Business Valuation: Case Study #1

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The first question I'm asked by my clients is always, "what do you think my restaurant is worth?" I will typically refrain from answering that question until a little further due diligence is presented.

We offer an opinion of value for many different reasons; selling, financing, partnership disputes, bankruptcy, estate planning or other reasons. Determining market value of a restaurant is a challenging task and can be very subjective and not an exact science.

The term "fair market value" is defined as the price at which an asset would change hands between a willing and knowledgeable buyer and a willing and knowledgeable seller. This assumes market value is only determined when a transaction has been completed. So how can we come to a value without a completed transaction? We make very educated assumptions, both by our deep rooted knowledge of the marketplace, recent transactions and really getting to understand details of your business.

A Valuation Report:

- Assumes that the new owner(s) of the Company will have the necessary resources and commitments to not only acquire but also to grow the Company.

- Assumes that the buyer is fully knowledgeable about the Company and its operations and will accomplish a rigorous due diligence process to verify all purported facts, estimates, calculations and suppositions.

- Highlights the Company's desirable qualities, past and future improvements, enhancements and future performance that may or may not be realizable.

As mentioned earlier, the appraisal of a closely-held business is not an exact science and requires considerable judgment of many factors such as:

- The history and nature of the business the Company is engaged in.
- The outlook for the overall economy and the industry the Company is in.
- The latest financial condition of the Company.
- The future earnings capability of the Company and the associated related risks.
- The capability of the Company to continue to generate the necessary cash flow to support a purchase.
- The worth and value of the goodwill/intangible assets of the Company.

For the most part, valuations include the following Company tangible and intangible assets:

- Furniture/Fixtures/Equipment customary to the normal operation of the business.
- All customer lists and information and past/present sales and marketing data.
- All proprietary Company information and methods of doing business.
- All rights/patents/trademarks for the Company's proprietary products.

- All rights to the Company trade name and Web site.
- All Goodwill and other intangible assets not specifically listed.

They do not include the following tangible assets and liabilities:

- Cash and cash equivalents
- Accounts receivable
- Prepaid expenses
- Inventory (at cost at the time of sale)
- Liabilities
- Real Estate

Although there are many variations of ways to estimate the value of a business, they tend to group within three approaches:

- Asset Based Valuation
- Market Comparison Valuation
- Income Based Valuation

If the restaurant has a history of earnings and profit, the most appropriate valuation approach is the Income Based Valuation. In the absence of historical earnings and profit, the Asset and/or Market Based Valuations are used. Unfortunately with these last approaches, the value is typically much lower than with an Income Based Valuation approach.

Most of the valuation assignments that I undertake are based on the income approach. If the restaurant is profitable, this approach usually gives a better picture of the value than Asset and/or Market based approaches. The Income Based Valuation approach is further broken down into four generally accepted methods:

- Present Value of Future Earnings Valuation
- Capitalization of Excess Earnings Valuation
- Multiple of Discretionary Earnings Valuation
- Gross Revenue Multiples

The valuation method I like to use is a combination of both the widely used and professionally accepted Gross Revenue Multiples method and the Multiple of Discretionary Earnings. This combined approach will assign a multiple to a Company's reconstructed earnings that are reflective of the risk associated with the continued operation of the business with recent proven financial results. These financial results can reasonably be expected to continue after the business sale for an indefinite but substantial duration.

In applying this combined valuation approach a Company's latest three full fiscal year's pre-tax discretionary earnings will need to reconstructed. Additionally, the multiplier used in the valuation calculation will need to be determined. Calculating the multiplier is very technical in nature for which I will not get into here. I can tell you that it contains factors such as historical earnings, business type, location and facilities, lease, competition, skill level of employees, and other factors.

As a very general rule of thumb, the multiplier for a restaurant IN TODAY'S MARKET will most likely range from 2.0 to 3.0 times its discretionary earnings. This means that a buyer will most likely get his investment back in a period of 2.0 to 3 years.

It's important to note that a valuation is based in part on the average weighted reconstructed cash flow, also referred to as the "earnings before interest, taxes, depreciation, amortization (EBITDA), and discretionary expenses. In addition to paying for the business and providing operating capital, a new owner will also be responsible for interest expenses, income taxes, and equipment replacement costs.

Recent Case Study

I recently had an opportunity to complete a business valuation for a local restaurateur. The purpose of the valuation was for a partner buyout. The Company has been in operation since 2004 and for the most recent three years, has had a stable business history with average yearly sales of $2,316,724.

The Company's Federal Income Tax Returns (for the most recent three years) were reconstructed to determine the potentially available cash flow for a new owner. This was done to show the "free cash flow" or "current net earnings" in the business to allow a potential buyer to determine the true investment value of the business.

A weighted reconstructed annual adjusted earnings number was calculated. This number was to be a factor in calculating an estimated overall value for the business under the premise that the most recent results are the most predictive of future earnings and therefore should carry greater weight in a three year span of consideration. The calculated three-year weighted average adjusted reconstructed earnings (free cash flow) in my case study was **$318,500.**

Next, a multiplier was determined. I calculated the multiplier for this Company to be equal to **2.90**. Applying the valuation formula results in the preliminary valuation of the designated Company assets as follows:

Preliminary Value = Reconstructed Weighted Cash Flow times the Multiplier
Preliminary Value = $318,500 x 2.90 = $923,650

In my case study, I calculated the Company's fair market value to be approximately **$923,650.**
In this case, the partner being bought out had a 25% stake in the business. Before the valuation, there had been quite a dispute of what that 25% was worth. After the valuation was done, they simply took 25% of the $923,650 (or $230,913) and called it a day. They were finally able to bring closure to a lingering dispute.

So there you have it. A brief synopsis of the most important elements of a business valuation and a recent case study. For more information or if you are interested in a business valuation, please contact me at (858) 792-5521 ext. 108 or jbravo@locationmattersinc.com