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The Value of the Owner to the Business's Value

Every so often I hear the statement, "the business is so well run you can hire a manager for $50-60,000 a year to keep it running." The implication is that the rest of any owner compensation is really profit and therefore the value (and price)* of the business should be higher.

This may make sense for a micro-business (a lot of franchises are good examples of where a non-owner manager can run it just fine), but do you really think this applies to a sizable small business? Say one with $5-7 million in sales and 10-15% profit? I've always found it absurd when someone insinuates that the owner of a business making well above the average profit margin could be run just as well by someone willing to work for $50-60,000 a year. You don't get much management skill at that pay level, and even less leadership ability.

Real Life Story

Gary sold a wonderful business with the following features:

- Net profit of over 25% of sales.
- Profit in the very high six-figure range.
- Growth of sales and profits every year during the recession.
- A typical workday (for Gary) of a few hours in the office every morning to do some bookkeeping and keep an eye on things. This on the days he was actually in town, not traveling around the country or to his place in Central America.

So, could a $60,000 a year manager run Gary's business? Sure, for a while. A very short while, after which it would start to deteriorate. You see, Gary, like a lot of owners who have been around and are "coasting," could spot things in 10 minutes that might take a new owner or a hired COO (not a low-priced manager) a day, a week or longer to spot. He could see it in the numbers, the operations and the job flow. And he could make adjustments quickly; so quickly the untrained eye might not notice anything was done. This is exactly why the statement in the first paragraph is bogus. There's more to it than just showing up.

The intricacies

I tell buyers and sellers that the transition period is the time when the seller teaches the buyer all of the little intricacies that make the business what it is. In blunt terms, these are the things that allow the seller to receive a price based on profits vs. net asset value because those profits have created goodwill.

It's rare that a buyer will pick up everything immediately. It takes some time before you can walk in, see something off kilter and correct it quickly. The good news is, once a buyer realizes those insights and combines them with their skills and energy they can take the business to the next level.

Conclusion

Every business seller wants to get as high a price as possible. At the same time, the buyer doesn't want to be swamped in debt or be under-collateralized. And the bank wants to be sure they get paid back. It all comes back to what the true value of the business is, after allowing for fair-market owner compensation.

And, on the flip side of the above, a buyer who has been making $400,000 in his or her job can't expect to plug that salary into the valuation equation for a business that can't justify that owner salary, which would drive the price down if used in any valuation formulas.

* There is a difference between value and price. A business's value is a partially theoretical number based on proven and accepted methodologies and it's called a valuation. The price is what a buyer will pay for the business based on their skills, insights and desire and is based somewhat on the valuation. Some buyers will discount the valuation because of personal factors. Others will have the opinion of my former client Craig (whose story is in my book) when he said, "I don't care if I pay X for the business or X plus $100,000 because I know what I can do with it."