Buy Then Build: How Acquisition Entrepreneurs Outsmart the Startup Game

Deibel, Walker (2018-10-30).

Part 1

Opportunity "No army can withstand the strength of an idea whose time has come." —Victor Hugo

Chapter 1

Don't Start a Business

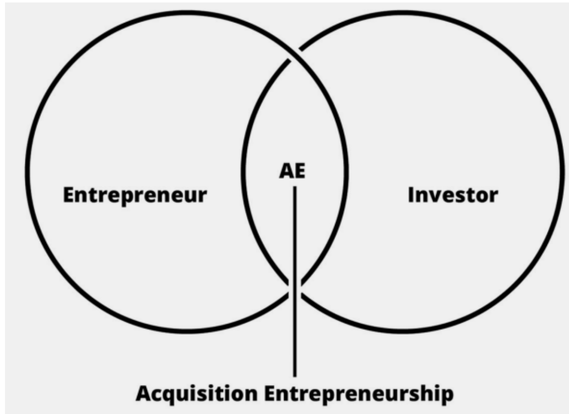
Startups have an inherent flaw: they mostly fail. Even with overwhelming talent, outstanding early product trials, and an all-star team, success is still unlikely. We've all heard the statistic that one out of ten startups make it. It's not a secret. We

Babson College statisticians reported through the Wall Street Journal that the average startup in the US kicks off with $65,000 in invested capital. Similarly, the average down payment on a home for the last three years5 was approximately $57,000,

There is a lot of opportunity inside small companies that operate on legacy systems, never upgraded to lean business models, or never developed sales teams or effective online marketing.

Activities like managing, innovating, and growing the company start on day one.

All in all, buying a business is way more affordable than you think. In terms of initial capital required by the entrepreneur, it looks amazingly comparable to either starting a company or buying a house.



According to Harvard Business School lecturer, Shikhar Ghosh, even VC-funded startups— the ones that every MBA startup strives to attain— have a 75 percent failure rate.

The VC game is one of portfolio management. Meaning there needs to be a sizeable enough portfolio for VC backing to make sense. This is why, as of 2008, the average VC fund is $ 350 million. 10 This provides capital for eight to fourteen companies per fund.

Gazelles are defined by rapid growth and not size. To be classified as a gazelle, a company must have a starting revenue of at least $ 1 million, then grow at a rate of 20 percent every year for four years, resulting in the company doubling in size during that time. Acs observed that gazelles are found in all industries.

In fact, it's the old dogs with new tricks that have a higher probability of withstanding disruption within their markets. The old dogs have the benefit of existing revenue and earnings. They have infrastructure and invaluable industry insight. They have customers wanting to update to the trends.

The rate in which boomers are retiring is going to increase significantly over the next eighteen years. By 2021, baby boomers will be retiring at a rate of 11,000 per day. Almost 77 million people, about 20 percent of the US population, are going to retire between 2013 and 2029, and it is estimated that $ 10 trillion in existing business value14 will need to change hands. The boomers are already selling off their established, successful small businesses at record rates. 15 These businesses provide an unprecedented opportunity for acquisition entrepreneurs to focus on running, growing, and innovating a business immediately, all while enjoying a stability not found in startups.

In loose math it would look like this (and to simplify, let's assume this equation does not include working capital, inventory, closing costs, or real estate): $65,000 invested plus 90 percent SBA loan equals a $650,000 purchase price. A company of that size is commonly acquired around a multiple of three times adjusted earnings.7 Adjusted earnings therefore are $216,000

($650,000 divided by three). Assuming a 15 percent adjusted earnings-to-revenue ratio, this company is generating over $1.4 million in revenue.

<u>Maxloyal example</u>

Investor pays cash into existing business and get specific equity based on valuation

Business get growth and development and equity bank loan to improve business with

Example: xyz AB worth $100K John invest $60K and get 60% of xyz AB shares

Xyz takes an equity loan for $70K to improve and expand business

Liability for this loan is on business and split 60/40 per shares

Now business use the $70K to grow and then its valuation after 3 years is $300K

Then John can get $180K for his $60K investment.

Chapter 2

Engineering Wealth

80% OF AFFLUENTS own their business and they are entrepreneurs. Owning your own business is not only an opportunity to provide value through products and services, but it's arguably the best way for most people to build real wealth.

While considering acquisitions as an investment, keep three fundamentals in mind: return on investment, margin of safety, and upside potential.

Return on Investment

Depending on the industry, you can expect to pay anywhere from two-and-a-half to six times the total annual cash flow to the owner. That's a big range. The large volume of transactions that do not involve a private equity acquisition will settle in at an approximate three to four times.

For now, just know that it's referred to as seller's discretionary earnings (SDE, or sometimes just "DE" for discretionary earnings).20 This represents the total pretax cash flow benefit to the owner of the company. In other words, the total amount of cash that can be used for ongoing salary, debt service, reinvestment, etc.

To put this in perspective, conservative, long term professional investors will attempt to beat the market's historical 8 percent annual ROI.21 In real estate investing, the rent paid out to the owner in comparison to the purchase price of the building is called the capitalization rate, or "cap rate." Cap rates tend to fluctuate between 4 percent and 12 percent depending on the risk associated with the tenant and other variables.

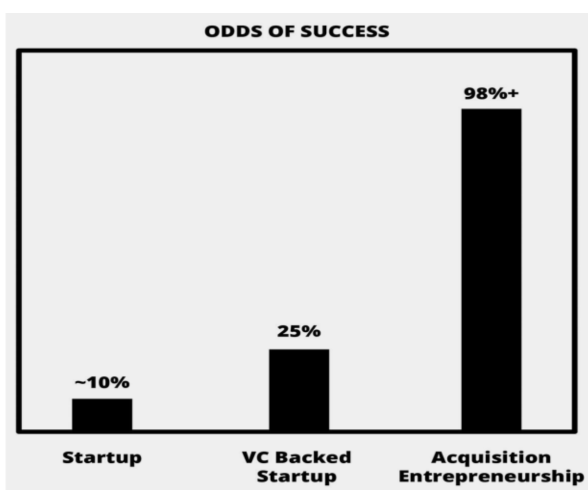
Margin of Safety

Risk is relative. The risk-return spectrum dictates that the more risk an investor takes the greater the return needs to be. Unfortunately, the "high risk, high return" model frequently plays out in the high-risk part winning out and producing lower returns.

Warren Buffett, widely considered one of the most successful investors in the world, practices what's called value investing. The fundamental belief of value investing is that there is an intrinsic value to every company. This intrinsic value is not an exact number and is subjective in nature. In loose terms, it can be derived by calculating a liquidation value, then observing the additional value a company produces over and above that: competitive advantage, brand awareness, and present value of future cash flows,

By investing when the price is favourable to the intrinsic value, it effectively limits the downside risk, building in a level of protection into the investment. Managing the downside risk is one of the great fundamental practices of the world's most famous investors.

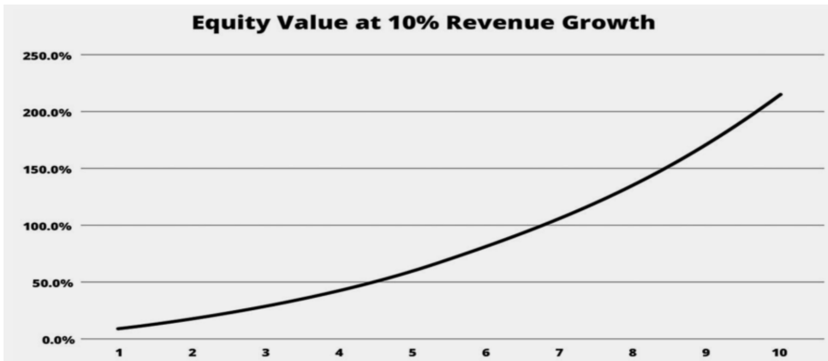
"You make money when you buy, not when you sell." That framework is the anchor for real estate investors the world over.



Upside Potential

Having a margin of safety is critical for protection if the worst would happen, but that's not why we invest. We invest because of the upside potential available in an investment.

If a 10 percent growth rate is achievable in your business, then it will be twice the size it is today in just seven years. The cash flow increases and the value of your asset increases, providing a vehicle for building wealth.



A Faster Route to Value Creation Acquisition entrepreneurship is an active, rather than passive, approach to investing. By aligning your work with your asset, you're able to take wealth building into your own hands and build something worth working for.

One thing that the venture capital firms are getting wrong is that 99.9 percent of all exits occur with companies under $30 million in revenue—and the trend is increasing. The demand for buying this size firm is approaching insatiable—

Part 2

Evaluation

"Set your mind on a definite goal and observe how quickly the world stands aside to let you pass." —Napoleon Hill

Chapter 3

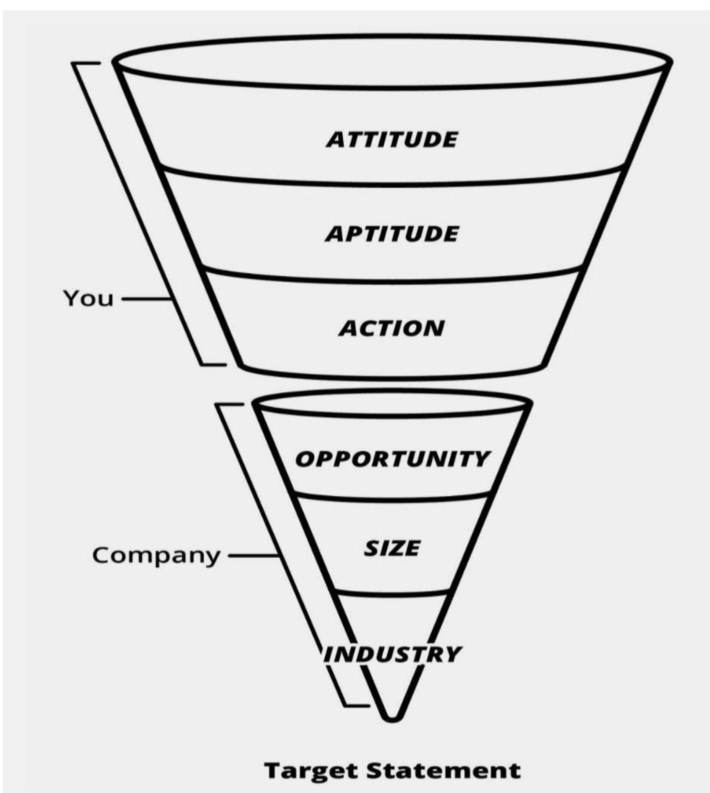
The CEO Mindset

Most people start looking for a company to acquire completely the wrong way. They start by thinking about what industry they would like to target. Even most intermediaries start with this question: what type of business do you want to find? Rarely is this the right place to begin.

With the exception of a definitive motivation to stay in the same industry to leverage existing relationships or unique operational advantage toward a specific opportunity, this is completely backwards. Successful acquisition entrepreneurs turn the traditional search process upside down.

They understand correctly that the building blocks of how to build a company and a vision don't come from what's "on the menu," but from aligning their attitude, aptitude, and action, and leveraging that alignment toward a specific opportunity.

Knowing why and how you will win before you start is critical to knowing what game you are looking for in the first place. Starting with yourself, and aligning your "3 As" of attitude, aptitude, and action, will help identify the right parameters for your search.



Building Blocks

Leadership to manage a company successfully. These are the traits:

Strategic-thinking skills

Interpersonal skills

Intellectual ability

Industry experience

Ability to deal with ambiguity

Tenacity

Organized

Laser-focused

Achievement-oriented

Thick-skinned

Risk tolerant

Self-confident

Creative

Optimistic

Assertive

Decisive

Perfectionistic

This is the Law of Three As mentioned earlier.

Attitude

One of the most tremendous predictors of long-term success is having a growth mindset.

Dweck makes a distinction between a growth mindset and a fixed mindset.

In a 2016 article for the Harvard Business Review, Dweck summarized a fixed mindset as being held by those who believe their talents are innate gifts and worry about looking smart.33

On the contrary, a growth mindset is one that views the world as more malleable, believing success is achieved through effort. A growth mindset is the little difference that empowers people to have a sense of free will. They embrace rather than avoid challenge, and they persist during times of setback. A growth mindset views effort as the path to mastery. They learn from criticism and are inspired by the success of others. Hard work, good strategies, and input from others are the tools utilized by those who believe their talents can be developed. They put their energy into learning.

The good news is if you aren’t currently oriented toward a growth mindset, it can be cultivated. Dweck observed that everyone is a mix of growth and fixed mindsets. Changing your thoughts toward developing a dominant growth-oriented mindset is the first step to be entrepreneur.

She suggests we learn our fixed mindset “voice.” This voice appears in our thoughts during times of challenge, setbacks, or when facing criticism. If your thoughts revolve around fearing failure, risk, or blaming others rather than taking responsibility, then you may want to spend some time getting your mindset ready for the job.

Aptitude

Aptitude is made up of both raw intelligence and competencies. These are your skillsets, your strengths and weaknesses. Raw intellect has been measured by IQ tests for decades. As a result, we have a lot of data around IQ and its correlation with successful businesses results. High intellectual ability is currently the single largest predictor of success in entrepreneurship and in management. In fact, high IQ plus the drive to succeed is the essential formula for success.34

Martin Seligman; In one of his more recent books, Flourish: A Visionary New Understanding of Happiness and Well-Being, he reveals the five pillars of well-being, which he identified identified through the acronym PERMA:

Positive emotion

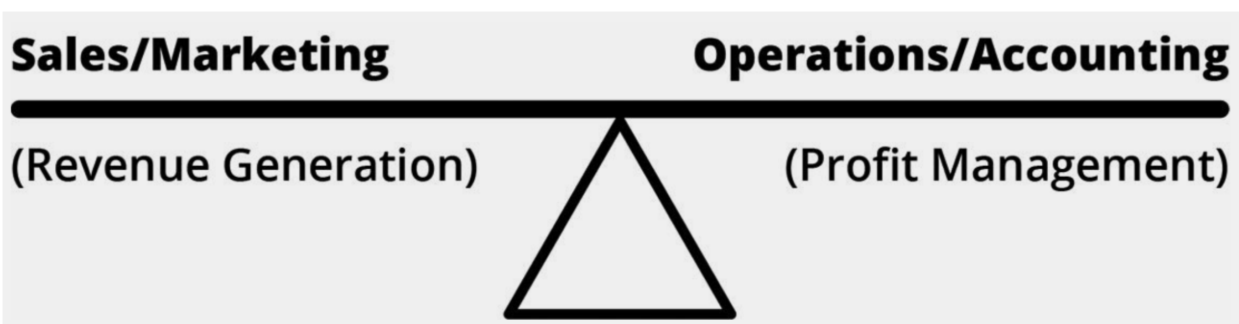
Engagement

Relationships

Meaning

Achievement

PERMA is a five-pillar list of ingredients, but the recipe for living the best life possible is different for every individual. Some people require a greater meaning in their lives, while others focus on engaging work or nurturing relationships. Achievement means just that—people driven by achievement in their lives in order to truly flourish as individuals.



You need to manage both sides of business to be acquiring entrepreneurial business

Chapter 4

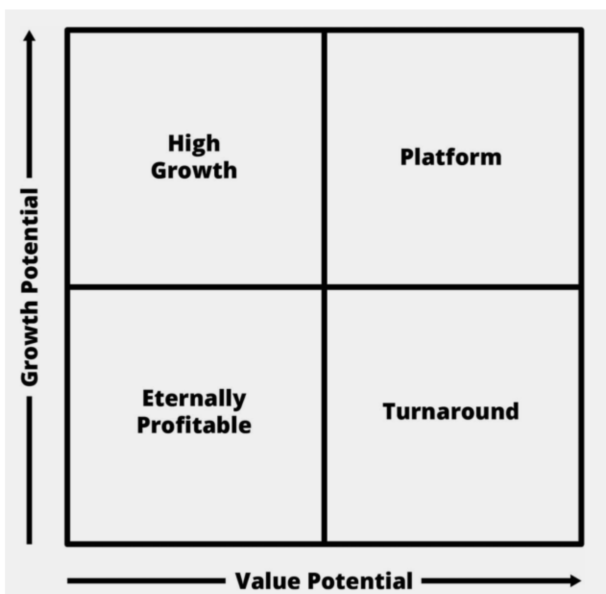
Defining the Target

Finally, we'll bring it all together into your own personalized target statement. Your target statement will be the driver of your search and ascertain that you are communicating exactly what you are looking for to the right people.

Opportunity Profiles

The number one thing that I stress when helping people find the right company for them is to I believe that there are four main models of building value in a company after you acquire it. Although I personally tend to look for more-or-less stable, evergreen businesses with strong potential upside, there are other models to consider based on your strengths.

Are you looking for a turnaround. What about high growth or an "eternally profitable" business? Or perhaps something that has components that allow you to leverage existing relationships for growth? These are all very different profiles, and each is extremely valid.



Eternally Profitable

The profile of an eternally profitable businesses Snow lowing It's a "cash cow" with very small growth opportunity, but also small threat of industry disruption. It's a stable and dependable business that you can count on. It may also be assumed from a business like this that the customer relationships have been long established and the company has a dependable track record.

Turnaround

The turnaround is a tremendous place to create value if you are strong in operations and have a great understanding of financial reports and managing cash flow. A turnaround describes the acquisition of a company that has fallen on hard times, with the goal of improving operations, building efficiencies, and strengthening the value that the company provides to its customers. It's the company version of the "fixer-upper." Often, however, the best opportunities are with companies in pretty bad shape, even bankrupt.

These companies typically have complicated messes to work out. Still, for the operational expert, these opportunities can be the diamond in the rough. To them, the assets are acquired for a favourable price and then "fixed." The point is that the assets of the company are discounted from a typical selling valuation— sometimes as low as liquidation value—due to the underperformance of the company.

High Growth

Growth in revenue and earnings is what drives maximum value of every business at the end of the day. A company coming off, say, three years of significant revenue growth is exciting and attractive for many buyers.

The good news behind high growth is that there is clearly demand for the product or service, and the company is doing well at delivering it. The bad news is that because revenue and earnings growth drive value, you will be paying more for that prior performance. This is worth it as long as the growth rate continues under your leadership, but paying a higher multiple introduces added risk to your company if you use significant debt in the acquisition process.

Remember the margin of safety we discussed in Chapter 2? Overpaying for a company reduces that margin of safety.

Another great help is to ask for income statements on a cash basis versus an accrual basis for high-growth companies. This will give you insight into the variance in demand for inventory or costs of goods sold per month

Platform In private equity, a platform company refers to the first company a firm acquires in a specific industry. The main driver that identifies a platform is that the specific growth opportunity matches your aptitude and activity goals. A good goal would be a 10 percent year-over-year pace.

If you have insight into an industry and want to build a SAAS-model software for a certain industry, you can find a company with a customer base ideal for such a rollout.

Looking for Growth

Whenever I am looking at any business, I'm looking to identify the path to growth and the amount of upside potential. How big can this business be? Try to understand the driver behind a company's value and how to best scale it. How to accelerate it, change it, or keep it as a lifestyle business.

Now, I want you to clearly define the growth opportunity you are looking for. Is it a company that needs to build a sales team? Improved marketing? New distribution channels? Financial engineering? Operational improvement? Or a customer base in a certain market? The truth is, you already know. Identifying this clearly is the first part of what will become your target statement.

Instead, define the target by the amount of SDE. To review, the Seller Discretionary Earnings (SDE), is a measure of how much total cash flow the seller of the firm has been enjoying. It is calculated by taking the pre-tax earnings of a company, then adding back any interest and non-cash expenses like amortization and depreciation (which will give you Earnings Before Interest, Taxes, Depreciation, and Amortization). Finally, adding in any seller benefit such as salary, personal insurance and vehicles, and any one-time expenses the company had during that time. As listings move from Main Street to middle market, a definition largely defined by size, you'll likely see Adjusted EBITDA as the metric used instead of SDE. They typically refer to the same thing. The difference is often that Adjusted EBITDA is the term largely used for passive ownership, while SDE refers to active ownership.

PP=SDE*M

PP	PAC	M	SDE	ROI/Year	50% SDE Ext Valuation	Net ROI Loan paid 60%	Estimate COC%
$50,000	$25,000	3	$16,667	66.7%	$97,500	$67,500	170%
$100,000	$50,000	3	$33,333	66.7%	$195,000	$125,000	150%
$200,000	$100,000	3	$66,667	66.7%	$390,000	$250,000	150%
$300,000	$150,000	3.5	$85,714	57.1%	$585,000	$375,000	150%
$400,000	$200,000	3.5	$114,286	57.1%	$780,000	$500,000	150%
$500,000	$250,000	4	$125,000	50.0%	$975,000	$625,000	150%
$600,000	$300,000	4	$150,000	50.0%	$1,170,000	$750,000	150%
$700,000	$350,000	4.5	$155,556	44.4%	$1,365,000	$875,000	150%
$800,000	$400,000	4.5	$177,778	44.4%	$1,560,000	$1,000,000	150%
$900,000	$450,000	4.5	$200,000	44.4%	$1,755,000	$1,125,000	150%
$1,000,000	$500,000	5	$200,000	40.0%	$1,950,000	$1,250,000	150%

Size

When it comes to buying a company, size matters. Typically, the size of the target is identified by revenue but then valued on a multiple of SDE or cash flow.

You can find a simple acquisition modelling tool to help you define your target by size at BuyThenBuild.com. This will help calculate the amount of equity you would need to close on a certain-sized business. Or, if you prefer, help identify what size business you can acquire with the amount of cash you have to invest. But let's walk through how the calculation works here.

Product, Distributor, Service

All business can probably be identified as offering a product, acting as a distributor, or providing a service.

Business Reference Guide.42 This is a wonderful reference for determining trends, valuations, margins, expense breakdowns, other benchmark data, and expert comments. Once you start working with brokers, they will all have a copy they can reference for you, but at just over twenty dollars per month for an online subscription, I find it's a great way to explore all the possibilities before getting lost in the details of specific deals. It will also help you later, while previewing potential opportunities, to know whether you are looking at a standard, sub-standard, or optimal performance for the industry in which it's in. It's a minor cost for such a transparent view.

Now it's time to pull all of this together in your target statement. This is what you will use as your compass as you start your search journey. It goes like this:

I am looking for a [choose product, distribution, or service] company with [enter the type of growth opportunity], generating [define size by SDE range], with [enter any limiters].

The order isn't critical and you can eliminate any part that doesn't apply to you, but it's important that all aspects are considered. Here are a few examples: "I am looking for a distribution company with strong sales and marketing processes but needing operational excellence, generating $300,000 to $400,000 in Seller Discretionary Earnings, in or around the Chicago area." "I am looking for a manufacturing company with no current eCommerce presence, generating $250,000 to $300,000 in SDE." "I'm looking for a commercial IT service business with solid operations but lacking a strong B2B sales effort, generating between $750,000 and $1,000,000 in SDE in the regional southwest." "I am looking for any service company tied to real estate with a direct sales effort needed as the driver for growth, generating between $400,000 and $500,000, located in the greater Portland area."

Chapter 5

The Search

The serious buyers begin reaching out to brokers or intermediaries after that. Out of the few potential buyers that get a true search going, only about one out of ten eventually buy a business. Obviously, the current process is flawed or there would be greater success rates.

Finding a job that is a good fit for your skillset is probably 90 percent networking. Finding a business is no different, skip the online job sites they may not have the real deals that Less people know about. These sites exist for people who do not have deal flow themselves.

All the jobs aren't bad, but most of them are, and the great jobs never find themselves on an online job posting site. Finding a job that is a good fit for your skillset is probably 90 percent networking. Finding a business is no different.

Getting past the internet listings and getting upstream to the brokers themselves will help generate your own deal flow. Anything that ends up on the online marketplaces has already been shown to those buyers known to the listing broker, as well as likely other brokers in the same or neighbouring firms. Once no one they know buys it, it can get listed on the internet (perhaps their own site first, then the marketplaces later).

Meeting Brokers

During your first meeting with an intermediary, they want to know three things:

1- Who you are, what type of investor you are?
2- DO you have the resources and willingness to buy?
3- What type of business you think is good for you?

Brokers who screen their listings are taking on a different level of responsibility than those who don't. This does not mean you don't want to work with those who don't, but you need to be aware that everything you look at from the beginning should be assumed to be false, since the broker takes no responsibility to qualify their listings. This will make due diligence longer and even more critical.

Every Business Is for Sale

Where do intermediaries find listings? Listings are current businesses where, after talking to a broker who reached out to them, the owner has expressed an interest in potentially selling. I like listings a lot because the broker has spent time with the seller, prepped them on the valuation of their company, and spent time getting the seller to the point where they are willing to explore a sale. Also, as you get into the acquisition process, you'll experience first-hand the tremendous benefit having a broker in the deal provides.

You need someone to walk through the valuation with them, to get them ready emotionally, and to negotiate on behalf of what's best for "the deal," and not just the buyer. The seller has a lot to think about, and they might not understand all of those points immediately. It's best to establish an intermediary right away in those discussions.

I simply tell them that there is a broker I'm working with who can work confidentially with them on putting together a valuation. If the potential seller likes the valuation, the broker can present it to me and we can go from there. This is a great strategy for getting the ball rolling. If there is a personal relationship or network, it works wonders.

Conclusion Knowing what you're looking for is half of the search. Actually, it's more than half. If you know what you're searching for, you can move forward quickly, with clarity, and you will and save months of tire kicking and time wasting. You will be able to behave like a professional buyer, knowing when you like something and why. You will be able to see in short order if it is a real yes, a real no, or something that requires next steps to evaluate whether it is a good fit.

Part 3

Analysis

"If you change the way you look at things, the things you look at change." —Wayne Dwyer

So far, you've learned the economics of acquiring a business; you've aligned the Law of Three As, including completing personal assessments around your strengths and weaknesses; you understand the Acquisition Opportunity Profiles Matrix; you've developed your target statement; and you've initiated your search by going upstream. The amount of preparation you've put into this alone separates you from the vast majority of potential buyers, just so you're aware. The next step will be bringing a deal together so you can acquire a firm.

Entrepreneurship is the art of creating something out of nothing, creating value where it wasn't before. Bringing a deal together is exactly that. It's the art of making something out of nothing.

Conversely, purchasing a company with all cash will maximize safety but lower the ROI to the absolute minimum. Again, this is up to you. I have known people who have purchased companies at both extremes. The final recipe is up to you (and the bank).

What Banks Look For Ultimately, banks will be looking at the target company's ability to pay back the loan. At the end of the day, that's all they truly require. They look for a minimum debt-to-earnings ratio of 1.25, but often banks will look for more—this is just the minimum.

Life insurance isn't just important for the bank but your family as well. If something happens to you, the insurance will pay off, at absolute minimum, the uncollateralized portion of the debt so the business can be operated or sold without having to worry about the loss of your involvement. If your family chooses to operate it, the total cash flow will increase either by eliminating the need for monthly loan payments altogether, or through increasing the cash benefit at exit with the equity build-up provided by the insurance.

A good CPA can understand a business by looking at the history and comparing internal statements with tax returns. They understand business strategy and know where the snakes can hide in the grass in financial statements. They will be critical in helping you with due diligence later and asking the right questions. More importantly, they'll help identify where problems lie and can keep you out of trouble.

Lawyers

Time and time again, lawyers are deal breakers and not deal makers. This is because their mission is to protect their client at all costs, even if it means the deal doesn't go through. Redline documents going back and forth will be the most sensitive time of the process. Everyone is emotional, stakes are high, and the lawyers get in the middle.

The buyer is the one who wants the rights and warranties, whereas the seller doesn't want any, so utilizing the buyer's legal team's documents can put the buyer in the best position and limit the first round of back-and-forth.

Chapter 7

Buy for the Future, Pay for the Past

In this chapter, we'll address the numbers surrounding a potential acquisition. Entire books and entire careers are built around understanding, analysing, and projecting financial performance. Since we'll be spending one chapter on the topic, my goal is to give a brief overview of how cash flows through a company, understanding what the financial statements are telling you, and how to attach your own value to a company.

Initial Review When you first request more information about a company and sign a confidentiality agreement, you'll be given an Offering Memorandum (OM), which will typically include two parts. First, a write-up on the business including things like:

asking price name location product or service offering number of employees who they are and their roles customer overview and concentration reason for selling typically, a growth plan for moving forward.

Second, a report on financial performance, typically given in the form of recast income statements for the past two to five years and a current balance sheet.

As you begin to review financial performance and statements, there are five areas of specific importance you'll be wanting to look into: revenue, profit, operational efficiency, cash flow, and the total Owner Benefit (the SDE). All of this information can be found in their financial statements provided in the OM.

There are three standard financial statements: the balance sheet, the income statement, and the statement of cash flows.

Assets = Liabilities + Owner's Equity

An even simpler calculation would be to acknowledge that assets, those things of value owned by the company, minus the liabilities.

A balance sheet, Moment in Time

You can learn a lot about the overall health of the company by analyzing the balance sheet. It's common to look at ratios like Return on Equity (ROE);65 and debt to equity, the quick ratio to measure liquidity;66 and Current Ratio, which is current assets divided by current liabilities. These help identify the return owners are getting from the business, how much leverage is being used to operate, and the ability to pay off short-term obligations.

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The Income Statement

While the balance sheet is a snapshot of a specific date, the income statement reports a company's financial performance over a specific period of time, whether that be monthly, quarterly, or annually. Commonly referred to as the profit and loss statement (P&L), the income statement provides all revenue and expenses of a company during that period and reports whether the company is profitable or not.

Operating Expenses

Operating expenses fall below gross margin on the income statement and largely represent fixed expenses. There might be some variance based on sales level (additional inventory charges or sales commissions, for example), but they largely represent the overhead associated with a business, or costs that must be met every month.

Expenses are typically broken down into five categories: selling, general, and administrative (SGA); depreciation and amortization; other expenses; interest expense; and taxes. Net income is presented on the infamous "bottom line" after all the expenses are taken from the gross margin dollars. Net income is the profit that can be used for reinvestment in the company or additional cash to the ownership.

To understand the cash the company has generated as a result of its operations, analysts will calculate the company's Earnings Before taking out Interest, Taxes, Depreciation, and Amortization. This is creatively called EBITDA. It's not a line item on the income statement, but you can quickly calculate it with the information available. ultimately, EBITDA points to the company's ability to make money regardless of how you finance operations.

Cash Flow Statement

The third major financial statement is the statement of cash flow. This statement reports the cash at the beginning of a period, the cash at the end of a period, and the cash in and cash out that impacted the difference. Cash flow statements are sometime provided in an OM, typically on larger-sized deals, but it's not common. You'll typically see this during due diligence. The purpose of the cash flow statement is for a potential buyer to understand the working capital demands of the business, and to make sure the company is producing enough cash to pay its expenses.

Valuation

Valuing a privately held company can be as complicated as you make it. Ultimately, there is a value to the buyer and a value to the seller, and getting the two parties to agree on a transaction usually means that both parties are getting most of what's important to them out of the deal.

Asset-Based Valuation

There are three main asset-based valuations: book value (BV), fair market value (FMV), and liquidation value (LV).

Book Value Book value we discussed earlier while reviewing the balance sheet. It's the net worth of the company as reported by its financial statement under owner's equity. It applies the value of the assets currently on the books, then subtracts the liabilities. This can be an interesting academic understanding, but in my experience, it's not at all accurate.

Fair Market Value Fair market value addresses the issue that the value of the assets on the books is probably in error. There are professionals for hire who will evaluate the condition and attempt to calculate an estimated value of all the assets on the open market, should each asset be sold off individually. This type of analysis will discount accounts receivable that may or may not be in question, use the cash balance to simulate paying off payables or any liabilities, address value to current inventory levels, and apply useful life analyses on furniture and equipment.

Liquidation Value Liquidation value estimates what all the assets in a company would sell for in a fire sale, then subtracts any outstanding liabilities. Essentially, if the company were to liquidate today in order to turn everything into cash, how much cash could it generate?

Cash Flow Based Valuation

Cash flow based valuation has two common methods: Discounted Cash Flow (DCF) and Valuation Multiple.

Discounted Cash Flow

Discounted Cash Flow is the most common valuation method for transactions at investment banks. The approach starts with projecting the future earnings of a company by looking at prior history, industry projections, and a dozen assumptions, then discounting those future earnings by applying a weighted average cost of capital to a value that it would be worth today.

Valuation Multiple

It didn't take long for markets to determine that all these valuation models result in some kind of multiple applied to a metric in the business in anticipation of capturing a certain return of invested dollars. We've discussed EBITDA and SDE (or Adjusted EBITDA), which represent the cash flow of a company over the prior years to the shareholders or owner. Markets change all the time, but most Main Street businesses will sell for 2–3 × SDE, while most lower middle-market companies under $5 million in transaction value will sell for 2.5–6, depending on a number of factors. Look at the prior three to five years and apply more weight to the more recent years. For example, the most recent year would be weighted 70 percent, the year prior 30 percent, and the third year back 10 percent.

Given the fluctuation in applied valuation models, it's critical to determine what the business is worth to you, not the marketplace.