



Market Method for Valuing Small Businesses

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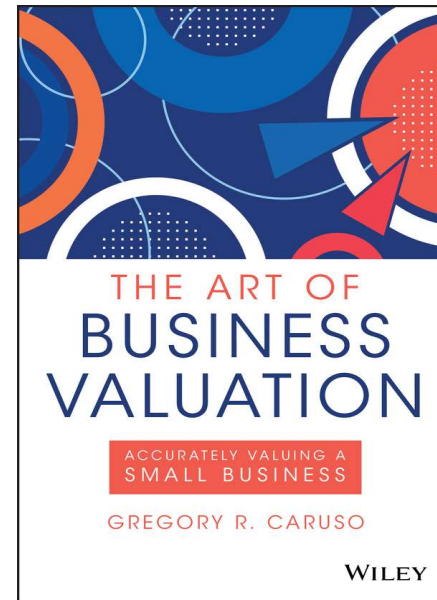
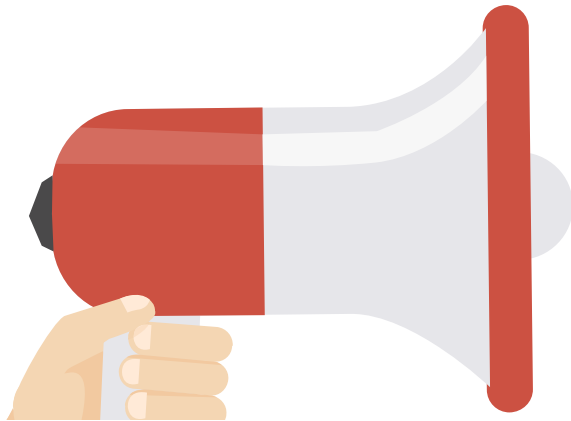
- Managing Partner, Harvest Business, LLC, Business Valuators
- *Author, "The Art of Business Valuation, Accurately Valuing a Small Business" Wiley 2020*
- *Editor, "Around the Valuation World, NACVA, from January 2016 to June, 2021"*
- *100's and 100's of business valuations – all types of businesses and valuation purposes*
- *Present and publish on valuation with BVR, NACVA, CPA Academy, etc. (One of NACVA's Instructors of Year)*
- *Lead broker in over 65 transactions.*
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Valuing Micro and Small Businesses is Different

This Book explains
how to do it right!



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Its an uncertain world, so

Disclaimer:

This set of slides and the related PDF worksheets are solely my opinions.

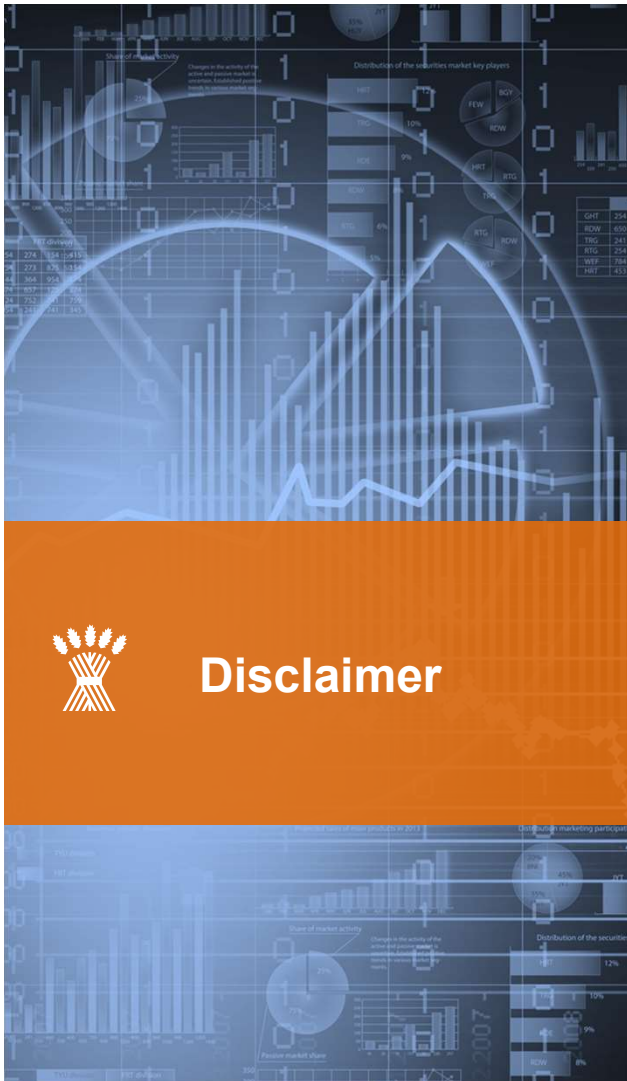
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In every instance, small changes to facts or assumptions may completely change methodologies used and outcomes estimated. Business valuation requires a high level of professional judgement and often more than one methodology and result may be reasonable.

As my father said, “I would rather be approximately right, rather than completely wrong.” Or as I say, ask yourself, “Does this makes sense?” If not, keep working until it does.

THIS PRESENTATION IS INTENDED PRIMARILY FOR VALUING COMPANIES WITH UNDER \$10 MILLION OF REVENUES.

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Why are these results so far apart?

Example			
Auto Repair - Nice Company		75th Percentile	
Method	Cash Flow	Multiplier	Value Found
Market - Revenue	\$1,040,000	0.53	\$551,200
Market - SDE Cash Flow	\$243,600	3.1	\$755,160
Variance			\$203,960

36% variance – I have seen much worse.
Particularly high revenue low profit Co.'s

Today I will show you a solution to this
“ISSUE”.



The “ISSUE AT HAND”

How do we justify our Specific Company Premium?

COE Capitalization Rate

Cost of equity

Risk-free Rate of Return	1.8%	
Common Stock Equity Risk Premium	7.3%	
Small Stock Risk Premium	5.0%	
Plus/Minus Industry Risk Premium	0.0%	
Company Specific Premium	6.5%	
Total Cost of Equity		<u>20.6%</u>
Less Sustainable Growth		<u>3.0%</u>
Next Year Capitalization Rate		<u>17.6%</u>
Current Year Capitalization Rate		<u>17.0%</u>
Selected Capitalization Rate		<u><u>17.0%</u></u>



The “ISSUE AT HAND”

“Professional Judgment” - You mean – “Because I know!!!”

- How well does that work with your children?

Market Method for Valuing Small Businesses

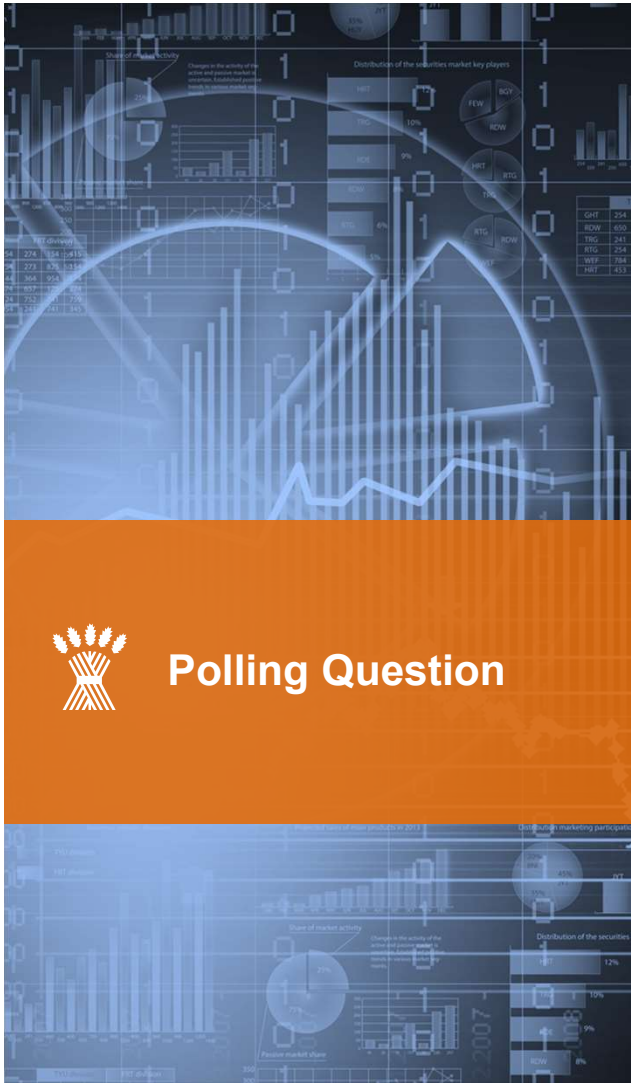
Goal: *To be able to use the market method to estimate value. (REALLY!)*


- Determining the Multiplier
- Determine Cash Flows
- Balance Sheet Adjustments



Expected Future Cash Flow
X
Multiplier
=
Value (Price)





 **Polling Question**

Polling Question

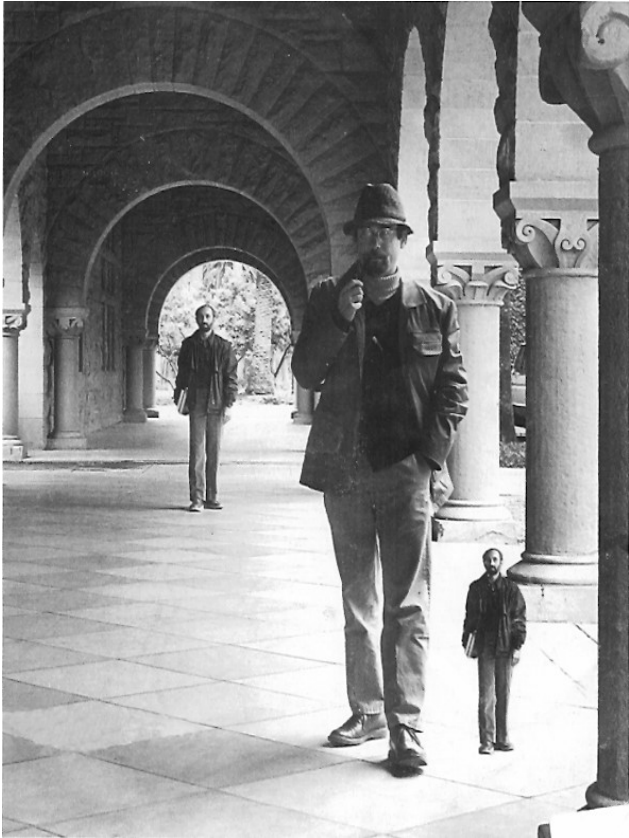
Market Method for Valuing Small Businesses

**Expected Future Cash Flow x
Multiplier = Value (Price)**

**Plus Discounts & Premiums
Plus Balance Sheet Adjustments**



In theory the market method is the most accurate method



Which man is taller?



What are we missing in this picture?

USPAP Standards Rule 9-5 Comment

“The value conclusions is the result of the appraiser’s judgment and not necessarily the results of a mathematical process.”

2018-2019 USPAP



Valuation is NOT just
math

Pros / Cons of Market Method

Pros:

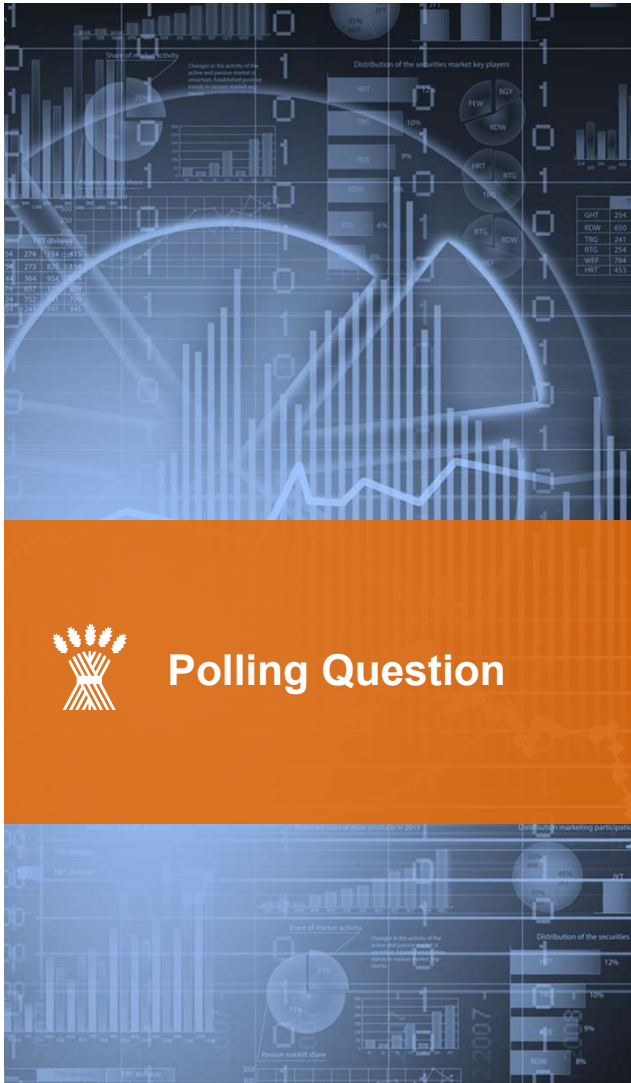
- Direct Sale Data
- Companies are often similar to those being valued
- SBA has provided reliable financing for 20+ years

Cons:

- Uneven quality of data
- Unknowns / unknowable's about comparables
- Year before the sale is all that is reported
- Florida / other bias?



Market Method is a
Comparative Method



Polling Question

Sources of Data:

Very Small Businesses:

- DealStats – BVR. Combined both SEC data and broker reported data. Safeguards in place to check data. Extensive but inconsistent reporting. Newer tends to be better
- ValuSource Market Comps – Formerly IBA Database
- BIZCOMPS – very small businesses and limited data
- Peercomps – SBA data

Small/ Midsize Business:

- DealStats – SEC data provides lower middle market coverage
- FactSet -
- Capital IQ – Very expensive very detailed



Each Data Source Compiles
and Calculates Measures
Differently

Typical Sorts

Industry – NAICS or SIC Codes

- Google look-up
- Sometimes need multiple codes, similar type work / risk

Sales Revenue / Size of Business

- Multiples can vary significantly over sales revenue ranges

Cash Flow

- Create apples to apples dataset for comparisons
- Remove extreme multiples

Key Words / Other



Does this sort produce comparables similar to your subject company?

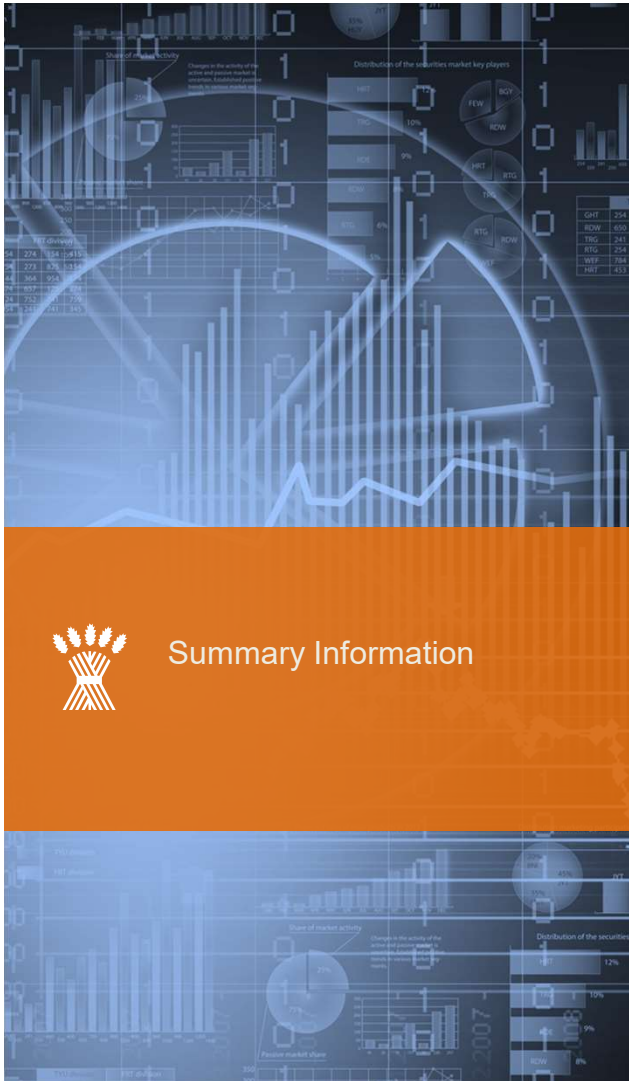


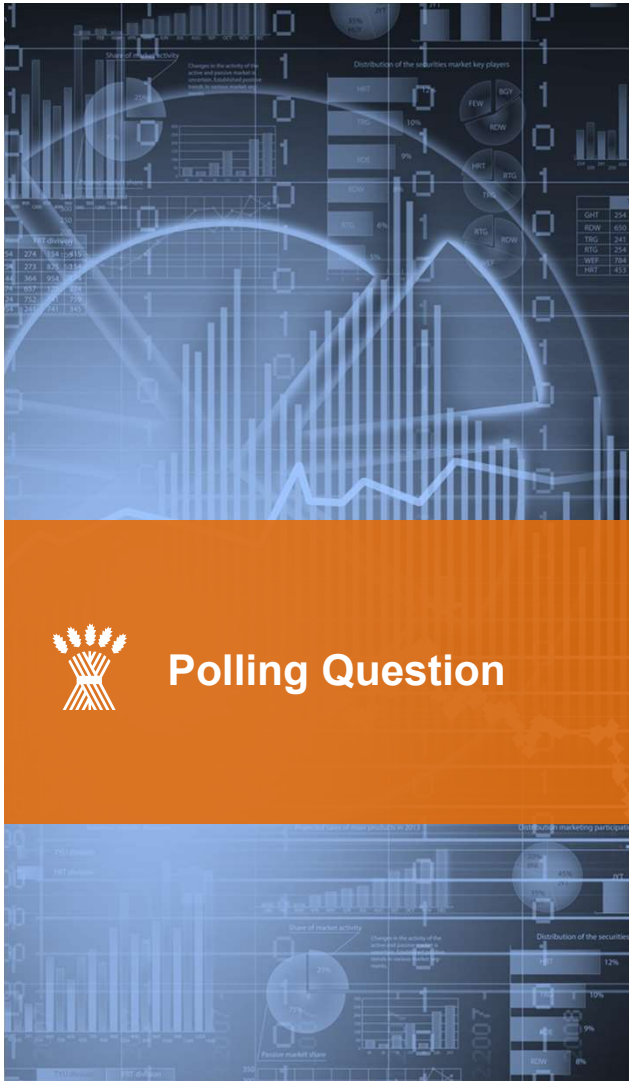
Demonstration

Demonstration

Sample Search – Auto Repair

DealStats contained 103 transactions with the following criteria:			
Net Sales was between \$750,000 and \$1,750,000			
SDE was greater than or equal to \$50,000			
NAICS contains "811111"			
This group of transactions displayed the following valuation multiples:			
Valuation Multiple	Median	Harmonic Mean	Mean
MVIC/Net Sales	0.44x	0.36x	0.46x
MVIC/Gross Profit	0.73x	0.64x	0.87x
MVIC/EBITDA	3.7x	3.2x	9.1x
MVIC/EBIT	4.7x	3.4x	15.1x
MVIC/Discretionary Earnings	2.4x	2.0x	2.6x
MVIC/Book Value of Invested Capital	2.7x	2.2x	4.1x
This group of transactions displayed the following ratios:			
Profitability Ratios	Median	Mean	
Gross Profit Margin	56%	56%	
SDE Margin	18%	20%	
EBITDA Margin	10%	11%	
Operating Profit Margin	9%	10%	
Net Profit Margin	8%	10%	
Return on Assets	30%	42%	
Return on Equity	58%	484%	
Liquidity Ratios	Median	Mean	
Current Ratio	2.59	4.57	
Quick Ratio	2.08	3.77	
Leverage Ratios	Median	Mean	
Fixed Charge Coverage	12.70	4,326.64	
Long-Term Liabilities to Assets	0.00	20.94	
Long-Term Liabilities to Equity	0.00	1,635.23	
Activity Ratios	Median	Mean	
Total Asset Turnover	4.71	6.28	
Fixed Asset Turnover	16.04	94.00	
Inventory Turnover	46.65	108.05	





Polling Question

Statistics

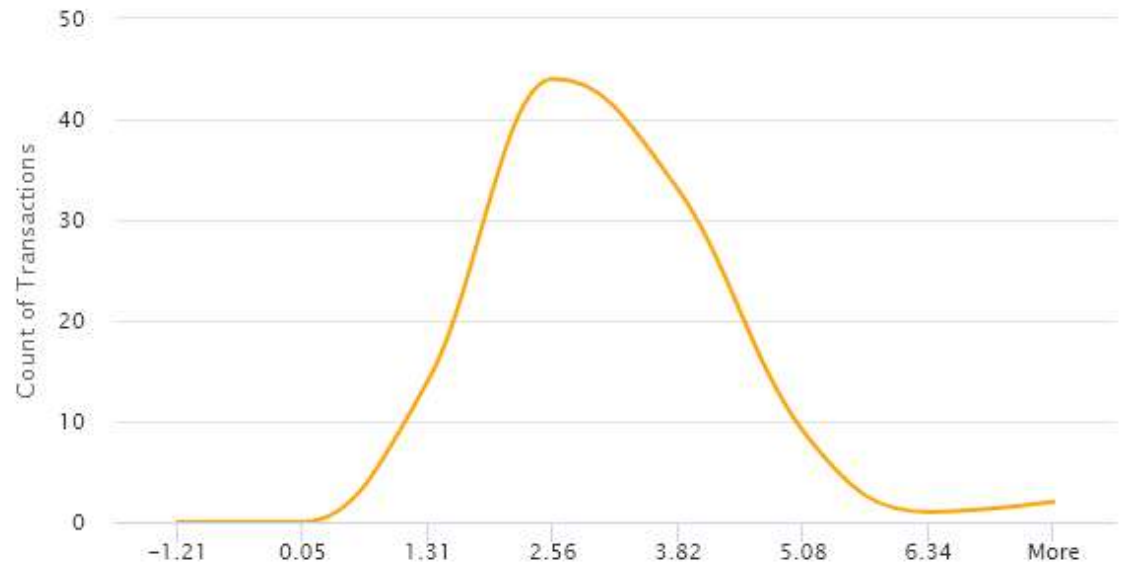
Statistic	Count	Range	10th Percentile	25th Percentile	Median	75th Percentile	90th Percentile	Harmonic Mean	Mean	Coefficient of Variation
Sale Date	103	08/03/1995 — 07/15/2019								
Net Sales	103	\$751,000 — \$1,677,451	\$791,253	\$848,101	\$1,041,245	\$1,254,423	\$1,408,917		\$1,074,011	
MVIC Price	103	\$93,500 — \$2,250,000	\$221,000	\$337,234	\$445,000	\$610,000	\$789,700		\$494,163	
EBITDA	85	(\$71,024) — \$650,000	\$24,952	\$51,730	\$97,867	\$180,000	\$254,618		\$122,753	
Seller's Discretionary Earnings (SDE)	103	\$56,730 — \$850,000	\$98,633	\$136,424	\$188,275	\$260,152	\$324,547		\$210,264	
Gross Profit Margin	90	19.5% — 100.0%	36.3%	44.1%	56.0%	69.7%	74.3%		56.2%	
SDE Margin	103	6.2% — 100.0%	10.7%	13.8%	17.9%	23.4%	28.4%		19.7%	
EBITDA Margin	85	(5.8%) — 76.5%	2.3%	5.0%	10.1%	15.7%	22.3%		11.4%	
Operating Profit Margin	103	(6.3%) — 76.5%	1.1%	3.6%	8.8%	15.2%	22.2%		10.4%	
Net Profit Margin	98	(6.4%) — 76.5%	0.8%	3.7%	8.1%	14.2%	20.8%		10.1%	
MVIC/Net Sales	103	0.09x — 1.51x	0.22x	0.32x	0.44x	0.53x	0.69x	0.36x	0.46x	0.47
MVIC/Gross Profit	90	0.19x — 4.47x	0.38x	0.56x	0.72x	1.01x	1.53x	0.64x	0.87x	0.68
MVIC/EBIT	97	0.6x — 416.7x	1.8x	2.5x	4.7x	9.0x	19.0x	3.4x	15.1x	3.1
MVIC/EBITDA	81	0.6x — 106.2x	1.8x	2.5x	3.7x	7.0x	13.5x	3.2x	9.1x	2.0
MVIC/SDE	103	0.6x — 7.7x	1.2x	1.8x	2.4x	3.1x	4.0x	2.0x	2.6x	0.5
MVIC/Book Value of Invested Capital	26	0.9x — 12.9x	1.2x	1.4x	2.7x	5.0x	9.9x	2.2x	4.1x	0.9



Do the statistics look like the subject company?

If Available – What do the distributions look like?

MVIC/Discretionary Earnings



Does this make sense?

Estimating Profitability v. Multipliers

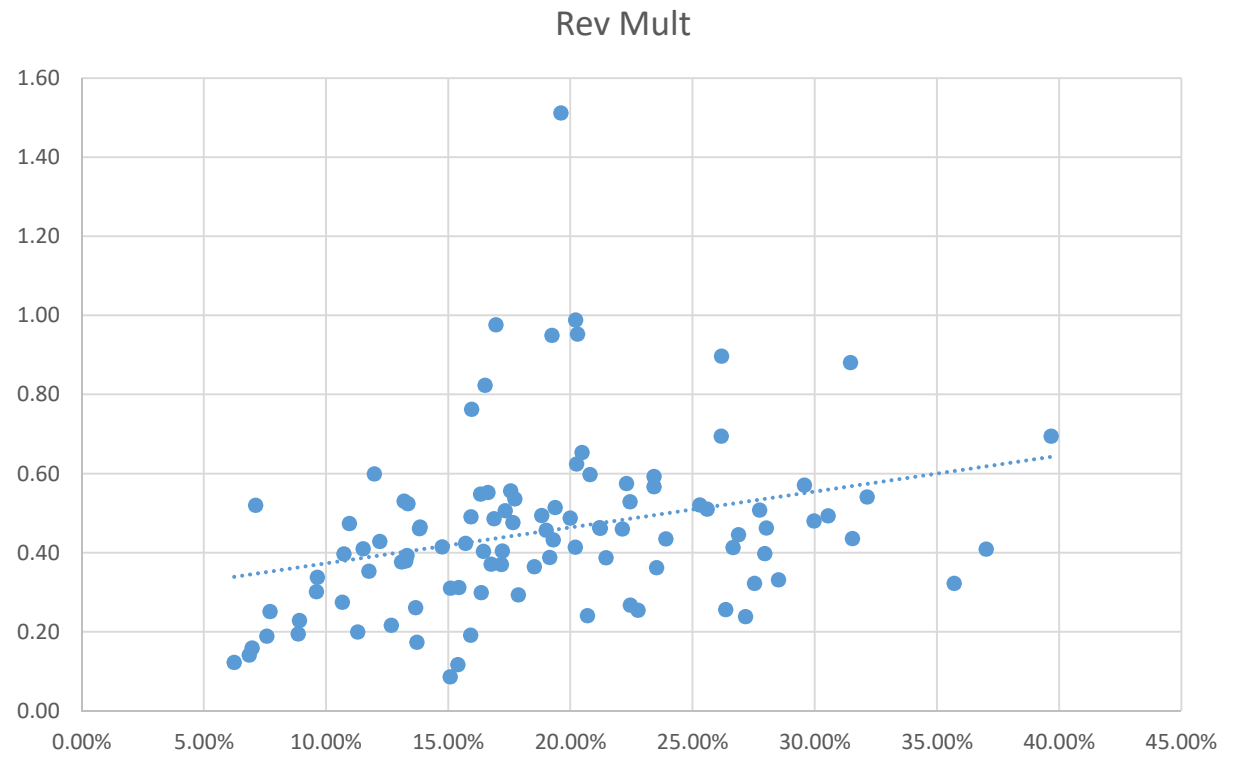
Y		X			Cash Flow
MVICPrice	NetSales	SDE	SDE/ Rev %	Rev Mult	Mult
\$225,000	\$751,727	\$122,954	16.36%	0.30	1.83
\$295,000	\$888,023	\$253,286	28.52%	0.33	1.16
\$400,000	\$767,000	\$194,000	25.29%	0.52	2.06
\$475,000	\$1,144,495	\$168,812	14.75%	0.42	2.81
\$2,250,000	\$1,488,122	\$291,890	19.61%	1.51	7.71
\$625,000	\$1,366,000	\$259,696	19.01%	0.46	2.41
\$850,000	\$1,605,273	\$360,188	22.44%	0.53	2.36
\$510,000	\$1,032,249	\$315,355	30.55%	0.49	1.62
\$675,000	\$1,246,764	\$400,799	32.15%	0.54	1.68
\$550,000	\$841,151	\$172,295	20.48%	0.65	3.19
\$210,000	\$833,346	\$64,305	7.72%	0.25	3.27
\$550,000	\$1,262,081	\$301,796	23.91%	0.44	1.82
\$515,000	\$1,041,245	\$196,028	18.83%	0.49	2.63
\$93,500	\$794,147	\$122,254	15.39%	0.12	0.76
\$428,000	\$1,086,641	\$144,754	13.32%	0.39	2.96
\$391,650	\$1,294,779	\$124,441	9.61%	0.30	3.15
\$650,000	\$1,410,628	\$312,156	22.13%	0.46	2.08
\$625,000	\$1,138,523	\$185,844	16.32%	0.55	3.36



Really understand the data

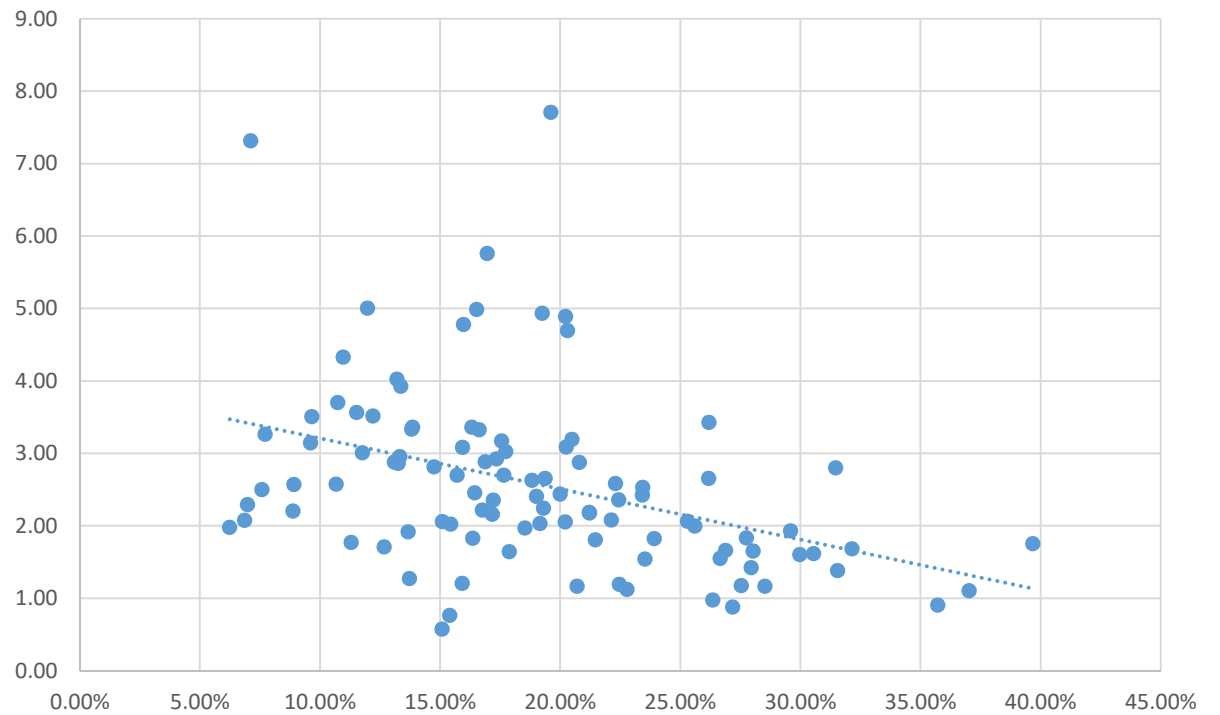


Plotting the Revenue Multiplier



Plotting the Cash Flow Multiplier

Cash Flow Mult



Note the cash flow multiplier decreases as profitability increases

Statistics with Market Method

Pros & Cons

- Statistics show correlation – NOT causation
- Statistics can be very deceptive
- Correlations do indicate relationships
- Must be applied with judgment

Regression Analysis

- Shows level of correlation in specific points or factors

Coefficient of Variation

- Creates a numberless number that allows comparison between methods – It is a dispersion of a probability distribution



Can Statistics Replace
Judgment?

Regression Analysis

The regression equation of a line is shown as:

$$Y = mX + b$$

Y = dependent variable, which will be assigned to business sales price more formally called the market value of invested capital.

X = independent variable, which will be assigned to the cash flow used measure which may be revenues, gross margin, profit, SDE, EBIT or EBITDA.

m = samples or data points of the independent variable (otherwise known as a factor).

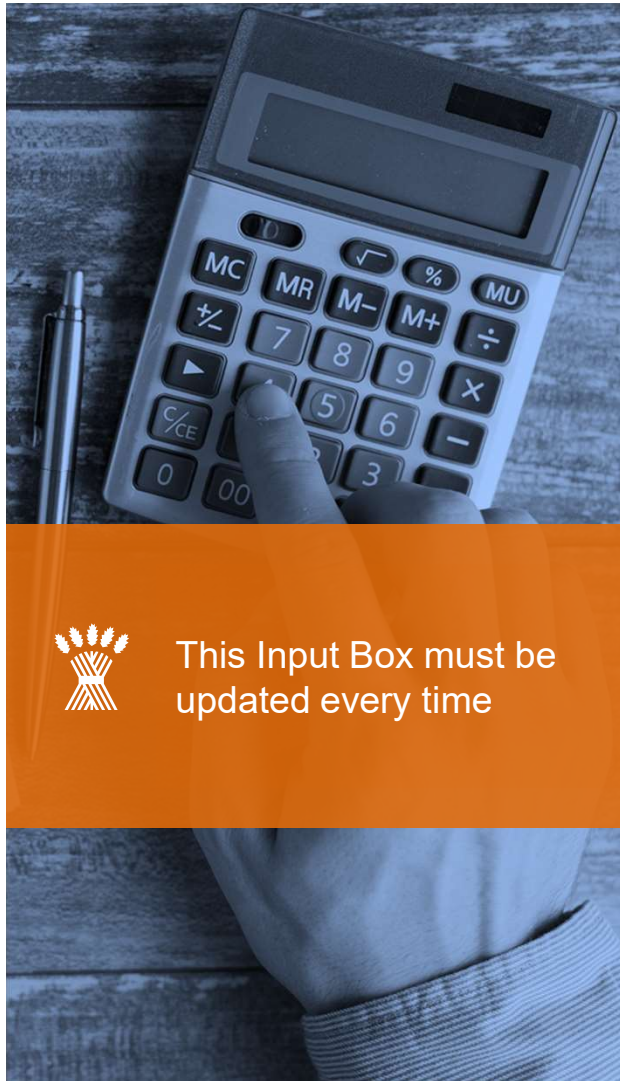
b = is the intercept or null variable. It is where the value found is equal to 0 which may be a positive or negative number.

What regression analysis does is show whether the selected metric (say SDE to Price) provides cogent or correlated results.



In theory the closer the points are to the trend line the more reliable the point becomes

Regression Input Box



	A	B	C	D	E	F	G
1	Predicted	Actual					
2	161	156					
3	130	128					
4	157	153					
5	171	169					
6	115	106					
7	92	93					
8	122	120					
9	180	189					
10	203	209					
11	124	133					
12	128	132					
13	160	166					
14	193	190					
15	200	193					
16	191	191					
17	149	142					
18	104	102					
19	134	125					
20	148	142					
21	174	165					
22							

Regression

Input

Input Y Range:

Input X Range:

Labels Constant is Zero

Confidence Level: %

Output options

Output Range:

New Worksheet Ply:

New Workbook

Residuals

Residuals Residual Plots

Standardized Residuals Line Fit Plots

Normal Probability

Normal Probability Plots

RESIDUAL OUTPUT

OK Cancel Help

Regression Analysis / Excel

SUMMARY OUTPUT

Regression Statistics	
Multiple R	0.461069
R Square	0.212584
Adjusted R Square	0.20471
Standard Error	259196.5
Observations	102

This shows that the data is less reliable (less than .50)

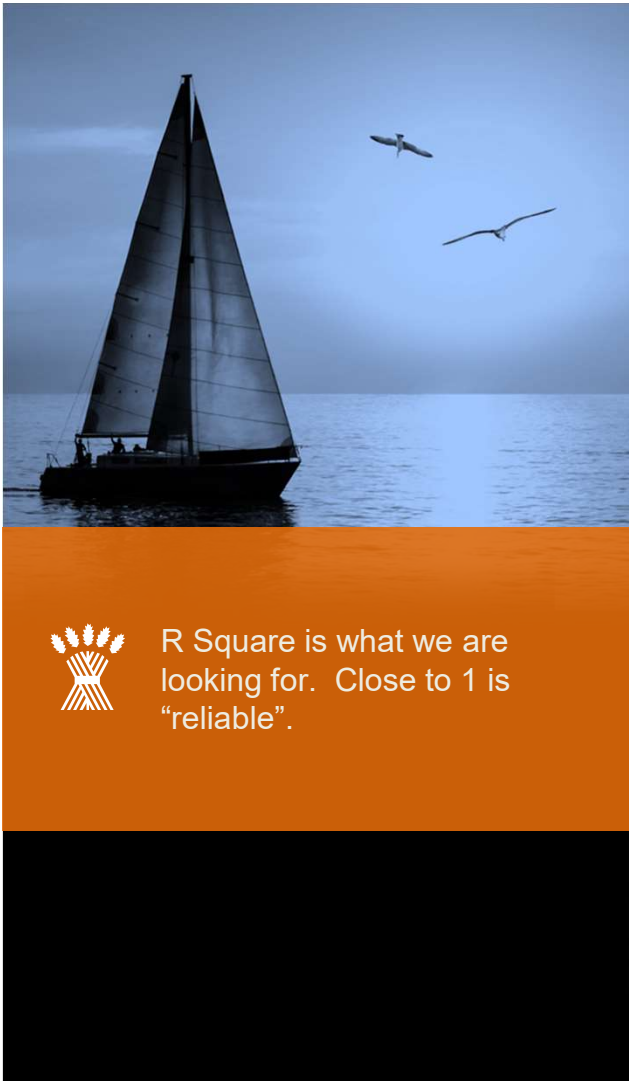
ANOVA

	df	SS	MS	F	Significance F
Regression	1	1.81E+12	1.81E+12	26.99775	1.08E-06
Residual	100	6.72E+12	6.72E+10		
Total	101	8.53E+12			

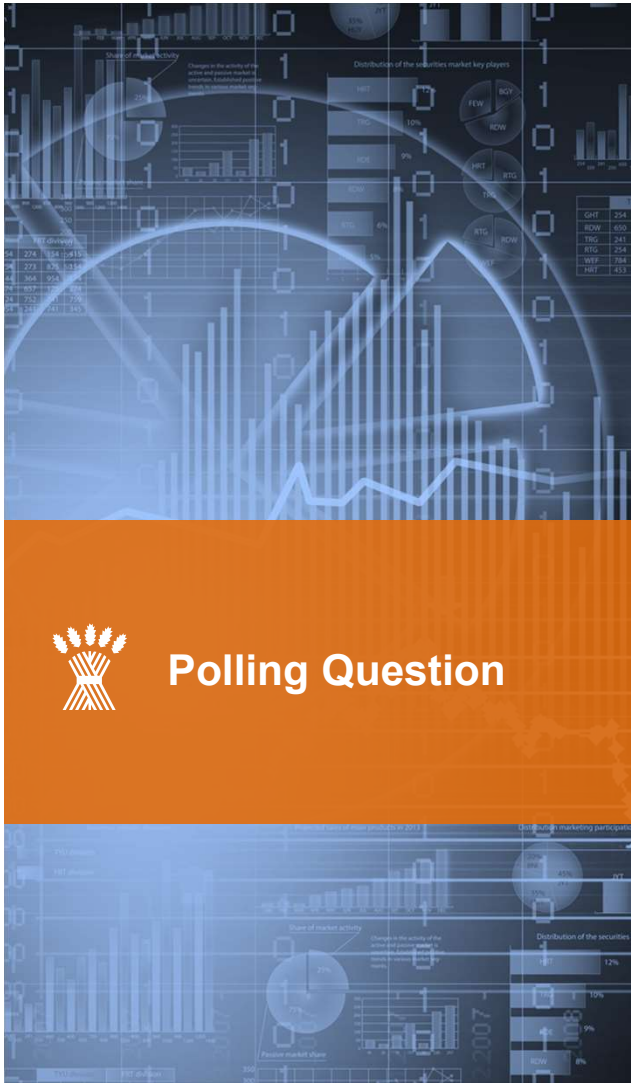
	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%	Lower 95.0%	Upper 95.0%
Intercept	187852.5	64242.75	2.924105	0.004273	60396.75	315308.3	60396.75	315308.3
X Variable 1	1.5001	0.288706	5.195936	1.08E-06	0.927315	2.072886	0.927315	2.072886

X Variable is the angle of the line graph generated. It can be viewed as the base "multiplier"

The Intercept is where the nul variable (essentially 0 value) would cross through the 0 value of the Y axis of the graph chart.



R Square is what we are looking for. Close to 1 is "reliable".



Polling Question

Statistics



Coefficient of Variation for comparison?

Statistic	Count	Range	10th Percentile	25th Percentile	Median	75th Percentile	90th Percentile	Harmonic Mean	Mean	Coefficient of Variation
Sale Date	103	08/03/1995 — 07/15/2019								
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MVIC/Gross Profit	90	0.19x — 4.47x	0.38x	0.56x	0.72x	1.01x	1.53x	0.64x	0.87x	0.68
MVIC/EBIT	97	0.6x — 416.7x	1.8x	2.5x	4.7x	9.0x	19.0x	3.4x	15.1x	3.1
MVIC/EBITDA	81	0.6x — 106.2x	1.8x	2.5x	3.7x	7.0x	13.5x	3.2x	9.1x	2.0
MVIC/SDE	103	0.6x — 7.7x	1.2x	1.8x	2.4x	3.1x	4.0x	2.0x	2.6x	0.5
MVIC/Book Value of Invested Capital	26	0.9x — 12.9x	1.2x	1.4x	2.7x	5.0x	9.9x	2.2x	4.1x	0.9

Coefficient of Variation

$$CV = \text{Standard Deviation} / \text{Mean}$$



Coefficient of Variation can be compared between different measures

	Price/SDE Standard Deviation	Price/SDE Average (Mean)	Price/SDE Coefficient of Variation
2.58 Mean (Average)	1.248041186	2.58	48.32%
2.38 Median (Middle Point)			

Coefficient of Variation - Issues

That is, it shows the variability, as defined by the standard deviation, relative to the mean.

The coefficient of variation should not be used for data that are not on a ratio scale.

Also, if the mean value is near zero, the coefficient of variation is sensitive to small changes in the mean.

Also, the coefficient of variation cannot be used to compute confidence intervals from the mean. (National Institute of Standards and Technology)



Is CV actually a useful
measure?

Links for Excel

- Analysis ToolPak
 - <https://www.excel-easy.com/data-analysis/analysis-toolpak.html>
 - Regression Analysis
 - <https://www.spreadsheetweb.com/regression-analysis-better-predictions/>
- Coefficient of Variation
 - <https://exceltable.com/en/analyses-reports/coefficient-variation-in-excel>
 - <https://www.itl.nist.gov/div898/software/dataplot/refman2/auxillar/coefvari.htm>



Expected Future Cash Flow X
Multiplier = Value (Price)

Estimating the Cash Flow

Review / Enter Financials:

- Cash v. Accrual
- Tax Return or Internal, Compilation, Review, Audit
- Add backs
- Comparative – Measure to Use
- One-time / Excess
- Discretionary



Which set of financial information will best reflect the future?

SDE or EBITDA?

Comparable "Required" Discount Rate as After Tax Cash Flow Drops

This chart shows the "Implied" Discount rate as businesses get very small. Note how the rate drops precipitously. While a simplification this chart clearly shows problems with the model as business value drops below \$2,000,000 and even more so under \$1,000,000 of value.

SDE		\$100,000	\$200,000	\$300,000	\$400,000	\$500,000	\$600,000	\$700,000	\$800,000
Reasonable Salary		\$150,000	\$150,000	\$150,000	\$150,000	\$150,000	\$150,000	\$150,000	\$150,000
EBITDA		(\$50,000)	\$50,000	\$150,000	\$250,000	\$350,000	\$450,000	\$550,000	\$650,000
SDE Market Multiplier	2.5								
SDE Value Estimate		\$250,000	\$500,000	\$750,000	\$1,000,000	\$1,250,000	\$1,500,000	\$1,750,000	\$2,000,000
Implied EBITDA									
Discount Rate			10.00%	20.00%	25.00%	28.00%	30.00%	31.43%	32.50%



SDE is more accurate for very small businesses

Normalization Adjustments



How much verification do you do of discretionary add-backs?

Polling Question



Polling Question

“Soft” Factors:

High Consideration / Deference:

- Trend of cash flows including revenues and measures of profitability
- Management structure and size of company
- **Concentrations** or unusual risks or reduction of risk
- Clarity of comparables
- Any known local market comparables (reported or not)
- [Comparability of subject company to comparables](#)
- Profitability charting as shown
- Timing of Economic cycle
- Industry trends



Why will this Company thrive
or contract?



How much verification do you do of discretionary add-backs?

Review / Enter Financials:

- Cash v. Accrual
- Tax Return or Internal, Compilation, Review, Audit
- Add backs
- Comparative
- One-time/Excess
- Discretionary

Weighting of Cash Flow

Year	2020	2019	2018	2017	Calculated Cash Flow
SDE Annual Cash Flow	\$40,000	\$60,000	\$80,000	\$100,000	
Weighting Methods					
Average	1	1	1	1	
As Weighted	\$40,000	\$60,000	\$80,000	\$100,000	<u>\$70,000</u>
Weighting Current Years	4	3	2	1	
As Weighted	\$160,000	\$180,000	\$160,000	\$100,000	<u>\$60,000</u>
Weighting Early Years	1	2	3	4	
As Weighted	\$40,000	\$120,000	\$240,000	\$400,000	<u>\$80,000</u>
Weighting Current Year Only	1				
As Weighted	\$40,000	\$0	\$0	\$0	<u>\$40,000</u>

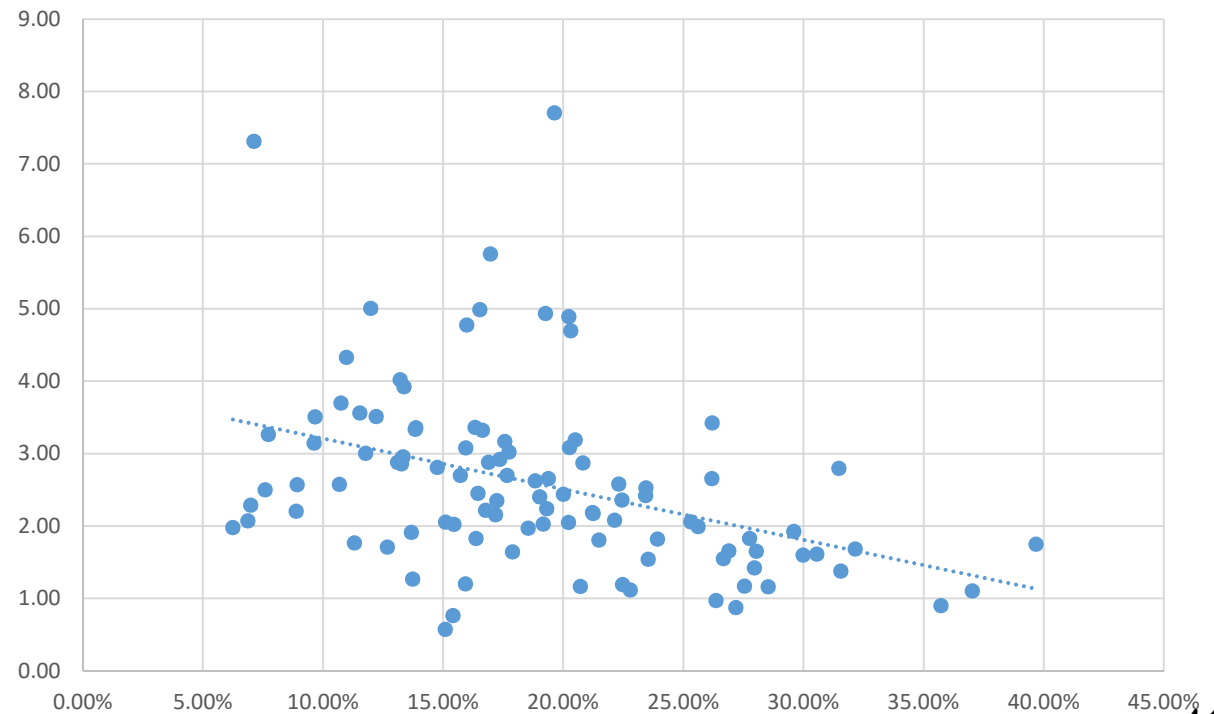
An example showing the power of weighting. Weighting will vary with the fact pattern behind the numbers.



Does this sort produce comparables similar to your subject company?

Plotting the Cash Flow Multiplier

Cash Flow Mult



Note the multiplier decreases as profitability increases

Selecting Multiplier / Indication of Value

	2019	2018	2017	2016
Revenue	\$1,132,700	\$988,600	\$951,500	\$1,087,300
Weight	1	1	1	1
Adjusted Revenues	\$1,132,700	\$988,600	\$951,500	\$1,087,300
	<u>\$1,040,025</u>			
SDE	\$254,800	\$237,500	\$206,800	\$275,200
	1	1	1	1
	\$254,800	\$237,500	\$206,800	\$275,200
	<u>\$243,575</u>			
SDE / Revenues	23.42%			

	Cash Flow	Multiplier	Indicate Val
Revenue Estimate	\$1,040,025	0.5	\$520,013
SDE Estimate	\$243,575	2.2	\$535,865



Resources are available for DealStats users

Balance Sheet Adjustments

General Assumption – Small Asset Sales

- Equipment included in cash flow value
- Inventory will be purchased above the price
- Seller retains all other current assets and all liabilities
- Always read what is included in the database you use.

Asset v. Stock Sale

- From DealStats – Shows balance sheet data on some transactions. Assumption that Stock Sales include balanced working capital assets.
- Small Broker reported (as opposed to SEC documented) beware of that assumption
- Fred Hall, Analyzing Transactional Databases
<https://quickreadbuzz.com/2018/01/10/analyzing-transactional-databases/>



Balance Sheet Adjustments

▪ **Asset v. Stock Sale – Working Capital**

- Many valuers assume stock sales have all assets included. That is often NOT the case with small and very small businesses.
- Some asset sales do have working capital included.
- Most business brokers for smaller transactions do not understand these matters.
- “Deal” balance sheets often have more to do with taxes than conveyed assets.
- “The numbers work themselves out” if the parties are motivated.

- **Working Capital**

- Fred Hall recommends removing data based on detailed information
- If data is suspect why do we assume detail is correct and incomplete is not?
- I suggest trying to apply common sense and the following rules of thumb (yes, be careful with rules of thumb but we need to start somewhere).



What is included in the cash flow value?

Balance Sheet Adjustments

Rule of Thumb (Starting point to apply professional judgment). These will vary. Good luck.

- **Under \$1,500,000 - \$2,000,000 Value (SDE)**
- Seller keeps all current assets (inventory is paid for above the price by Buyer) and pays all liabilities
- **Between \$2,000,000 and \$5,000,000 value (EBITDA or SDE)**
- This range gets negotiated. What makes sense? Remember return on “Total Investment” must make sense.
- **Over \$5,000,000 value (EBITDA)**
- Includes reasonable working capital adjustment.

- **In all cases consider inventory turn also**



How much verification do you do of discretionary add-backs?

Polling Question



Polling Question



Demonstration

Demonstration

Very Small Business Balance Sheet Adjustment

Selected SDE	\$100,000
Multiplier	<u>1.5</u>
Indication of Value	<u>\$150,000</u>
Plus Current Assets	
Cash	\$25,000
Accounts Receivable	\$10,000
Inventory	<u>\$7,000</u>
Total Current Assets	\$42,000
Liabilities	
Accounts Payable	\$5,000
Long Term Debt	<u>\$20,000</u>
Total Liabilities	(\$25,000)
Net Current Assets	<u>\$17,000</u>
Indication of Value	<u><u>\$167,000</u></u>



Generally current assets and liabilities are retained by the seller in market data

Estimating Working Capital

Working Capital Estimate

30-Jun-17

Concrete Contractor with Retention

A/R Aging

	Current	1 - 30	31 - 60	61 - 90	> 90	TOTAL
TOTAL	<u>358,181.73</u>	<u>745,709.75</u>	<u>437,959.40</u>	<u>188,402.20</u>	<u>288,721.18</u>	<u>2,018,974.26</u>

Other Info.

Annual Revenues	\$6,000,000
Profit	\$200,000
A/P	\$250,000

Monthly Revenues	Rev/12	\$500,000
Less Monthly Profit	Profit / 12	\$0 Negligible in this case

Collect at 45 days	1.5 months	\$750,000
Invoice end of month	1 month	\$500,000
Less A/P		<u>(\$250,000)</u>
		\$1,000,000

Retention	10%	<u>\$125,000</u>
Total Required Working Capital		<u>\$1,125,000</u>



Is working capital in the
"value" or not?

I'd love to hear from you

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