MOST PROBABLE SELLING PRICE

One of the more effective methods of setting a price for a business is to determine its probable selling price. While each business is unique, there are common metrics that the market uses to set prices. Large corporations with access to capital markets can use methods such as fair market value to set enterprise value. Small businesses, in contrast, must rely on other methods (describe below) as proper barometers for selling price. Most Probable Selling Price (MPSP) is the most commonly used method to establish a starting selling price for a small business.

What is MPSP

The International Business Brokerage Association defines MPSP as "that price for *the assets intended for sale* which represents the total consideration most likely to be established between a buyer and seller considering *compulsion* on the part of either buyer or seller, and *potential financial, strategic or non-financial benefits* to sellers and probable buyers." *Emphasis added.* The assets intended for sale are those assets of the subject business that are reasonably necessary for the buyer to produce similar operational results that the seller enjoyed. This usually includes the inventory, furniture and fixtures, equipment including computers, perhaps vehicles, and intangible assets. Intangible assets include intellectual property such as customer lists, vendor lists, employee roster, trade names, trade secrets, patents, copyrights, websites, email addresses, and social media accounts. The seller usually transfers title of the equipment free and clear of any debt or encumbrances. The seller usually retains the operating cash, accounts receivable, trade debts, employee obligations, long term debts, and all other liabilities and obligations.

MPSP transactions assume the buyer, seller, or both are compelled to close the deal. This means the parties are motivated and engaging in good faith negotiations to identify and resolve issues. Without compulsion, the parties are merely posturing to discuss theoretical, intrinsic values about the business.

Sellers and buyers may have financial, non-financial, or strategic reasons regarding a transaction. Sellers want to cash out (financial) and retire or do something other than the operation (personal). Buyers are typically looking for a job. Some buyers may want to buy the business for strategic reasons such as to reduce competition, expand its footprint, enter a new geographic market, or broaden their service offerings.

How is MPSP Determined

This discussion covers small businesses under $2 million in annual revenue. Business intermediaries (BIs) use three primary methods for determining MPSP: the Market Approach, Income Approach, and Asset Approach. Under the Market Approach, BIs use the Direct Market Data Method (DMDM). In the DMDM, the BIs calculate seller's discretionary earnings (SDE) or the operation's revenue and uses a market multiple of historical transactions to determine MPSP. They use the operation's primary NAICS, size, and unique characteristics to determine the market multiples' mean values. The final estimates are a range of market multiples. BIs adjust these multiples based on how favorable or unfavorable they believe the subject operation compares to a standard operation. If, for example, the subject operation has an unfavorable concentration of revenue (e.g., a few customers represent a substantial portion of its sales), then the market multiples used to determine the MPSP range would be lower than the mean market multiple range. History shows that the multiples have not varied much over time within an industry. However, MPSP based on SDE tends to be more reliable than on revenue.

Under the Income Approach, BIs can use the capitalization of earning approach or a discounted futures benefit approach. Under the capitalization of earnings approach, seller's most likely discretionary earnings are divided by an investment rate consistent the risk associated with the subject property. The investment rate is a build-up rate which include the risk-free rate, a premium for systemic industry risk, and a premium for risk unique to the subject operation. The discount future benefits approach uses forecasted SDEs which are discounted based on the market required rate of return for the subject operation. It is best to compare the rates one uses under these methods with comparable rates published by reliable industry sources.

Under the Asset Approach, BIs determine the likely selling prices for the business assets sold "as is" to any ready, willing, and able buyer. This approach is commonly used when the liquidation value of the operation probably exceeds the going concern value. The above methods are used to the extent reliable data is available.

How is MPSP Used

Ideally, BIs will use the three MPSP methods to determine the MPSP range. It is a starting point for negotiations. It also assumes the typical deal structure. Typical deal varies by industry. Some industries typically include bank loans and seller carryback notes (e.g., adult care facilities) while other industries are all cash deals (e.g., dental and medical practices). As the deal structure changes, so does the negotiated selling price ranges.