



What's It Worth? A Guide To Determining and Increasing the Value Of Your Child Care Business

When planning for your eventual exit from your child care business, determining how much a buyer will pay to purchase the business is critical. Often child care business owners have put decades of time, energy, and resources into founding and growing the business, and it can be an emotional process to assign a monetary value to your efforts. Unfortunately, most business owners don't have a good sense of what their business is worth, and letting emotions drive the process can set the stage for difficult negotiations and/or disappointment.

This guide explains the process used to estimate the value of a child care business.

► **Materials**

The materials you'll need to prepare to ensure that the value of your child care business can be properly calculated

► **Basics**

The basics of how business value is calculated.

► **Factors**

The different factors that impact the value of child care businesses

► **Increase Value**

Ways to increase the value of your business and better meet your financial goals

What Is Business Valuation?

Valuation is a process of understanding what your business is worth, based on how much profit it can be expected to generate in the future.



Business valuation is a process used to estimate the value of a business' assets or equity. A business valuation tells you the "fair market value" of your business and why the fair market value is what it is. The fair market value is defined as "the price at which the business

would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts."





**Thinking about retirement?
Understanding the value of your business
can help you identify if there is a gap
between what your business is currently
worth and the price you need to meet
your financial goals for retirement.**

the gap you need to fill between today's value and the value you need when you exit. Additionally, having a general understanding of the value gives you a roadmap for making business improvements and other strategic decisions.

To produce a detailed and objective valuation of your business, you might need to work with a qualified, impartial third party. The scope and cost of a valuation depends on the size and complexity of the business and the purpose of the valuation. Before hiring a professional to complete a valuation, it is important to articulate why you are seeking a valuation and how you will use the valuation.

Preparing For Your Company's Valuation

Once you've begun thinking about selling your child care business, you need to prepare the appropriate materials so that an accurate valuation can be completed. It's not necessary to have all of this information ready before you start the process, but the following information is essential to complete a valuation and formalize a plan for selling your business. Even if you're just beginning to think about the process, this checklist can come in handy to prepare your business down the line.

► 3 to 5 Years of Financial Statements and Tax Returns

While audited statements are preferable, statements prepared by management also work.

► An Up to Date Business Plan or Marketing Plan

Accurate earnings projections are key to establishing the business value based on its income.

► Business Operating Procedures

The more detailed, the better. These make it easy to understand how the business works, who does what, and what skills are required.

There are multiple approaches to business valuation, but all approaches assume that an individual purchases a business for the primary reason of generating wealth, which is measured as business profits. Therefore, a buyer will consider how much profit the business has generated historically, and its ability to generate profits in the future.

Business valuations are most commonly used to estimate the selling price of a business. The final sale price might not equal the number determined by the business valuation, but the valuation provides a benchmark for the buyer and the seller as they negotiate a sale price.

A business valuation can provide you with useful information even if you do not have intentions of selling your business soon. A valuation identifies

► **Customer List, Vendor Contracts, Leases**

It's important to be able to "check under the hood" of the financial statements to ensure that the projections are realistic.

► **Legal Paperwork**

You'll need to amend the articles of incorporation and by-laws, so it's important to know how things are structured and governed now.

► **A List of Key Managers and Staff**

It's especially important to understand who will be taking a leadership role in the company going forward.

How Are Valuations Conducted?

Most child care businesses are closely held companies, and determining the value of a closely held company is difficult and an imprecise science. There are multiple methods, each with their own strengths and weaknesses. Given this, it is best to understand the range of values that can be reasonably estimated from multiple approaches.

Valuation isn't an exact science. It's best to understand your business value as a range of reasonable values estimated from multiple approaches.

There are three general approaches to business valuation:

- 1 **Market based valuations**
- 2 **Income based valuations**
- 3 **Asset based valuations**

The examples provided in this guide illustrate the process for using these approaches to determine the "enterprise value" of a business, or the cash-free, debt-free value of the business. Because the enterprise value does not include the cash a company has in its bank account or any long-term debt, it's a useful metric to compare companies of different sizes and industries.

1 **Market Based Valuations** seek to determine the value of a business by analyzing the values of similar child care businesses, such as centers of a similar size, to determine what others in the market are willing to pay. A multiple¹ of earnings



1 A multiple compares two metrics as a ratio, such as the ratio of the sale price to the company's earnings. For example, if the earnings multiple for similar businesses is 3 and the earnings of the business being valued is \$100,000, the earnings multiple suggests that the business may be valued for a sale of \$300,000 (\$100,000 x 3).

or cash flow is often used to determine the market value. For example, a company's value might be calculated by multiplying its earnings before interest, taxes, depreciation, and amortization (EBITDA) by an amount in proportion to similar firms.

While this method benefits from being simple, it is often challenging to find useful market data, especially for small businesses like child care centers. A general rule of thumb for the selling price of small-to-medium-sized service businesses is 2 to 3 times their EBITDA. EBITDA stands for:

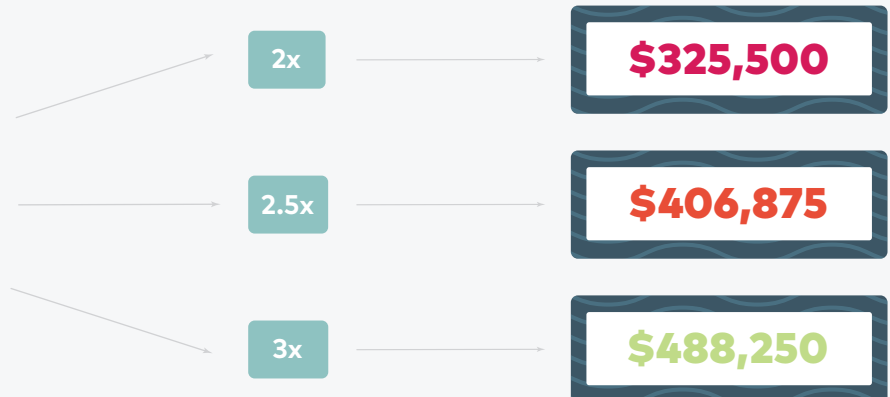
E	Earnings
B	Before
I	Interest expense for outstanding loans
T	Taxes
D	Depreciation of assets, and
A	Amortization of intangible assets.

This method is illustrated below for a child care business that had an average EBITDA of \$162,750 over the last four years.

Average EBITDA



Value

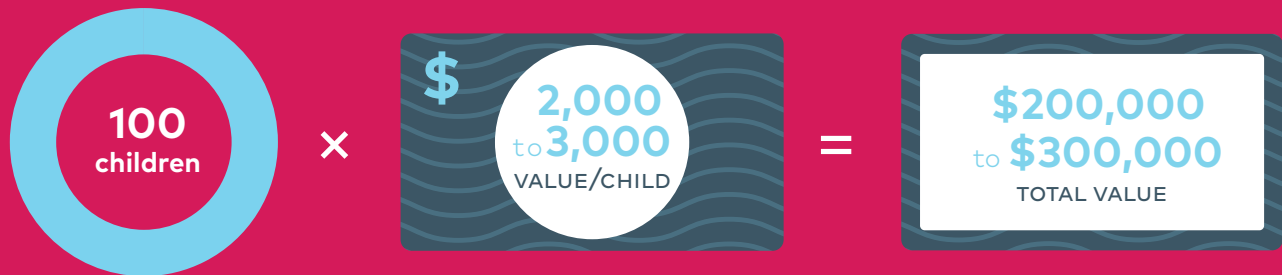


Research conducted by ICA on completed transactions since 2007 for child day care services companies with revenues of between \$500,000 and \$1,250,000 in the United States indicated a median EBITDA multiple of 2.79, similar to the rule of thumb above.

Valuation Rules of Thumb

Brokerages with experience selling a large volume of child care businesses have developed several "rules of thumb" to easily estimate business value. These guidelines include:

- ▶ \$2,000 - \$3,000 in value per licensed child



- ▶ A value of 2-3 times the owners' cash flow



② There are two types of **Income Based Valuations**, both based on the idea that the best way to determine a company's value is to determine how much cash it can produce in the future. These methods are used when:

- ▶ The company's earning capacity contributes significantly to the value of the company
- ▶ The company has intangible asset value
- ▶ Significant value is added to the company's services through labor
- ▶ The company has positive earnings
- ▶ Expected growth is predictable

The two methods are the capitalization of cash flow method, which looks at the current annual cash flow for the company, and the discounted future cash flow method, which is based off of projections of how the business will perform in the future.

Using the discounted future cash flow method, a business appraiser would forecast financial performance for a “forecasting period” which is based on the length of time it takes for the business to reach maturity, or a steady state of revenues or profits. Child care businesses with an operating history are likely at maturity, meaning the forecasting period might only be one year. Projections are used to determine what cash flows (income) a buyer can expect from the business. Because a dollar in the future is worth less than a dollar today, these cash flows are then discounted at an annual rate to arrive at an estimate of present value.

③ An **Asset Based Valuation** focuses on the company's balance sheet and is based on the idea that the company's value is equal to the underlying value of the company's net assets, which is also referred to as book value. Book value is calculated as:

$$\text{Total Assets} - \text{Total Liabilities} = \text{Book Value}$$

Most of a child care center's assets are considered intangible assets. These intangible assets, such as the relationships the center has with families, are translated into profits earned by the business. Tangible assets, such as furniture, equipment, and cash in the bank, have value regardless of business performance. An asset based valuation, however, is only used when the company does not have an established earnings history, or if it consistently has had negative earnings and the value of its earnings is less than the value of its assets.

Transaction Structure and Business Value: When is \$200,000 Worth \$220,000?

The Market Value of Invested Capital (MVIC) refers to the total compensation that is paid to the seller and includes any cash, notes, and/or securities that are used as a form of payment for the business. The structure of the transaction influences the MVIC. For example, if you sell your business to someone who pays 100% of the selling price in cash, that cash amount is your total MVIC. But, most sales of businesses include seller financing, which means the buyer pays the seller in installments over time. The terms of seller financing, including the interest rate and repayment period, are negotiated between the buyer and seller. In that scenario, your MVIC would include both cash payments and interest payments you receive from the buyer.

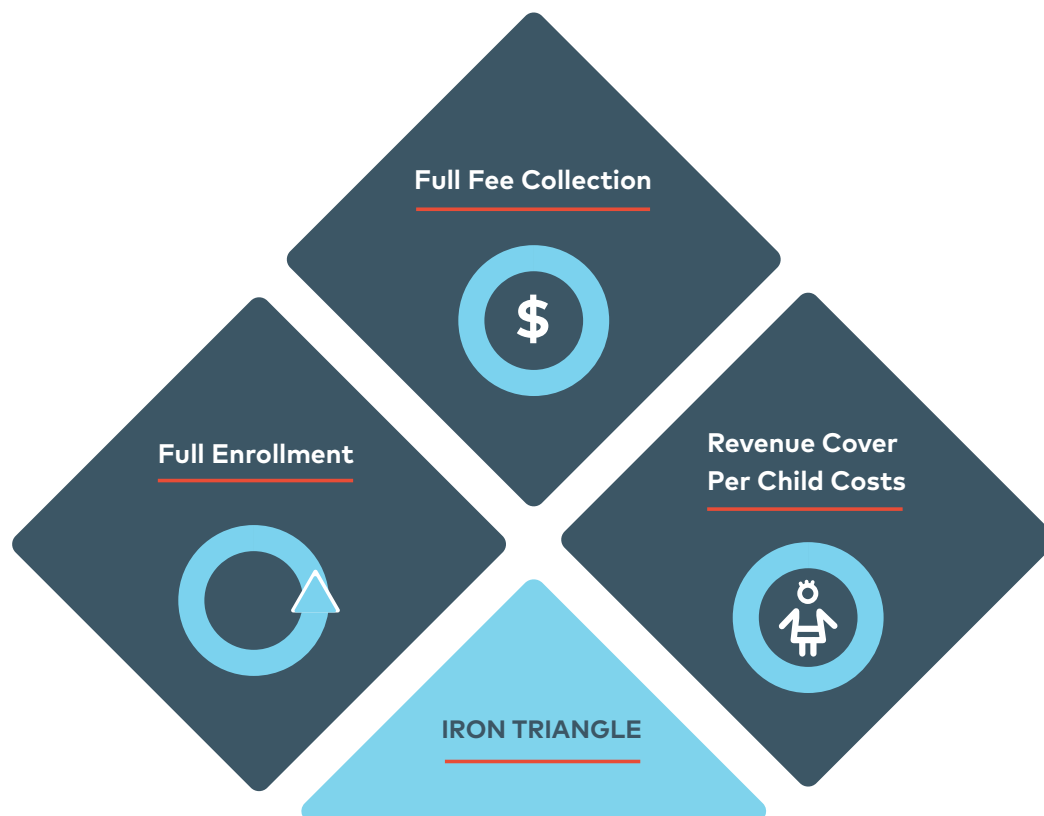
Imagine your child care center has \$100,000 in EBITDA, and you think your center is worth \$200,000. One buyer offers to pay you \$150,000 in cash. A second buyer offers to pay you \$50,000 in cash and an additional \$150,000 over the next three years out of the center's profits.

Which option is better for you? With the first buyer, you would receive \$150,000 all at once. With the second buyer, you would receive approximately \$220,000 as cash and interest payments. While the second option directs more money to you, it also has more risk: if the business doesn't turn profits after the sale, you'll only receive the initial \$50,000.

Financial Metrics That Impact Business Value

The "Iron Triangle" metrics were developed by child care finance and policy expert Louise Stoney as key child care business metrics that directly impact your ability to generate profits:

Since EBITDA is commonly used in small business valuation, these metrics are a useful tool to increase the profitability of your child care center and its value.



1 Full Enrollment

Full Enrollment, which means ensuring full enrollment every day in every classroom. Center owners should strive for 95% enrollment, but expect 85% enrollment.

2 Full Fee Collection

Full Fee Collection, which means collecting all tuition and fees owed to your center in full and on time. Center owners should strive to collect at least 95% of all money owed to the center.

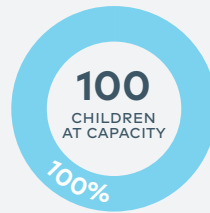
3 Revenues Cover Per Child Costs

Revenues Cover Per Child Costs, which means that all tuition, fees, and third-party funding should cover your per child costs, or your program will lose money.

To illustrate how these metrics play out, consider two centers with licensed capacity of 100 children and average weekly tuition rate of \$215:

Shared Attributes

Staffed Capacity



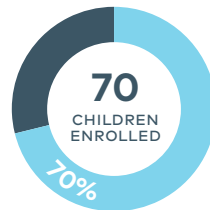
Tuition



Effect of Iron Triangle Metrics

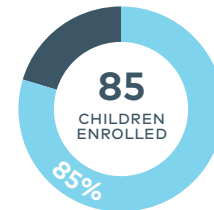
Enrollment

Butterfly Day Care



vs

Bumble Bee Child Care Center

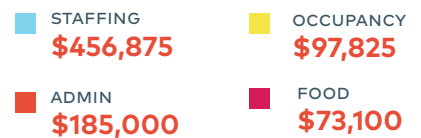
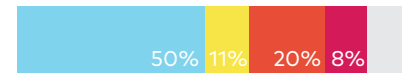
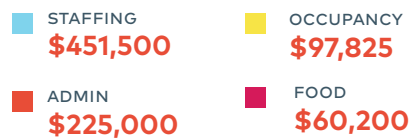
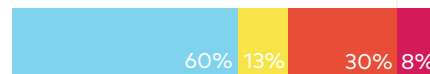


Revenue

\$752,000

\$913,750

Costs



Total Expenses

\$834,525 111%

\$812,800 89%

EBITDA

-\$82,025 -10.90%

\$100,950 11.05%

Estimated Value of Earnings

0

\$302,850

Estimated Value of Equipment and Supplies

\$50,000

\$50,000

Likely Sale Price

\$50,000

\$302,850

Estimated Valuation

Butterfly Day Care is operating at 70% enrollment with \$752,500 in annual revenue. While occupancy and food costs are in line with industry standards, staffing and administrative costs are high. Butterfly Day Care is losing money with EBITDA of -\$82,025. Because the center does not have positive earnings, the estimated value of earnings is \$0. Therefore, a potential buyer would consider the \$50,000 in equipment and supplies that Butterfly Day Care has as assets, resulting in a likely sale price of \$50,000.

Bumble Bee Child Care Center is operating at 85% enrollment, with \$913,750 in annual revenue. Its occupancy, food, staffing, and administrative costs are in line with industry standards. Bumble Bee Child Care Center has a history of positive earnings, with EBITDA of \$100,950. We can apply an earnings multiple of 3 to the EBITDA to produce an estimated valuation of earnings of \$302,850. This number represents a likely sale price.

Working towards full enrollment at your center is critical, because as you increase enrollment, you also increase your profitability. This is because increased enrollment brings in additional revenue and uses your fixed costs and semi-variable costs more efficiently.

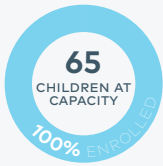
Fixed costs are costs that stay the same, regardless of the number of children you care for, such as rent, director's salary, and cleaning services. Variable costs are costs that vary with the number of children enrolled, such as food costs. Some variable costs, such as teaching costs, vary by ratio cohorts as opposed to individual children, and are also called semi-variable costs. For example, once you have met the costs for a group of 5 children, your costs do not increase significantly to care for a 6th, 7th, or 8th child. But when you add an 9th child, your costs will significantly increase as you'll need to hire a new teacher.

Our experience indicates that centers operating at consistently high enrollment are able to maintain healthy operations, compared to centers with enrollment challenges, which often struggle financially.

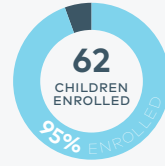
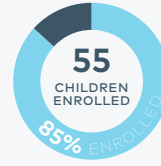
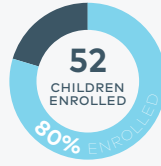
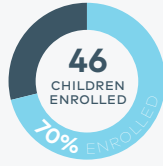


► Case Study: Rainbow Child Care Center

Staffed Capacity



Enrollment



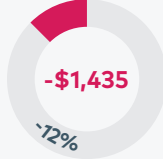
Tuition



Revenue



Net Profit



Rainbow Child Care Center has a staffed capacity of 65 children and an average weekly tuition rate of \$250. At 70% enrollment (46 children), the center loses money. As it increases to 80% enrollment (52 children), its variable costs- food program costs – go up slightly, but its fixed costs and semi-variable costs remain the same because it doesn't have to hire more teachers or administrative staff or rent more space to care for those 6 additional children. The center is able to break even, with its revenues covering its costs. At 85% enrollment (55 children), the center is able to make a small profit, and at 95% enrollment (62 children), the center has a 15% profit margin. By maintaining a high level of enrollment, the center more efficiently uses the resources provided by the teaching staff (semi-variable) and facility/director (fixed) costs that it has already invested in.



Other Factors That Impact Business Value

Your company's iron triangle metrics are impacted by a number of factors. Some of these factors, such as child care subsidy reimbursement rates, impact your ability to cover costs and be profitable, but are beyond your control. Understanding all the factors that impact your company's value can help you make business decisions that will preserve and increase the value where you can.

Additional factors that impact business value include:



► Facility

An up to date facility that's in compliance with local and state regulations minimizes risk for a buyer, since it's more likely that the facility will pass licensing and building inspections and that a buyer won't have to pay for major repairs soon after purchase. Similarly, being able to guarantee that a buyer will be able to continue to operate the center at its current location, whether through building ownership, a long-term lease, or a landlord who will continue to rent the building to a new owner, can minimize risk for a buyer and increase the business value.



► Strong Brand

A distinct brand and a reputation for quality and safety makes it easier to fill spots at your center, which improves profitability and increases buyer confidence. National accreditation, rave reviews on social media, new student referrals from current families, and strong connections to elementary schools, churches, and community centers are all great signs. Similarly, monitoring and adapting to trends in parent preferences (e.g. Montessori, nature-based curriculum, etc.) builds your appeal.



► Transferrable customer base

It's important that your customers are loyal to your brand and child care center beyond their relationship with you, so that they'll remain customers even after you leave. Ensuring that families have strong relationships with teachers and staff and are excited about your curriculum are a couple of ways to build their loyalty and commitment to the center.



► Staff

If a buyer purchases your business, they'll want to make sure it can keep running smoothly without you in charge. An independent director or a strong management team who keep things running when you're not around can increase buyer confidence, as can long-tenured and committed teachers.



► Documented operational policies and procedures

Clearly documenting your policies and business practices provides a blueprint for the business to run without your leadership, minimizing risk for a buyer.



► Revenue Sources

A mix of revenue sources, such as state subsidy reimbursements, parent copays, private pay tuition, quality add-ons, and contracts with Head Start and PreK programs can both increase your total revenue and minimize risk if any of your revenue sources temporarily or permanently disappear. Similarly, offering summer camps and after school care creates additional and diversified revenue sources. It's also important to show strong collections systems and that your business is regularly getting paid for all the money its owed.



► Clean and Up To Date Financial Records

Ultimately, a buyer will want to understand how your company performs financially. Being able to provide clear and up to date financial records for the past 3-5 years will provide a buyer with the information they need to most accurately estimate the value of your business.

How ICA Can Help

ICA recognizes that as the owner of a child care center, you've put your heart and soul into your business and the quality care it provides. Although it can be hard, we believe that planning your eventual exit from the business is one of the best things you can do to preserve the value of your business, ensure your legacy, and achieve the retirement goals you desire. Our exit planning staff will work with you to help you set exit goals and determine your financial needs for retirement. After working with us, you will receive a summary report including:

- **Business Health Check and Cost of Care Analysis**
- **Enterprise Valuation**
- **Analysis of Business Value Drivers and Tips to Maximize Value**
- **A Summary of Paths to Exit the Business**

Visit icagroup.org/childcare to learn more about succession planning services.

