Business Valuations:
What Every Small Business Owner Should Know

Magellan Advisors, Inc.

Business Transition Intermediaries

You've decided to place your business on the market. You need an asking price. The question you're faced with is "What is my business really worth?"

You'll probably consider purchasing an independent business appraisal – a complex endeavor unfamiliar to most small business owners. You'll soon learn that business appraisers offer a range of valuation packages, but you have no idea what you really need. You're seeing new terminology like SDE, EBITDA and goodwill and you find yourself totally bewildered. Well, you're not alone. Most people who purchase a business appraisal are venturing into new territory and don't know what they're committing to.

Valuing a closely-held business is a subjective process using diversified methodologies, interpretive analysis and assumptions, and without formal rules and regulations. There are no right or wrong answers. It's been said there are as many methods to appraise a business as there are business appraisers.

In The Small Business Valuation Book, author Lawrence W. Tuller aptly describes the business valuation process as follows:

> *"Valuing a closely held business is like forecasting the weather: Everyone wants an absolute, scientifically determined, accurate answer, but no one has come up with a way to achieve this goal. If there is one thing that everyone can agree on, however, it is that business valuation is an art, not a science. All the statistical, mathematical, and economic formulas concocted over the years cannot determine with certainty the value of a going business to a specific party over a future time period."*

Let's try to dispel some of the confusion by sorting things out with some background discussion and definitions.

Total entity value

The aggregate value of any business is driven by two factors: earnings and assets. Despite the myriad of valuation techniques available, all business valuations are derived in some way from the following equation:

Total entity value = Earnings value + Asset value

Although this axiom has universal application, a business can be valued for different reasons, putting "spin" on the numbers. For example, a valuation for divestiture will focus on anticipated future earnings, while a valuation for tax purposes will focus on historical earnings. Regardless of the reason for valuation, it's important to understand that the calculated entity value shown in an appraisal report will fluctuate over time. In practice, the value of a business is determined for a specific purpose and as of a specific date.

Fair market value

As defined by the IRS, *fair market value* is "the amount at which property would change hands between a willing buyer and a willing seller when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."

Under this definition, fair market value is somewhat hypothetical and cannot be determined until an actual sales transaction has occurred. As a general rule, the fair market value of a business is directly proportional to the number of prospective buyers.

No one can calculate actual fair market value.

Intrinsic value

Intrinsic value is the value based on the business fundamentals and operational performance. This is the value that a business appraiser calculates. It's assumed that fair market value equals intrinsic value until the facts prove otherwise. Differences between fair market value and intrinsic value are caused by the subjective valuation factors of both buyer and seller. These differences arise because businesses are bought and sold under the laws of supply and demand in a free market.

The intrinsic value shown in an appraisal report is not a guarantee of sales price.

Earnings – the primary driver

Businesses are purchased for anticipated future earnings. Nobody buys a commercial venture to lose money or to break even. The price to buy a business is equivalent to an investment in bonds or CD's: the investor is expecting a return on the invested capital and, as with all business investments, there is a degree of risk. The higher the risk, the higher the required rate of return. Distressed businesses are purchased with the intent of being turned around and the transaction price is appropriately discounted to reflect the risk.

Earnings are driven by revenue, but revenue in itself does not guarantee earnings. Revenue, therefore, is not the real driver of business value. Also, future earnings may or may not correlate with historical earnings. When a business is valued for divestiture, an assessment of future earnings is an essential part of the appraisal process. The challenge facing the appraiser is working with the business owner in establishing a reasonable projection of future earnings.

> ***The true market value of a business is directly proportional to the value of future earnings and inversely proportional to the assumed business risk.***

Earnings multiples

An earnings multiple is applied to an earnings base to determine the value of the entity's core assets and goodwill. For example, if the earning is $1,000,000 and the earning multiple is 5, the calculated entity value is $5,000,000.

An earnings multiple is the reciprocal of the capitalization rate that represents business risk plus the risk-free cost of capital. If the capitalization rate is 20%, the earnings multiple is 5. As business risk increases, the corresponding earnings multiple decreases along with entity value. When valuing a business, its business risk needs to be quantitatively calculated, not just pulled from the air.

Using an earnings multiple to value a business has limitations. Firstly, an earnings multiple is not applicable if the business is operating at breakeven or losing money. Secondly, an earnings multiple does not recognize the value of excess assets that may exist in the form of cash, receivables, inventory and equipment.

Assets – the secondary driver

The tangible assets of a business have standalone value with certain limitations. From the standpoint of value retention, assets fall into two broad categories: discrete assets and non-discrete assets. *Discrete assets* can be physically removed from the business and still retain their value in the general market. These include real estate, investments, artworks, precious metals, vehicles and certain finished goods inventories. *Non-discrete assets* are linked to the business and have value because they contribute to the generation of earnings. If removed from the business, their value may be significantly impaired. Examples are production equipment, tooling, fixtures and inventories of proprietary components.

In a *liquidation sale*, the entire sales price is for the assets with no value attributable to earnings. Asset values may be further reduced by liquidation costs.

Goodwill

Goodwill is the portion of the sales price over and above the fair market value of the net balance sheet assets. Stated differently, *goodwill* is the earnings value. This is where you earn the real money on the sale. Without goodwill, you are essentially selling the company for what you put into it plus asset appreciation.

The IRS has prevailed in tax court taking the position that goodwill has two components: going-concern goodwill and demonstrated goodwill. *Going-concern goodwill* is the value attributable to the intangible assets such as company name, workforce, customer base, patents, trademarks and so forth. *Demonstrated goodwill* is the value attributable to the firm's assets in generating profit.

A business that satisfies the requirements of a going concern has a minimum turnkey value even without historical earnings.

Seller's discretionary earnings (SDE)

Seller's discretionary earnings is the total amount of real earnings the seller has available to withdraw from the business and is used as a yardstick to measure cash flow performance. It's equal to entity earnings before taxes plus all compensation paid to the primary owner, interest expense, depreciation and amortization, non-operating and extraordinary expenses, and less interest income and non-operating and extraordinary income.

EBITDA

EBITDA stands for earnings before interest, taxes, depreciation and amortization. It's a benchmark often used by investors to evaluate cash flow. EBITDA does not represent true entity earnings and needs to be interpreted for the specific situation. A business that has significant lease expenses for real estate and equipment will have lower EBITDA than a business that owns and depreciates such assets.

Recasted earnings

Historical earnings need to be "recast" to portray normalized financial performance that excludes extraordinary and discretionary transactions, and where all expenses are recorded at levels that are reasonable and necessary for the business to operate. The objective here is to identify the true economic earnings of the enterprise versus the books earnings compiled by the accounting system and the tax earnings reported to the IRS. Typical adjustments are for owner's compensation and perks, marketing, entertainment, litigation and R&D. The process of recasting earnings requires subjective analysis by the appraiser.

Valuation objectives

A business may need to be valued for a variety of reasons that include estate planning, stock buy/sell agreements, litigation or divorce settlement. When selling a business, the purpose of an independent valuation is to substantiate the intrinsic value portion of the asking price. In doing so, the seller makes it more difficult for the buyer to justify arbitrary discounts. As such, for a valuation report to provide real benefit, it must be defensible and well documented.

The appraisal fee paid for a comprehensive valuation report will be recovered many times over by a higher sales price.

Valuation methods

There are three generally recognized methods to determine the value of a going-concern business: the asset-based method, the market-based method and the earnings-based method. All valuation methodologies are derivations of or combinations of these three basic approaches.

In a nutshell, the *asset-based method* establishes value by restating the balance sheet at current value with recognition for goodwill. The *market-based method* establishes value by comparing the subject company to sales transactions of similar businesses. *The earnings-based method* establishes value by analyzing the operational fundamentals of the subject company as a standalone business entity.

Asset-based valuations are the most comprehensive, but are time consuming and expensive because the services of multiple appraisers may be required. For most small businesses with a diversified asset base, this approach is probably cost prohibitive.

Market-based valuations are more straightforward but have significant limitations. This approach relies on business sector averages and requires an adequate number of comparable businesses to perform extrapolations. It's best applied to the generic “main street” businesses that operate under a rigid business model with predictable performance.

As business operations become more unique and assets become more diversified, a market-based valuation loses relevance and can be easily challenged. Used inappropriately, a market-based valuation can over value a poor performing company and under value a good performing company. Some of the businesses that should avoid market-based valuations are manufacturing, construction, specialized services and any company that is a niche provider.

A competent appraiser understands the limits of market-based valuation. Nonetheless, many appraisers lean toward market-based valuations because a “cookie-cutter” methodology is easier for them.

The earnings-based method is generally regarded as offering the best balance of appraisal cost and valuation accuracy. It uses similar techniques as asset-based valuation, but provides less asset detail. The quantification of business risk is a critical factor in earnings-based valuations.

> ***The biggest mistake in commissioning a business appraisal is not specifying the valuation method.***

The valuation process

The valuation process, by its very nature, requires the appraiser to work with the business owner. The appraiser needs to understand the business operations in depth because the real value of the company may be hidden in the numbers.

Preparing a comprehensive valuation requires a large amount of historical data. This is essentially the same information that an investor will ask to examine during the due diligence process. Here is a starting list of what needs to be assembled:

- ☐ Federal tax returns for last 5 years
- ☐ Spending detail by account for last 5 years
- ☐ Current year-to-date income statement
- ☐ Current balance sheet
- ☐ Latest accountants' report
- ☐ Revenue by major customer (greater than 5%) for last 12 months
- ☐ List of significant assets
- ☐ Corporate bylaws or operating agreements
- ☐ List of ownership
- ☐ Business plan
- ☐ List of salaried employees with titles and compensation

Getting to know your appraiser

The quality of a business appraisal is determined by the qualifications and commitment of the individual appraiser. A skilled appraiser should be able to interpret financial statements and tax returns, be capable of doing financial projections and have a broad understanding of how businesses operate. You should satisfy yourself that the appraiser has the background and skills to value your business accurately and professionally.

Be aware that business valuation is a labor intensive endeavor. Given the fact there are no professional standards for valuation methods and that most appraisals are performed for a fixed fee, appraisers are often inclined to cut corners. A low cost appraisal that compromises technical quality can turn out to be expensive in the long run. Appraiser credentials are no guarantee that adequate time will be devoted to the engagement.

The scope of the appraisal should be defined up front and documented in a written contract. The following are some specific questions to ask the valuation firm:

- ☐ Which method will you use to prepare the valuation?
- ☐ Will you provide the supporting calculations?
- ☐ Will you base the valuation on historical or projected performance?
- ☐ Will you recast earnings?
- ☐ Will you answer subsequent questions without additional fees?
- ☐ How will you assess business risk and establish a capitalization rate?
- ☐ How will you protect my anonymity during the valuation process?
- ☐ Will you advise me of due diligence issues that may be uncovered during the valuation process?

Business valuation references

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