warrenbdc
Warren Business Development Center Inc.

Seven Steps for Determining a Proxy Value of Your Business

Single Point of Contact

Buying, Selling and Building Company Value

Contact Information

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Introduction to the Seven Steps for Determining a Proxy Value of Your Business

Welcome to Warren Business Development Center AKA WarrenBDC and thank you for downloading this Proxy Valuation Form.

Congratulations, you've taken the first step on the road to transitioning out of your company and moving on to an incredibly rewarding and exciting time in your life. After you sell go play, do some business or both. Nobody ever said you had to stop having fun.

The Proxy Valuation Form contains seven steps to guide you through the process of determining the current proxy value of your business. These steps enable you to get a starting point for the value, it is not as accurate as a true business valuation but it is great for the purposes of determining whether you are anywhere close to where you need to be, or want to be, for sale purposes.

If you have any questions please contact us, we can help you complete the form and work with you from 'I'd like to sell or transition through to I've sold.' This is not a do it yourself endeavor. It takes a team to transition a business successfully.

Find out how a DIFY (do it for you) company can help. Start your confidential one on one conversation by contacting our CEO Eric Gilboord by email at eric@warrenbdc.com or calling 416-270-2466.

About Warren Business Development Center Inc.

WarrenBDC helps to increase the value of a business, while preparing the owner and the company for sale or transition. When the owner and the business are both ready, the company can be confidently sold or transitioned on their terms.

We lean toward working with boomer aged business owners who own companies enjoying annual sales of $3-25 Million. Larger or smaller companies are considered on an individual basis.

Our Team

It takes a team of talent to successfully prepare for transition. Warren Business Development Center has attracted several highly experienced team members who represent a breadth of experience in senior management positions and all share many years of current experience with Small and Medium-sized Business Owners / Operators. We continue to add more talent. Discover what a DIFY (do it for you) company is.

Applying the Seven Step Formula for Determining a Proxy Value of Your Business

The process of determining a proxy value of your business may sound complicated at first. Once you start working with the seven steps you'll understand the process is no more difficult than working with the everyday operational numbers you're used to handling on a daily basis.

This first section requires information from your financial statements and reasonable estimates of certain expenses. It may be useful to review this with your accountant.

Step 1. EARNINGS

The starting point is to determine earnings, a simpler idea than profit, which may require adjustments. Earnings is gross sales less cost of goods sold and expenses.

Free cash flow is determined by starting with the average of earnings over a three- or five-year timeframe and then making two further adjustments to those earnings. The adjustments are EBITDA and normalization.

The tables used to illustrate the seven step formula are for one year. To determine the average of a three- to- five-year timeframe simply repeat the seven steps for each year and divide by the number of years.

Step 1. Determine Earnings

Annual revenue.	
Less cost of goods.	
Less expenses.	
Equals Earnings	

Step 2. EBITDA.

EBITA stands for earnings before interest, taxes, depreciation and amortization. The idea is that interest, taxes, depreciation and amortization are not operational expenses that affect the business.

EBITDA is commonly used but not everyone agrees with it. Some prefer another formula called EBIT. More sophisticated valuations use DCF Discounted Cash Flow models.

The point is that there are other methods of determining value, but they are all hypothetical, so for illustration purposes EBITDA is just fine.

Step 2. Determine EBITDA

Earnings	
Plus interest.	
Plus taxes.	
Plus depreciation.	
Plus amortization.	
Equals EBITDA	

Step 3. NORMALIZATION

Normalization is a process that accounts for the personal benefits an owner of a family business takes and any other non-business lifestyle-related decisions that find their way into the financial statements. Owners often pay themselves and family members' salaries and benefits that are more favorable than normal salaries and may take other perks that an unrelated employee would not get. The theory is that a normal business would not pay for these additional perks so they can be added back to determine a more realistic picture of a normal free cash flow. Another common add-back is any non-recurring charges like a substantial repair or an unusual loss due to weather.

Step 3. Normalize Earnings to Determine Free Cash Flow - Part 1

EBITDA	
Plus owner's salary and benefits above what would be paid to an outsider.	
Plus family member salaries and benefits above what would be paid to an outsider.	
Plus owner's family automobile expense above what would be paid to an outsider.	
Plus charitable donations Plus or minus rent adjustment to FMV Fair Market Value.	
Plus owner's family life and disability insurance payments above what would be paid to an outsider.	
Plus legal, accounting and tax advice expenses.	
Plus owner retirement plan contributions.	
Plus owner travel and entertainment expenses above what would be paid to an outsider.	
Plus subscriptions, memberships, private clubs, etc., unless necessary to stay with business.	
Plus extraordinary one-time (non-recurring) expenses.	
Total	

(Part 2 is on the next page)

Step 3. Normalize Earnings to Determine Free Cash Flow - Part 2
(Continued from previous page)

Total from above	
Less annual earnings from redundant assets.	
Equals Free Cash Flow (sometimes called normalized earnings)	

Step 4. MULTIPLE

The multiple is determined by the Return On Investment the buyer wants. To determine ROI you divide 100% by the multiple. If the multiple is 4× that means the buyer wants a 25% return on the investment per year (100% ÷ 4 = 25%). In other words, the buyer wants to make their money back in four years. A typical multiple for companies under $10 million in annual sales is often between 1× and 4×.

For companies over $10 million in annual sales the sale price can be 6× or more.

To calculate the multiple in general terms look at the number of risk factors the business faces. Reducing risk in your business will increase the value. Delegation equals value. The less the business relies on the owner the more valuable it is. This means you can slow down and increase value at the same time.

It is important to note that any one of the risks (outlined below in the exercise) in a business may be so serious that it alone may prevent a sale. For example, if all the goodwill in the business was non-transferable personal goodwill then the only sale possible would be a liquidation sale.

Many industries rely on a rule of thumb whereby all businesses are valued using the same multiple. For example, insurance agencies are sold on the basis of 2× annual revenue. One valuator has said that rules of thumb are “dumb” because one size does not fit all. Most buyers prefer a more in-depth analysis of the risk factors of the individual business they are purchasing.

Step 4. Determine a Multiple - Part 1

Assign a value from 1 (lowest) to 4 (highest) to each item below. Value 1 to 4

Owner involvement: Does the business have a good process in place that does not require the owner (4) or do you run the business out of your head (1)?	
Goodwill: Is the goodwill in the business transferable (4) or is it the personal goodwill of the owner (1)?	
Replaceability: Can the suppliers and employees be replaced (4) or does the business depend on certain key suppliers and employees (1)?	
Financial records: Does your business have audited financial statements that reflect all income (4) or are your records informal and not inclusive of all your business revenue (1)?	
Legal documentation: Are your key agreements and legal assets documented (4) or is everything based on handshakes and personal understandings with the owner (1)?	
Clientele: Do you have a broad base of profitable clients, with no client representing more than 5% of your revenue, and do you have good customer lists and contracts (4) or do a few customers account for most sales, without customer lists or strong, transferable contracts (1)?	
Products: Does your business offer distinctly different, better and difficult-to-copy products and services; serve an exclusive territory; or offer an exclusive product line under transferable contracts or arrangements (4) or does it offer products identical to those offered by other businesses in your market area with no distinct competitive advantage (1)?	
Recurring revenue: Does your business sell via subscriptions, monthly fees, automatic delivery programs or other approaches that deliver ongoing revenue from established customers (4) or are most sales single-time transactions by one-time or occasional customers (1)?	
Staffing: Does your business have key staff with transferable contracts who will assist with the business transition (4) or are you the one-and-only key person (1)?	
Location: If your business's success relies on its location, is it in a growing and desirable market area and does it have a long-term, transferable lease and good facilities and equipment (4) or will a new owner need to move or improve the location (1)?	
Brand and reputation: Does your business have a well-known name, respected reputation and top position within its competitive arena (4) or are the reputations of competitors considered stronger and preferable (1)?	
Annual sales: Over \$3 million (4), \$1–\$3 million (3), \$100,000–\$1 million (2), under \$100,000 (1)	
Annual growth: Over 15% (4), 5–15% (3), under 5% (2), 0% (1)	
Total	

(Part 2 is on the next page)

Step 4. Determine a Multiple - Part 2

(Continued from previous page)

Total from above	
Multiple: Total divided by 13	

Step 5. REDUNDANT ASSETS

An asset is redundant if it could be removed from the business without harming operations. Examples are fully owned real estate that could be rented out and excess cash in the bank that does not get reduced at some point during the year or seems excessive when compared with peer companies. Redundant assets represent value over and above business value that can be extracted without harming the business.

Step 5. Evaluate Redundant Assets

Cash not required for operations.	
Real estate that could be rented.	
Any other assets not required in business.	
Total Redundant Assets	

Step 6. BUSINESS VALUE

Business value, which is the value of the whole enterprise, equals free cash flow times a multiple plus redundant assets.

Step 6. Calculate Business Value

Free cash flow.	
Times multiple.	
Plus redundant assets.	
Equals Business Value	

Step 7. SHAREHOLDER VALUE

Shareholder value is different from business value because what we are concerned about with shareholder value is the amount you will get for your shares if you sell them. The first step is to reduce business value by the amount of debt that will have to be paid or assumed on the sale of the enterprise and then calculate based on the percentage of shares you own.

What follows is a chart for getting a rough idea of the sale value of your business. If you do plan to sell your business you should seek professional assistance. This chart does not take into account the possibility of a strategic purchaser, who may pay double or more the amount calculated by this formula.

Step 7. Calculate Shareholder Value

Business value	
Less debt or obligations	
Divided by share ownership %	
Equals Shareholder Value	

A Final Note

Thank you for downloading our Proxy Value Form. The amount of work required to prepare your company for sale or transition is immense, frustrating and very time consuming. Not to forget the emotional toll it will take on you personally.

Thinking about giving up a life you have known and lived for decades in exchange for a life you're uncertain about can be overwhelming and stop you from moving forward.

Remember this is not a do it yourself endeavor. The time frame is typically 3 – 5 years. If you think you can do it on your own and in a shorter time frame you will find out it is not likely. It takes time and a team to complete the process successfully. As you choose your team we recommend working with trusted advisors who have experience buying and selling companies.

If you have any questions about this Proxy Valuation Form or the process of preparing to transition or sell your company, we're here to help. Please contact our office.

Eric

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