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What makes your business valuable in the marketplace?

Brad Cherniak | October 29, 2014 4:15 PM ET

Fotolia *It is important to note that for a small business, valuation is all about negotiation — offsetting the inherent and unique negatives of your company with the unique positives.*

It is perilous to make generalizations about the market valuation of small to mid-sized businesses (the value in a transaction, such as a sale of the company) — even more so than fundamental (or theoretical) valuation, which is generally more rules-based, stable and predictable.

Each industry, and even niches within an industry, has its own formal and informal metrics. And these metrics vary widely by size of company, and with general economic and market conditions.

But they especially vary with what I'll call "local supply and demand." In other words, the merger and acquisition markets for smaller privately held companies are not efficient or liquid on a national or even regional basis, the way they are for large companies.

This is partly due to the nature of the companies themselves, and partly the structure of the investment bankers.

It is harder and more expensive — time- and money-wise — for both buyers and advisors to identify and do due diligence on companies that are not close to a major airport. And the smaller the company or the advisor, the more relatively onerous the expense is. The internet has improved this, but only marginally.

So it is an atomistic market in terms of both supply and demand. There are pockets of activity, where deep supply meets deep demand, which can create more robust, stable and sustainable valuations, but these pockets can come and go quickly — like finding a small boat on a rough sea.

It is important to note that for a small business, valuation is all about negotiation — offsetting the inherent and unique negatives of your company with the unique positives. While the same holds true for larger companies, the range of valuations tends to be tighter across methodologies and time. For smaller companies, the sweet spot is much trickier to identify and the ranges are much larger.

There are, however, some commonalities that tend to be highly correlated with a higher, or lower, valuation.

Value negatives

— SMBs have fewer redundant resources, and are therefore more fragile and more risky than larger businesses, all else being equal. Because of the limited resources, performance can be hit materially by a single customer, salesperson or other key employee leaving. This tends to make growth in sales and profits more spotty, unless the company is in a secular growth curve for its product or technology.

— There is also a prevailing bias that all small companies should be high growth and that the only reason they are small is because they haven't had enough time to grow into large companies. For the vast majority of small companies, this is not the case. Hitting growth targets in the low single-digits is often as daunting for them as it is for Hewlett Packard or IBM. This means many companies don't have the growth to offset their higher risk and more volatile operating performance. This can create a downward valuation vortex, where it becomes difficult for business owners to see sufficient value for their companies, other than the absolute top performers.

As I have written about before, there is a black hole just below the top performers, and has been for some time. *(Avoid today's valuation black hole,* Feb. 11, 2013*)*

Value positives

— You should have sustained, high gross margins above industry average. The higher the better. Most investors and acquirers realize that fat and sustainable gross margins are indicative of a true competitive marketplace advantage — the hardest competitive advantage to gain. Translating gross profits into net profits involves having good operational management, which can generally be hired. If you have poor gross margins, selling your company may not be your biggest challenge, so the exercise of improving them could be beneficial in any event.

— Having an advisor and an active board shows seriousness of intent to do a transaction, reducing the buyer's risk. If an advisor is good, he should be better at the negotiation than the business owner. It comes down to practice making perfect. Small business owners should be careful with industry specialists, as they often have closer relationships with the buyers — their repeat customers. The key to getting a good advisor is pretty simple: look for technical skill, broad experience, independence (their objectives don't conflict with yours) and pure tenacity.

— Sell your company when you are showing year-over-year growth in key areas. If not in sales and profits, at least new customers. You need to show momentum. Everything drives off this, buyer confidence, credibility of forecast financials, even employee morale and loyalty. Selling while on the defensive is a tough thing to do. This goes back to the valuation black hole: Stay out of it if you can.

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