

Consider rate of return in pricing businesses

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The challenge of starting your own business and putting forth the time and effort



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required to make it prosperous and valuable can be fulfilling. A day may come when you want to sell it. Even if it's not in the current plans,

buyers may approach you. The rewards of building equity in the business can then be reaped.

Once the decision to sell a business is made, the obvious first question is: How much is it worth?

The basic principle behind valuing a privately held business is no different than assessing any other investment opportunity. Buyers of privately held businesses typically arrive at its value or how much is required to be invested by determining the total expected cash flows to be made in the future in terms of today's dollars (i.e., present value of future expected returns). In other words, business buyers are primarily concerned with the return on their money.

Using this valuation principle, a key variable in arriving at a value is the rate of return (typically stated as a percentage, such as an interest rate). Investors demand different rates of return for different types of investments. Generally, the safer an investment is, the smaller the rate of return will be enjoyed by the investor. By way of example, if you have \$500,000 to invest and your appetite for risk is small, you may consider a safe-rate type of investment, such as a Treasury bill yielding approximately 5 percent annually. Such an investment would yield an annual cash flow of \$25,000 on the \$500,000 invested.

Conversely, when an investor purchases a closely held business, he or she is abandoning a safe investment and taking on more risk. The rate of return will be increased from 5 percent to

approximately 20 percent or even higher to compensate for the increased risk. This is a fundamental concept in valuation — that is, the greater the risk, the higher the rate of return an investor requires.

Therefore, assuming that a business can generate annual profits or net cash flow benefits of \$125,000 for an owner, and assuming further that the potential owner wants an annual rate of return from such business of 25 percent, the potential owner may be willing to pay \$500,000 for the business (\$125,000 divided by 25 percent).

It is my experience that many private business owners initially tend to believe that the value of their companies is far greater than buyers are willing to pay. When they put the business up for sale, it often takes them a long while to adjust their pricing to reflect the realities of the marketplace. The market of

buyers for private businesses typically apply the valuation principles discussed above to determine the price they are willing to pay.

For example, let's analyze a company that has had average annual sales in the last five years of approximately \$10 million and average net annual profits over the past five years of \$500,000. The owner/seller believes he can command a sale price equal to annual sales (\$10,000,000). Buyers are analyzing a purchase by measuring return on their investment. If the business has annual profits of \$500,000, a buyer may require a rate of return of no less than 20 percent, meaning that he may be willing to pay \$2.5 million for the business (\$500,000 divided by 20 percent).

Buyers may reason that if they were to pay the \$10 million that the seller believes the company is worth, the

annual return on their money would be 5 percent, a rate that they could earn by simply investing in a much safer and less labor-intensive investment such as a T-Bill or investing in the stock market.

Investing in the stock market would also be a passive investment with a much greater chance of earning more than 5 percent annually. Therefore, business owners need to be mindful that, despite how successful a company they may have built over the years is, they will need to consider the valuation principles discussed, as buyers will likely calculate a price based on an appropriate risk-based rate of return.

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