Evaluation Methods

A business' value can actually be divided into five components:

1. Market value of assets.

2. Historical trends of revenues expense and cash flows.

3. The value of rights, privileges, and knowledge.

4. Estimated stability in the future.

5. Esthetic appeal.

This evaluation report addresses all five (5) components of a business' value through a series of questions, which define each of these aspects numerically. Software has been used to calculate the valuation methodologies, which were used to determine the suggested price. Not every method will necessarily be used in the evaluation report. The methods used in this report are described below.

Asset Value

The asset value method is used to determine a minimum value range for a business. That value represents the estimated worth of all tangible assets.

Asset value must not be determined solely on the basis of book value or an asset's worth in its current application but rather replacement value including all installation and testing costs. The upper and lower asset values are determined based on the accuracy of the asset data that was provided to the evaluator.

Basic Method

This method is based on two pricing formulas:

1. The first formula is a *rule of thumb* multiplier, which is calculated by adding one year's net cash flow to the business' assets, valued at current market value.

2. The second formula begins with the current market value of the assets and adds a multiple of the monthly discretionary income based on the number of months required to start a similar business and bring it to a break even cash flow position.

Capitalization Method (Return on Investment)

This method is based on a simple mathematical model, which calculates a total investment based on discretionary cash flow divided by a rate of return associated with the cost of money and the level of risk associated with the valued business.

Critical Factors Method

This method takes into account the critical factors, which will encourage or discourage a potential buyer in investigating and/or purchasing this business. Each factor is explained below.

Percent of Down Payment

This factor is based on the common belief that lending institutions generally require 20% of the total purchase price as a down payment. This factor also considers how large the down payment is in relationship to the business' post-sale cash flows.

Dollars of Down Payment

This factor relates to the absolute dollars required as a down payment to the potential number of qualified buyers with that amount of cash or other liquid assets. The larger the cash down payment, the fewer qualified buyers will be available, thereby limiting the demand and, consequently, reducing the suggested price.

Interest Rate, Interest Type, and Term of Years

This factor relates the various loan types, loan terms, and interest rates offered to a potential by the owner and any other available lending institution to the propensity of a buyer to purchase this business.

Industry

This factor weighs the possibility of market saturation, currently predicted survival for an established business and the future stability of profits.

Desire

This factor quantifies the buyer's motivation to buy based on status, visual appeal, profitability, risk and skills required.

Lease

This factor determines if sufficient time is available to repay loans and earn a reasonable return. A rate comparable to similar available spaces is used.

Utility

This factor examines the alternative use of the land and buildings for sale.

Accounts

This factor places value on the collectability of accounts receivable and the security of the client base.

Debt Capacity

This method of evaluation is purely a financial model. Direct cash expenses are deducted from direct cash revenues to determine discretionary cash flow. Deductions are then made for an operator's salary and the real depreciation costs of assets. The result is discretionary cash for debt service.

The maximum debt service this business could handle, given the current level of discretionary cash, is calculated based on the number of years financed, and an interest rate.

Most evaluators agree that any future increases in revenues while under the management of a new owner belong to the new owner. If the previous owner had generated more revenue the suggested price would reflect this.

Industry Method

This method is based on pricing formulas that have been developed for a specific industry. Most of these industry *rules of thumb* are based on a capacity or production volume times a dollar value. Other industries simply use a constant times gross or net revenues.

Discounted Cash Flow

This method is based on discounting the forecasted earnings or cash flow stream at a risk-adjusted rate of return. The earnings stream is forecasted for ten (10) years and a terminal value is calculated at the end of ten (ten)

years. The terminal value is calculated by capitalizing the last period's earnings and then discounting the result to its present value.

Comparable Sales Method

This method is based on comparing the business being valued with similar businesses that have been previously sold. Since revenue numbers are usually more accurate than net income numbers, we have calculated a weighted intangible price to revenue ratio, based on previous business sales, and then calculated an intangible value to which we added back this company's assets to arrive at a total value.

National Method

This method is based on a series of factors, which resemble many of the factors previously used in the weighted and critical factor methods. However, in spite of oversimplification and the inability of these factors to shift with changing economic conditions, these formulas have been included because they are routinely used by a buyer in evaluating a purchase. The following factors have been taken in to consideration:

Finance Years

This factor assumes the greater the loan period, the more a buyer will pay.

Financing Rate

This factor considers interest rates and types. It decreases the amount payable to a seller as the cost of financing increases.

Years in Operation

This factor assumes each year of past survival indicates a greater chance of future survival.

Consulting Time

This factor pays for education time from a seller.

Employees

This factor decreases value for a greater number of employees, as having a larger work force can create greater labor problems.

Net Cash

The greater a business' discretionary cash, the more a buyer should be willing to pay.

Local Economy

A better economy provides more certainty of future success, giving the business a higher value.

Labor Market

This factor assumes labor is a major business cost. If the labor market is soft for this business, labor cost will not rise; the converse is also true. The following have a direct effect on the labor market and therefore on the business value: union strength, age of industry, national economy, and industry market.

This factor also assumes that if a business requires high level skills, it poses a higher risk and, therefore, is worth less to a potential buyer.

Union Strength

This factor analyzes how an outside organization can control your business. The less control a business has over its labor force, the less a potential buyer is willing to pay.

Age of Industry

This factor increases value for stability and longevity in proportion to an industry's age.

National Economy

This factor assumes a growing economy increases a business' demand and price. Conversely, a declining economy decreases demand for a particular business and its price.

Industry Market

This factor looks at the future markets for the products or services of this company and industry. The security or risk assigned to the future will directly raise or lower the suggested price.

Weighted Factors

This method assumes that the business value is based on the highest potential value of assets plus the discretionary cash flow multiplied by a factor, which is based on the learning curve for this type of business. The current demand for this industry and business are also taken into account. The business value represents the maximum possible price a buyer would pay given a business at this scale of operations and profit level. Each factor adds or deducts from the target value to arrive at a suggested price. Each of the following factors has an affect on the final suggested price.

Labor

This factor weighs the stability of a company's labor force and the changes, which may reduce profits under a new owner.

Predictability

This factor reviews the company's historical and current trends compared to the local and national economic trends.

Management

This factor estimates the integrity of the current management system and how changes of ownership will impact the business.

Competition

This factor weighs the possibility of a new owner going out of business because of a saturated market.

Revenues

The past and present problems of collecting revenues will probably remain unchanged under new ownership.

Longevity

The number of years a business entity has survived and grown is usually proportional to the confidence level for future survival. This factor balances lease rates, years at this location, and the utility of this location for this business against current and potential competitive locations.

Loan Ability

This factor weighs this company's ability, based on its own assets, to acquire funding from lenders.

Clientele

This factor weighs the stability of clients and future expectations for revenue from those clients after a management change.

Liability

This factor weighs the hazard level of this business and how easily a bankruptcy situation could occur.

Multiple of Average Value Method

This method is the average of all the previously described formulas based on theory that a *reasonable* buyer will use more than one of the previous formulas. An average value derived from all of the formulas should represent the actions of a *reasonable* buyer.

Conclusions

All of the formulas described above are calculated and displayed in price ranges with a maximum and minimum level because the data used to calculate these values are based on estimates.

Upper Range Pricing

The *upper range pricing* represents the seller's optimistic view of his business given current market constraints.

Lower Range Pricing

The *lower range pricing* represents the buyer who is primarily concerned with financial rewards including return on investment and return on equity, and will buy a business based on conservative financial estimates.

Suggested Price Range

The *suggested price range* is based on all of the evaluation methods. It is strongly based on the multiple average but occasionally differs for a variety of reasons.

The first thing that will cause a variation between the multiple average and the suggested price comes from inconsistent data that was used to calculate the various valuation methodologies contained in this report. If there is too much inconsistency, bizarre results may be produced. If this occurs, the suggested price will be discounted based on the degree of inconsistency that was encountered.

Suggested Price

The methods used to sell the business can affect the *suggested price.* The accuracy of data used in this report will have a substantial affect on the suggested price. If the data is not accurate, the methodologies this report relies upon will generate a suggested total price range, which is wide and often unrepresentative.