two or three times adjusted annual profit. Heck, my building alone is worth way more than that, not to mention my cash, inventory and accounts receivable." Excellent point. We better define what we're valuing when we value "the business."

A BUSINESS IS LIKE A TRUCK

Think of a business as a truck. A truck earns profit by hauling freight, just as a business does by doing whatever it does. We all recognize that the value of the truck doesn't include the parking lot, future operating costs, the cargo on board, or money due for freight hauled in the past. The same is true of a business. The value of a business as determined by the profit times a multiple formula doesn't include real estate, cash, inventory or accounts receivable.

If owners also sell their real estate, accounts receivable, and inventory, those values would be added to the value of the business to determine the total price of the transaction.

WOO HOO! GOOD FOR US AGAIN

"Woo Hoo! Good for us again! Add-backs and now add-ons?" Yes, but let's use the truck analogy to look at one more thing. Debt. Truck buyers expect to receive free and clear title, unencumbered by the debt of the seller. The same is true of a business. If we still have business related debt, that's on us. It won't affect the price a buyer pays, but it will affect our net proceeds because sellers keep their debt.

BACK TO THE BEGINNING

In the first sentence above, we said that the value of a business is what a willing buyer and seller agree it to be, and that's true. None of the methods and conventions we discussed above are law. They do, however, provide insight into how experienced business buyers think, and by understanding buyers, we have the best shot at getting the best price for our businesses. To think like a business buyer:

1. Calculate EBITDA profit
2. Increase EBITDA by negotiated add-backs
3. Protect EBITDA by limiting negotiated deductions
4. Work diligently to increase the multiple
5. Add cash, accounts receivable, inventory and real estate to the value of the business (and to the price if the buyer is acquiring them too)
6. Anticipate that we, not the buyer, will have to pay debt, so subtract the debt from the value (not the price) of the business
7. Ask for more. You might get it!

How about you? Have you ever wondered what your business is worth? Do you know your EBITDA profit? Are you ready to negotiate with a buyer? Are you writing off a lot of questionable expenses in order to save money on taxes?

If you have any further questions, please don't hesitate to mail me at Martin@annealbc.com or visit www.annealbc.com

Martin Holland

Martin Holland is the son of a successful entrepreneur. He grew up hearing about margins and markets, R&D and sales, risk and return on investment. He learned to love the language and rigors of business and grew to believe that business is both the most human of all endeavors and the highest calling. After selling a company in 2011, Martin became a coach in order to help other owners build profitable businesses that do not require their day-to-day involvement.

A native of Norman, Martin earned a B.A. degree from Hastings College in Hastings, Nebraska and a Masters in Business Administration degree from the University of Oklahoma. Over the past 7 years he has written business plans that have raised over $52.4 million in bank and investor financing. He has helped 157 (and counting) business owners reduce stress and increase performance through clarity of purpose, better marriages, more money, and more free time away from the business.