Valuing a Business for Sale

Reprinted with permission of The Eastside Business Monthly, Bellevue, WA December 2005

The greatest myth is business buying and selling is often the greatest myth in valuing a business. It's not the accuracy of the financial statements or the quality of the customers or employees. It's the question, "What does the owner really do in the business and what is that worth?" In other words, what would it cost to replace the owner with a professional manager?

Situation and problem

Let's say we have a company with $4-5MM in sales, the owner takes a salary of $200,000 and profits are $300-400,000. There's a reason that owner cash flow is $500-600,000. That reason is the owner knows what he or she is doing. He or she has a strategic vision for the company, is great with managing the employees and especially the management team and they expertly work with and handle the customers.

The problem is that often you'll see that a $60-80,000 salary is plugged in because, "The business manages itself. All that's really needed is a GM." To which I say, "You're crazy." Corporations don't pay management people that amount. And, there's more risk of failure from bad management in a small business than from a middle management person in a large company. I also hear this from my clients whose businesses I help grow or prepare for future sale. They try to convince everybody they aren't that valuable to the company. When you have 10, 20, or 50 employees the owner is always important to the business.

A couple years ago there was a business on the market in Seattle. It was a very good business (I knew it from years prior) with high profits. They used the above logic so they could show profits higher than industry averages. My client passed at their price but it did sell. Now, I happen to have a good friend in that industry. I wasn't surprised to hear the business was struggling. Too much cash out the door every month means not enough cash to properly run and grow the business.

What to do?

I used to ask owners, "Can you take a three week vacation and have the business either survive or be in better shape when you return than when you left?" Now I follow that up with two more questions. First, what happens if you leave for 3-6 months? Second, what would happen if you did the following three things?

1. Have no customer contact for a year
2. Do no day-to-day management
3. Don't supervise any employees; just be the chairman of the board.

That's pretty heavy stuff. Most owners can't come close to eliminating those tasks because they truly have incredible worth to their business. For the owner who does want to move to the background I believe it's a three step process:

1. Define your role as owner for both now and what you would like it to be in the future.
2. Concentrate on bigger picture things. The bigger the better. This means you have to delegate and trust your managers.
3. Stick to it, even when things get a little bumpy.

This will definitely increase the value of your business and when it’s time to exit will mean more money in your bank account.

John Martinka is a business consultant and speaker. He helps people buy, sell, grow and value businesses. You can reach John at 425-576-1814 or via e-mail at john@johnmartinka.com. For more articles on this and related subjects or to subscribe to his free e-newsletter.