Business Growth and Value

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High rates of expected growth are factored into the BizEquity valuation model chiefly by way of elevated multiples (which are comparable to lowered discount and cap rates) based on time frames of 3 to 5 years. However, the de facto result is not indefinite growth - and the impact of growth after five years into the future is very low due to the time value of money (a dollar today is worth more than a dollar in the future due to opportunity cost, risk and inflation).

It is also the case that only high rates of expected growth (well above industry norms) will have a material impact on the value of owner-operated companies, as the hypothetical buyer is generally more interested in what cash flow is available today based on his full-time involvement now and in the near future (all other things equal).

Discussing Growth and Value with Clients

When discussing growth with business owners, it is helpful to focus on the concept of discretionary earnings (SDE or seller's discretionary earnings) and the size effect. Owner-operated businesses rise in value when the earnings increase or the risk of garnering the earnings falls. Throughout all of business valuation, there are no more solid relationships available than that of earnings size and pertinent multiples (on an industry by industry basis of course).

You can practically guarantee business owners that if earnings rise by X%, value will rise by Y% (all other things equal). It is the central focus of valuation for owner-operated businesses and it behooves the Financial Advisor to learn the basics of this pivotal calculation.

There are several ways to increase the pertinent multiple stemming from the control of risk associated with future cash flows. For example, reducing the firm's reliance on the primary owner-operator tends to reduce the risk of future cash flows and elevate the pertinent multiple (so-called absentee owner premium, which is effectively the opposite of a "key person discount").

The Size Effect

In simplest terms, higher earnings equal higher business value due to a dual impact explained shortly by example. For now, consider the size effect within the Pratt's Stats database:

The Size Effect (2015 – All Industries)

Total Sales	Price/SDE	Price/EBITDA
Up $1M	2.2	2.9
$1M - $5M	2.8	4.3
Over $5M	3.8	5.90

This relationship between earnings magnitude and pertinent multiple is one of the key rationales underlying merger and acquisition activity AND the so-called roll-up strategies where a holding company acquires numerous smaller firms at a multiple of X times earnings and then consolidates and sells the entire group at a multiple of 2X times.
When contemplating business valuation and deal making in general, and the size premium specifically, it is necessary to think in terms of segmentation (as follows):

Typical Multiples within the Markets for Corporate Control

Business Brokerage Segment (small, owner-dependent)	1 to 3 times SDE*
Middle Market (medium, less owner-dependent)	1 to 3 times SDE*
Publicly-Traded Firms (large, non-owner-dependent)	10 to 25 times Net Profit

*SDE refers to "seller's discretionary earnings", which is equal to pretax profits, a single owner's compensation (salary and benefits), interest and non-cash charges and any one-time, non-recurring, non-operating adjustments.

Key takeaways from these relationships include:

- As the amount of earnings/cash flow rises, the average multiple of earnings/cash flow will rise.
- As we move from segment to segment, the size of the average multiples increase.

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From the perspective of the small business owner who is planning an exit strategy alongside a strategic or business plan, this means that there are two routes toward enhancing company value from month to month and from year to year:

Two Simultaneous Earnings Routes Toward Enhanced Company Value

Route One:

Increase the absolute amount of earnings or cash flow available to the owner.
If earnings rise or double from $250K to $500K, the value of the company will at least double:

$250K times 3 = $750K
$500K times 3 = $1,500K
Increase in Value = $750K or 100%

Route Two:

Increase the pertinent valuation multiple.
If earnings rise or double from $250K to $500K, the pertinent multiple will rise from say, 3 times to 3.5 times, and value will increase by more than 100%:

$250K times 3 = $750K
$500K times 3.5 = $1,750K
Increase in Value = $1 million or 133%

Over the course of the business cycle, the most substantial source of higher value in private firms is simply the higher earnings generated during the growth phase. As the economy transitions from recovery to recession, the same relationships hold in reverse.

Conclusion

The average value of private firms will rise during periods of economic growth for four general reasons:

1. Higher revenue and higher earnings level (at any multiple)
2. The impact of the size effect (i.e. higher earnings warrant higher multiples)
3. Rising multiples based on specific industry trends (growth and risk)
4. Rising multiples based on lower risk of company-specific cash flows

The first two factors are most important, as each dollar of additional earnings will raise the firm value by a multiple thereof—and this multiple gets larger as the amount of earnings rise.