

SCORE SouthEast Wisconsin

Valuation of a Business for Purchase

There is no magic formula for evaluating an existing business.

The most helpful financial figures to consider generally are historical cash flow and earnings. Such data may help forecast a return [or no return] on your investment

Here are some of the essential components of a business valuation. [1] Past three year's cash flow. [2] Revenue trends [growth or decline]. [3] Gross profit margins and any variations. [4] Overhead expenses: current owner compensation; lease terms etc.. [5] Legal issues; other obligations. [6] Tax returns for last three years. [7] Anticipated costs of updating equipment or services, and /or personnel changes.

These items are a part of financial statements. What is the quality of these financial statements? Good question! Are they prepared by a third party [CPA]? Using what standard? GAAP [Generally Accepted Accounting Principles]? If they are self-generated, how much credence can you give them?

One commonly used rule of thumb is that you should be able to recoup your investment costs in five to seven years.

You will need to retain experts - an attorney or an acquisitions [M&A] firm - to read the financial statements and walk you through the complicated process and details.

Spend ample time at the business, interviewing the present owners, who might be willing to stay on for a while to help with the transition. Also ask questions about which employees might stay or leave, and about any legal issues the company might be facing. Research the competition, location and industry trends, and talk with customers and suppliers.

Check recent comparable sales in the business's industry, and the multiples of projected cash flow they sold for. Such data is for sale online on Web sites such as <www.BizComps.co> and <BVMarketData.com>. Also look at the Risk Management Association's Annual Statement Studies, which list the average financial ratios for businesses in hundreds of different industries.

Keep in mind. If there are too many red flags, usually the best thing to do is to walk away.