An Alternative Approach of Testing a Business Valuation
Business Broker Approach For Estimating Value
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Many attorneys come up to me and ask how they can better understand the process of and conclusions drawn in the valuation of a business. There are many articles that have been written on the subject of valuation and still many attorneys seek clarification. This is understandable since traditional valuation methods are very technical and confusing to the layperson; however, the complexity is necessary because of where appraisers get their data from and the way they are properly taught to apply it. Many authors try to simplify the explanations but still have difficulty again because the traditional methods of appraisal are complex but albeit necessary.

Quite frankly I see the same issues- I can explain valuation to some people and they get it, and some people continue to have difficulty understanding it. Does a person really have to be mathematically oriented to understand the simplest aspects of the valuation? I would like to believe they do not. In this article, however, I am going to approach the explanation of testing a valuation in a different way, and I would love to hear from readers as to whether this alternative approach makes more sense to them. It is more apt to give the attorney a better smell test rather than teaching them the intricacies of the valuation process.

First, the Same Old Stuff

Keep in mind that when investors put their hard earned or guaranteed borrowed money in a business they want a rate of return on their investment commensurate with the risks associated with the investment. For instance, a risk free rate of return for a twenty year U.S. Treasury investment is currently 1.3% (historically 3 to 5%). Going up the risk ladder, corporate long term bonds are at 2-4%, the S&P 500 long range stock outlook, as commensurate with history, is approximately 8-11%, and small public company stocks still range from 15-18%. Therefore, what should the rate of return be for a small closely held (likely micro-managed) business? The answer is most definitely between the mid range of small cap stocks and a number that is quite a bit larger. The *after corporate level tax* rate of return for equity rate for small businesses generally range, with exceptions, from 16%-20% depending on the quality of the company and a host of many other factors. Again, this is not the rate of capitalization but the rate of return. The capitalization rate (which is the earnings divisor) equals the rate of return less a long-term growth rate. And finally, the inverse of a capitalization rate is a multiple of earnings or a price/earnings ratio.

Some Different Terms and Definitions

- **EBITDA**-Earnings before interest, taxes, depreciation and amortization- Simply taking adjusted income and adding back the various non-recurring and perquisite. items to get EBITDA. This is a common measure of income by which Business Brokers and investment bankers will multiply by a number to estimate the potential value of a company they are selling
- **Owners Discretionary Income (ODI)** –Another commonly used business brokerage term that equals the adjusted income from the business and adding back owners compensation and perquisites as well as interest, depreciation and amortization.. This is the total available earnings to an owner including his/her salary. Alternatively, ODI is simply EBITDA plus owners compensation.

Covid-19

Covid-19 has affected many businesses in either a positive way or negative way. Some were not affected at all. If you owned a supermarket, you were able to stay open and you did very well. Home builders and building suppliers are doing very well. If one had a restaurant that relied on eat-in services only, you have been hit very hard and may have lost your value and maybe your business. For unaffected businesses, we have not seen any sharp declines in EBITDA multiples yet. In the publication called GF Data, there is no visible significant drop in EBITDA multiples of private equity group purchases through the date of this report.

Thinking Like a Business Broker

Our accounting and consulting practice perform some business brokerage of which we generally act as a buyer's agent. In addition, I do perform the valuation analyses and determine the adjusted income and EBITDA derived from the businesses. Of course, when a person is selling their business they are much more forthcoming about the "perqs" they take from the business or the amount of income they do not report than what we encounter in a divorce or other litigation situation. The glass is half full vs. the glass is half empty.

What I love about business brokers or investment bankers are that their approach to estimating value is so simplistic. However, when used with some common sense, their simplistic approach actually converts to values that business appraisers should generally approximate using more sophisticated approaches. Because most small business brokers are more sales oriented and lack the formal training of titled business appraisers, they will tend to put the estimated values of businesses in their simplest form at multiples of adjusted EBITDA or ODI (As defined earlier). This is something that the majority of non appraisal professionals should be able to comprehend.

Business brokers use the EBITDA multiple as if it were the gospel. The goals of the broker are to sell the closely held "bricks and mortar" or non-high-tech types of small businesses for a multiple of between 4 and 8 times EBITDA with the central tendency being in the 5 to 7 times range. "Bricks and mortar" business means a low technology service business such as an engineering firm or a low technology manufacturing firm such as a custom metal fabricator or food manufacturer or a wholesaler or retailer of common or custom goods. This is as opposed to a technology driven company that owns sophisticated intellectual property such as software or biotechnology. The technology driven companies, especially ones that are new or that have not reached a profitable status, are rarely valued using the business broker approach. We recently had clients that sold for upwards of 12-14 times EBITDA. These were strategic purchases. In today's environment, private equity groups are looking for a better yield than bonds for their investors so the multiples for more significant companies are higher than they have ever been.

Brokers less commonly but (often enough) use the multiple of Owners Discretionary Income (ODI) when estimating the asking price for a business for smaller businesses. This multiple tends to be between 1 and 4 times with the central tendency being 1.5 to 3.5 times. You see this measurement in Rule of Thumb books just as often as you see valuation multiples of revenues and, quite frankly it is an easier measurement than the multiple of EBITDA to apply because one does not have to perform a fair salary to owner assessment which is a sticking point with many valuations. However, this methodology is more apt to be used with small businesses that earn ODI under $500,000 because the greater the income, the more the multiple of ODI gets closer to the multiple of EBITDA. This is because the only item that separates the two defined incomes is fair compensation to the owners, and as income gets greater, the less meaningful the fair salary generally becomes; hence this measurement becomes less meaningful when the ODI becomes in excess of $500,000. I have also found the ODI multiple is not generally usable with medical or law practices or other professional businesses where fair compensation varies widely from specialty to specialty.

Why EBITDA or ODI

Using EBITDA or ODI is an unsophisticated way of estimating a company's debt-free cash flow which is the true measurement of determining a return on investment. In most instances it does not truly represent cash flow due to changes in noncash balance sheet items such as accounts receivable, inventory and accounts payable as well as purchases of capital equipment. Nonetheless, it is still the most commonly used measurement of income for valuation purposes in the business brokerage community.

Applying Multiples of EBITDA

The following illustrates how brokers apply the EBITDA multiples method, (I am sorry, but you will still need to hire a forensic accountant and/or business appraiser to perform most of this task because it will require forensic accounting to adjust the income statement to what is supposed to be the "true income.") However, you, as a non valuation person, can better question the results that the appraiser expert concludes with traditional methods by taking his/her numbers and applying a multiple:

	EBITDA Multiple		ODI Multiple	
Company Data-Calculating EBITDA:				
Unadjusted Income before taxes	$ 165,000		$ 165,000	
Add back: Owner's Salary	200,000		200,000	
Add back owner's perquisites	42,000		42,000	
Add Back Interest	22,000		22,000	
Add back Depreciation and Amortization	34,000		34,000	
Adjusted ODI	**463,000**		**463,000**	(A)
Less Fair Owners Salary	(125,000)			
Adjusted EBITDA	**338,000**	(A)		
Business Broker Method				
Multiple of EBITDA/ODI Goal	4.00	(B)	3.00	(B)
Goal Selling Price before debt	**1,352,000**	**(A) x (B)**	**1,389,000**	**(A) x (B)**
Less Interest Bearing Long Term Debt	(250,000)		(250,000)	
Goal Proceeds to seller	**$ 1,102,000**		**$ 1,139,000**	

Notice how simple it is to simply take the EBITDA or ODI number and multiply that number by a single digit number rather than dividing it by the all confusing capitalization rate. Also note that the valuation result includes operating balance sheet assets such as the minimal cash needed to operate, accounts receivable, inventory, prepaid expenses, fixed assets, accounts payable and accrued expenses. **The resulting value does not include excess cash, investment assets, real estate and other assets and/or liabilities that are not part of normal operations. Interest bearing debt also need to be subtracted.**

Why Subtract Debt?

The EBITDA/ODI multiple is a debt free number; therefore, interest-bearing long-term debt is subtracted from the results. Also, excess cash is added, and lack of working capital is subtracted.

Applying the Conventional Capitalization of Earnings Method

The following illustrates how an appraiser would apply traditional valuation methods to the above company:

Conventional Valuation Methods used By Appraisers-Capitalization of Earnings				
Adjusted Pretax Debt Free Income			$ 304,000	(after depreciation)
Income taxes			(121,600)	
Adjusted Pretax Debt Free Aftertax Income			182,400	
Projected Next Years Income	C		200,640	10% growth for next year
Required Return on Equity		18%		
Long Term growth Rate		-3%		
Capitalization rate	D		15%	
Value of Operating Assets	'(C)/(D)		1,337,600	
Less Debt			(250,000)	
Net Appraised Value of Business			$ 1,087,600	
Multiple of EBITDA Using Conventional Approach			**3.96**	

The above illustrated that both the EBITDA/ODI multiple goals of the broker and conventional valuation methods can and should come out similar. The conventional methods however are considered more concise and the broker method is an estimate.

Usually for growing, profitable small businesses (cash cows) a business broker will ask for five times or more EBITDA- however this multiple is generally too high for an investment buyer in a smaller business because usually it will be very difficult for them to realize any cash flow return on their investment for several years. This is because most investment buyers borrow much of the purchase price and have to pay back the debt within 5 to 7 years using after tax profits thusly draining any available cash flow for a return on their own investment. Hence, an ordinary investment buyer will rarely pay the higher multiples. The ordinary investment buyer is the hypothetical buyer in the "willing buyer/ willing seller" scenario that one has read about under the fair market value standard.

Low EBITDA Multiples (Below 4)

The following are the characteristics of companies that will be valued at a lower EBITDA multiple:

- Slow or no income or sales growth
- Aging customer base
- Aging technology or factory equipment
- Industry losing business to overseas companies
- Heavy reliance on a few customers
- Heavy reliance on a few vendors.
- Very little industry merger and acquisition activity (not always applicable in a litigation setting)
- Accounting Books and Records are inadequate (not applicable in a litigation setting)
- The success of the business is solely tied to the owner ie. professionals (not applicable in a litigation setting)

Poor books and records can kill many actual sales deals, but in a litigation setting the non titled spouse or the oppressed shareholder will not likely be penalized because the owner spouse or oppressing owner of the business has poor bookkeeping habits or is playing accounting games.

High EBITDA Multiples (6 or higher)

We work with a few private equity groups that buy controlling interests in businesses, and their purchase price today of a strong growing businesses is generally in the 7 to 10 times EBITDA (used to be 5 to 8) range but many times higher multiples if there is competition between equity groups bidding on the same company. These groups are well financed and generally have expertise in the businesses they buy; therefore, while they could be considered a sophisticated investment buyer, they are many times a *synergistic* buyer. Many of these groups only buy companies that are greater than say $30 million in sales and have greater than $5 million of EBITDA. Generally, they will buy platform companies with the following characteristics:

- $5 million EBITDA or better
- Depth of management- they will not buy businesses that are so tied to the selling owner(s) that the customer base or product quality will erode once the owner is gone. The buyer is looking for non owner management and a sales force that will stay with the company after the purchase.
- Historical strong sales growth with the potential to grow faster with a fresh infusion of cash or other forms of capital.
- Diverse customer base- nothing kills an acquisition deal faster than the dependency of a company on a few customers unless the customers cannot go elsewhere or are legally tied to the product and company.
- Proprietary Products-Products that are exclusive to the company.
- Diverse supplier base- Many wholesalers of goods are reliant on foreign manufacturers to make their products. If the company is relying on one vendor, that is a red flag to the equity groups unless they can make the products themselves- in which case they become a synergistic buyer.
- High gross profit margins and high net profit margins-This speaks for itself.
- Good management of inventory and receivables- The buyers look for the accounts receivables to be collected faster than the industry standard and for inventory to turnover faster than the industry standard. The ability of the company to quickly convert their sales to cash is very valuable.

Why EBIDTA Multiples are not always Cited in Valuation Reports

There is a limited amount of private_company empirical evidence to support EBITDA multiples (other than public company data). It is becoming more and more prevalent, however. The problem is that when a market data collection organization such as Pratt's Stats or The IBA database or BIZCOMPS receives financial information on the sale of a company, the balance sheet data and the income statement data are not generally adjusted for the items we usually adjust for in a forensic examination. Thus, the only reliable, somewhat consistent data points one gets when looking at these studies is a multiple of revenue and, to a lesser extent, multiples of owners income. Public company data can be gathered if you have a comparable company that is being valued. However, even with owner's income there can be flawed data because the study may not reflect all of the "perqs" that an owner receives. However, when we perform a market comparable approach in a valuation, usually multiples of owner's income and multiples of revenues are cited by us and the appropriate multiple is then selected and compared to other methods and/or approaches to value. For larger companies, one can extract public company EBITDA multiples and adjust them to fit the specific valuation subject but this doesn't generally work for very small companies.

Which EBITDA/ODI to Use

Now is the age old question of whether one uses an average, weighted average or most current year EBITDA to apply a multiple to for value. The number used should be indicative of the future income stream. If the reader has read any of my articles from the past, they will know that I abhor the blind use of averages or weighted averages especially if a company is in a steady growth cycle or attrition cycle. Do not forget, the true value of a company today is based upon what the expected future income will be. Sometimes it is measured by history or the most current year, and other times it is measured by a present value of future income.

From an historical income perspective, the following are examples of historical EBITDA patterns and what should be used for valuation purposes just from a gut instinct as the measure of value:

	2014	2015	2016	2017	2018	Weighted Average	Likely Suggested Number	
Company 1	100	120	160	180	210	173	210	Most current year
Company 2	100	80	110	100	95	98	97	Average 2014-2018
Company 3	100	90	80	70	75	78	75	Average 2014-2018
Company 4	100	90	80	70	60	73	60	Most current year
Company 5	100	90	90	110	140	113	140	Most current year

Every situation has its own facts and circumstances; however an appraiser should not use an average unless the historical income trend justifies using it, and the most current year should not be used unless the trend justifies it. For instance, in Company number 1, using an average will likely under-value the company because its growth trend clearly reflects that the company is likely not going to be earning the earlier years' income in the future and is clearly in a growth pattern. Company number 2, on the other hand, has an irregular pattern with up years and down years. Clearly the use of an average would likely be justified.

Conclusion

The reader needs to treat this concept of estimating value as more of a "smell test" than a concise valuation methodology. If the valuation an appraiser prepares does not fall within the guidelines of the parameters outlined in this article, then you should question it regardless of what side of the case you are on. Some common reasons could include that the formula did not exceed the company's book value and the book value ended up to be the concluded value.

Look for the EBITDA or ODI in an appraisal report. You will likely have to use a calculator and add a few numbers, but they should be relatively easy to find if the valuation report is clearly written. Test the valuation results with the multiples suggested in this article. Choose the income that is indicative of the future. Be careful because a complexity may arise if the appraiser's conclusions include non operating assets such as real estate, investments and excess cash. Look at the characteristics of a low EBITDA multiple companies versus a high multiple company and compare the subject to that.

If you are still having trouble with testing the expert's valuations, call us and we will be happy to assist you.

Leonard Friedman CPA/ABV CBA is partner with RRBB in Somerset and Maplewood, New Jersey. Leonard has been with the firm since 1987 and is a tax partner and head of valuation and M&A services. Leonard has over 30 years of public accounting experience, including more than 25 years of extensive fieldwork in business valuations, forensic accounting, hedge fund and SEC client valuation accounting. His work in this area has been mainly in preparing a multitude of business valuation reports related to matrimonial, stockholder disputes, private equity funds, estate planning and mergers and acquisitions. He has also served as an expert witness defending his work and financial conclusions in numerous litigation cases.