The Future of Your Business

To Sell Your Business, You First Have to Determine Its True Worth

By Frank M. Butrick

The first three articles in this series examined the most popular of long-term options for a business. There are many reasons why a business owner would want to know the fair-market value of his construction business. Most obvious, perhaps, would be if he had no successor and was approaching retirement age. The thought of selling out is automatic, and wondering about a price naturally follows. Another reason grows from estate planning: You cannot plan rationally unless you know the value of the estate and the consequent estate-tax liability. Perhaps you are toying with a buy-sell agreement between stockholders, or a key employee wants to buy in, or a stockholder wants to sell out. Or perhaps you look at your construction business, take pride in your accomplishment, and merely wonder the value of what you have built.

Whatever the reason, when you begin to put a price on a privately-owned business, you have entered a frustrating arena: There are too many formulas—and none of them yield the “right” answer, because the price a buyer will pay depends upon four things: The ‘formula’ value of the business, how badly the buyer wants to buy, how badly the seller wants to sell, and the ‘horse-trading’ abilities of each. Nobody can reduce these four to a formula, so everybody concentrates on the first and leaves the other three to chance and the future. But even when we concentrate on the formula, we find it is a form of roulette. All we have to do is pick the right number or, in this case, formula. There are six methods in wide usage: Price-earnings ratio, book value, appraisal of assets, comparable other businesses sold, return on investment, and replacement value.

METHOD I - Price-Earnings Ratio Valuation

This approach is favored by sophisticated buyers, brokers, and acquisition consultants like myself because the statistical projections yield future earnings and cash-flow analysis which is part of calculating a value. Nonetheless, nobody knows what the future will bring; most projections lean heavily upon inflation (just sit there, change nothing, and your sales volume—and profits will be 10% higher next year, courtesy of the boys in Washington). A rapidly growing contractor will be expected to taper off and a slowly growing business will be expected to catch up—which at least is based upon common sense and gives the statisticians a feel that logic is on their side.

To start, take the last five of your year-end financial statements. On an analysis sheet, put down for each year:

1. Net sales volume (after returns, discounts, adjustments, etc.).
2. Cost of sales (material purchased for resale plus direct labor and subcontracted work).
3. Subtract the cost of sales from net sales to get the gross profit.

Now we slice the apple a different way. Calculate gross profit as a percentage of sales volume for each of the previous three years, year to year, and the average of the four rates of change for each one. That is, if sales increased by 17% from 1974 to 1975; 11%, 1975-76; 21%, 1976-77; and 14%, 1977-78, the average rate of change is 15.75%. Using 10% for average inflation, divide 15.75 less 10 by 10 to yield 0.575% per year. This is a future growth ‘decay rate’ which a buyer would assume over the next decade. That is, he would expect your growth for 1978-79 to be 15.75 -0.575= 15.175%; 1979-80 at 15.175 -0.575 = 14.6%, etc. Apply the same technique to forecast your cost of sales and gross profit.

Now we slice the apple a different way. Calculate gross profit as a percentage of sales volume for each previous year. Discard the highest and lowest value and average the other three. Now apply this GP percentage to the sales volume forecast for each of the next five years. This will give you a somewhat different GP projection than just performed. Now sit back and study the two sets of numbers and determine where the truth may lie. Generally it will be somewhere between the two, although you may feel that your GP

Editor’s Note: This is the fourth part of a series of articles on management succession by Frank M. Butrick, national renowned small business management consultant and speaker.)
will increase with volume because of greater labor efficiency, larger-volume purchases, etc. This is probably hope rather than fact, and remember that a buyer will be less optimistic than you (and the IRS more optimistic). Develop projected numbers which suit your purpose.

Now take each individual item on your P&L and determine the percent of sales volume (or GP or both) of each one for each year. Come up with percentage numbers which appear reasonable (not all costs increase linearly with sales volume; some are even fixed) and use them to complete the five-year forecast. However, as you go, set aside two items for special handling (your salary and asset depreciation), and do adjust each number to eliminate entrepreneurial games (Uncle Joe buying gas for his car with a company credit card, your own vacation/business trips, and suits of armor your business buys, etc.). Your salary and fringes require particular thought. If you stay at a high salary you penalize yourself through taxation—your salary is ordinary income and it reduces the future profit projections and asking price. A greatly reduced salary shifts more money into the asking price, which will be taxable at the lower capital-gains rate. In any case, the buyer will also have to take out a salary for himself or for a hired general manager. Think this over carefully, then project accordingly.

Asset depreciation deserves even more careful thought. If you sell the stock of your corporation (or your construction business is a proprietorship) the buyer buys your financial books. That is, he takes over and the numbers do not change; a $10,000 truck depreciated to $1,500 goes into his books as $1,500. And if the buyer pays more for the business than the total of all assets less all liabilities (which is called net worth or 'book value') then the difference goes into his books as Goodwill, which is very difficult to write-off (it can be done, but it takes doing). Therefore, the wise buyer will probably want to buy only your assets and liabilities. He can assign current fair market to each asset and set them up for a new depreciation schedule, thus obtaining valuable income-tax shielding. Since you cannot know the buyer’s desire, set depreciation aside for the moment.

The end result of GP less expenses is the net profit before taxes, projected for the next five years. Now the plot thickens. First, deduct your normal depreciation for the next five years. This gives a taxable profit; deduct income taxes to get after-tax profits. Add them for the five years. This is one possible value of your business, subject to adjustments we will come to in a minute. Add the after-tax profits for the previous five years; this is another. Now calculate the fair-market value of all your assets and project five years depreciation on this stepped-up basis and the resulting after-tax profits. As you can see, the higher depreciation yields a lower after-tax profit but substantial cash flow. So now we need a cash-flow projection. Take the 1978 year-end after-tax profit, add next year’s sales less all expenses to get 1979 year-end cash. Then subtract the 1979 stepped-up depreciation from the ‘79 profit, get the taxable profit, and calculate the taxes. Deduct the taxes from the total cash and carry the after-tax cash to 1980 and so on for the five-year period. The end result, after five years, is a build up of cash, because of high tax shielding. Subtract the starting 1978 year-end profit and put the remainder aside as another possible price, subject to adjustment.

Now take the three prices—previous five years, projected five years using your books, and projected five years cash flow with stepped-up depreciation. Now we play with numbers. To the previous five years’ after-tax profit, add in the amount by which your salary exceeded a reasonable one for a hired manager. Also add in (if you dare, with the IRS looking over your shoulder) the value of your fringes. To all three, add the current value of any unusual assets—abnormally high inventory of good saleable construction materials, unusually new equipment, a build up of cash, etc. Subtract an adjustment for slow-moving or dead inventory; an allowance for old, worn-out equipment; bad debts, slow A/R, etc. The end result is three reasonable prices for your business. Each one is different, but each one is reasonable, and each is from a projection of earnings, using a 5X price-earnings ratio. A 6X ratio means bumping
each version by 20%. Most business are sold for between 5 and 6 times projected earnings.

**METHOD 2 - Book Value**

This is your total assets less liabilities, and is often considered a sales price. Forget it. It is more a function of age of the business than anything else; its only relationship to a reasonable price is purely coincidental.

**METHOD 3 - Appraisal of Assets**

In this version, calculate your bail out value—collect your A/R, pay all debts, sell the assets, and see what is left. Figure it two ways: A distressed, fast collection of A/R and an auction-block value for the fixed assets. Then also figure for a careful, orderly liquidation, getting top value for everything. This gives you two more reasonable prices for your business, but these are rock bottom. There is obviously no point in selling out for less than liquidation value.

**METHOD 4 - Comparison with Other Firms**

This is difficult to use because it is nearly impossible to find other businesses like yours which have been sold, get honest answers from both buyer and seller, and then adjust for the endless combinations of cash, stock, notes, terms, etc. If your construction firm is extremely large, you may have a better chance, but the process really works only for publicly-owned corporations.

**METHOD 5 - Return-on-Investment**

This method is favored by accountants and brokers because it is quick and easy and gives a reasonable number which is often acceptable to inexperienced buyers and sellers (and how can a seller be anything other than inexperienced—how many businesses does the average businessman sell? Ditto for buyers). Take the higher of the two liquidation values determined above in Method 3. Now calculate what that amount of money could earn (before taxes) in a good investment (how good is a question which will give you a range of perhaps 6 to 12%). Then put down a reasonable salary for a potential buyer if he did not buy your business, but just kept his job (this gives you a range of maybe $20,000 to $50,000). Take the average before-tax profit for the previous five years. (Also take averages from your two projections for the coming five years, if you want a really endless array of answers). Now add the earnings from the value of your assets in an investment to the guessed amount of a buyer’s salary if he stayed where he was, and subtract this total from your average before-tax profits. The numbers will encompass a range, from high to negative. Add this range to the value of the assets and you have another price—or range of prices.

**METHOD 6 - Replacement Value**

One last method: What would a buyer have invested if he started an equivalent construction business, buying used equipment like yours, bypassing some of your mistakes, and starting with enough capital to get to your size in, say, about two years? This generally is the top dollar a buyer will pay; a ceiling on the value of your business.

By now you are awash in numbers, no two alike. List them in order, high to low. Discard the top and bottom quarters and assume that a reasonable fair-market value for your business lies somewhere among the remaining ones. But remember, the price you will actually get depends upon a number of other human values:

The more a buyer wants to buy, the more he will pay.

The more a seller wants to sell, the less he will get.

The better ‘horse trader’ always ends up ahead.

A long-term sale will yield up to two or even three times as much as a cash sale.

Which leads us to the next article: How to find a buyer and close a cash sale, followed by how to arrange the term sale.