EDUCATION SERIES
VALUATION PROCESS

Businessbuyorsell.ca

Every company is unique, and every valuation is unique

We generally start with financial statements and financial reporting

Most buyers are primarily interested in the numbers, the more confident they are in the numbers, the better.

At least 3 years' financial reports (income statement and balance sheet) are essential, 5 or 7 years ideal.

The financials are put in a spreadsheet with the various line items placed across a single row to identify trends.

Once everything has been identified and trends understood the statements are adjusted to smooth out unusual changes, missing items or line items not directly related to running the business (autos are a common one for small businesses).

Business owners who know their statements well and answer all questions create confidence in the statements.

With selected items added back or deducted we have a derivative of net income known as Seller Discretionary Earnings (SDE). The idea of SDE is to derive an estimate of normalized residual operating cash flow to the owner.

We then look at the trends in SDE and develop an average SDE over a selected period. The more periods, the more reliable it should be.

As most small businesses sell on a multiple of SDE we perform attribute analysis to determine the right multiple to use. We usually start at 3.0X and adjust up or down. See next 2 pages for more on attribute analysis.

With this analysis done we have a potential range of values and move on the actual pricing of the business. Not every business should have a price determined, a topic we will discuss in another document.

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Attributes of the business that justify a higher multiple within the range:

- A consistent historical record of growth and profitability
- 10+ years in business
- Substantial hard asset value
- Owner retirement
- Business operates independent of owner
- Stable management team in place
- Long-term quality employees and customers
- A broad diverse customer base
- Apparent competitive advantages
- Proprietary or exclusive products
- Financial statements prepared by reputable accountant
- Up to date assets and premises in superior condition
- Highly favorable lease terms or ownership of real property
- Desirable location
- A high demand enterprise
- Favorable seller financing
- Easy to understand motivation for selling
- Sales contracts in place
- Trademarks and documented intellectual property
- Asset sale

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Attributes of the businesses that justify a lower multiple within the range:

- An inconsistent record of historical profitability
- Less than 3 years in business
- Little if any hard asset value
- Owner critical to operations, professional practices, or consulting
- Substantial involvement of family or partners in operations
- Few employees or a high employee turnover
- Small customer base
- A few customers accounting for substantial percentage of revenue
- No apparent barrier for completion to enter the business
- No clear opportunity for growth and/or improvement in operations
- Financial records derived from in house system
- Out dated assets in need of replacement or heavy maintenance
- Obvious deferred maintenance or capital reinvestment
- Premises in disarray and/or unsuitable for operations
- Unfavorable terms on leases
- Undesirable location
- Business in high failure segment (retail, bar, restaurant, or personal services)
- Unfavorable terms owner unwilling to finance, all cash required
- Questionable rationale for sale
- Share sale

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