

What's Your Business Worth?

What you see isn't usually what you get - or want!

"How much is my business worth?" and "How do I know for sure?" and "Why should I care? After all, I have no intention of selling it right now." As commercial bankers, we often heard our customers asking questions like these. But, as bankers, we also knew that the bank had good reason for caring about the value of a business -- because we wanted to lend to "valuable" businesses, not "worthless" ones.

Actually, the owners of closely-held businesses have even more important reasons for wanting to know the value of their businesses -- because (at least potentially) a business is the most valuable possession that an individual can have. Determining that value -- and its implications -- is a process that can be confusing, time-consuming, and expensive. Unnecessarily so, in our opinion. Our basic goal here is to "unfog" some of the key issues relating to valuing a company -- about *how* you could find out what your business is worth and some specific reasons for *why* you'd want to know.

Who Determines the Value of a Business?

An accountant (or a banker) might tell you that taking your assets and subtracting your liabilities will give you what you're worth (that is to say, you take what you own, subtract what you owe, and what's left is what you're worth -- at least *on paper*). But is that really what you're worth? In some cases: hopefully; in other cases: hopefully not.

Another way to determine worth would be to sell your business. Then you'd know what it was worth -- at least to the buyer. A more radical way to determine its worth would be to die. Then the IRS would come in to help you (or rather your heirs) figure out what it is worth. The higher the value the more potential tax your estate gets to pay.

Another way to determine the value of your business would be to hire someone to do a *valuation*. The scope, detail and cost of a business valuation can vary dramatically based on the size and complexity of the business being considered, on the purpose of the valuation -- and on the organization doing the valuation. (Banks, accounting firms, and consulting firms usually have the capability to do valuations.)

To produce a complete, objective valuation you need the assistance of a qualified, disinterested third party (a professional in the field of valuations); but the basics of business valuation are the same for all closely-held businesses. Despite what you may have heard, they're not *that* tough to understand. Part of the problem, as we see it, is a matter of definitions, so here are some.

What's the Difference Between Value, Worth, and Price?

In ordinary conversation, the terms "value" and "worth" are pretty much interchangeable. But, by definition, they are different when we are talking about the valuation of a business. First of all, the term most often used in relation to value is *fair market* value and the meaning of this term differs significantly from those of worth and price.

FAIR MARKET VALUE is *hypothetical* -- it does not address particular individuals in a real transaction, but rather *ideal* participants in a *model* transaction.

FAIR MARKET VALUE is subject to differing opinions and judgments -- different professional valuations may yield different "fair market values."

FAIR MARKET VALUE cannot be *proven* by actual sale transactions -- because fair market value is *ideal* and actual sale transactions are *real*.

WORTH is a judgment of the value of a business to a particular (real) buyer and/or seller.

WORTH does not necessarily address an "arms-length" transaction ("arms-length" means one in which neither the buyer or seller are under any compulsion to buy/sell and both are acting based on reasonable knowledge of the facts involved).

WORTH takes into account personal circumstances, emotions, preferences and limitations of the parties involved -- all of which usually make worth different from the *ideal* fair market value.

WORTH can be confirmed by the outcome of an actual transaction -- because the goal was to estimate what two individuals (or groups) would pay/accept for a particular business.

PRICE is directly connected to worth -- via the process of *negotiation*. The asking price is where the seller starts when an actual sale is contemplated; the selling price is where the buyer and seller end up, based on their individual judgments of *worth* and their skills as negotiators -- in combination with the particular pressures that may be pushing them toward buying and selling.

Why Would You Need a Valuation?

Besides wanting to know the value of your most important possession -- or needing to convince your bankers that they should make a loan to you -- there are a number of important reasons that business owners get valuations for their business.

If you're buying or selling a business . . .

. . . valuation helps set the floor (or ceiling) values for negotiating. It can be a vital aid in the decision-making involved with putting a business on the market, but it doesn't replace negotiation.

If you are setting up a Buy-Sell agreement . . .

. . . can provide for liquidating the ownership interest of a deceased or departing partner. It helps to avoid costly litigation in case of a dispute, and it needs to be updated periodically.

If you are considering an ESOP (Employee Stock Ownership Plan) . . .

. . . it provides value for contributed securities when a company contributes its own securities to an ESOP. It meets the requirements for "good faith" valuation.

If you need to report gift tax . . .

. . . it provides the value for requirements in connection with filing Tax Form 709 and it minimizes the risk of an IRS challenge.

If you need to report estate tax . . .

. . . it provides the value for ownership interest in determining the amount and payment of estate taxes. It also takes into account the impact on value when the deceased owner was an active manager of the company. Again, it minimizes the risk of an IRS challenge.

If you are considering re-capitalization . . .

. . . it provides for setting the value for different classes of stock.

If you are having a shareholder dispute . . .

. . . it establishes a value for the stock held by dissenting shareholders who may need to be bought out and it establishes a value for purposes of litigation.

If you are getting divorced . . .

. . . it meets requirements in community property states when both spouses are owners of the business.

If you need to raise equity capital . . .

. . . it indicates how much of the business an owner must give up to get the needed funds from venture capital sources.

What Determines Value?

So we've touched on how you could find out the value of your business and why you'd want to do it, but what about how your business influences its value? Well, the most frequently cited basis for valuing closely-held businesses comes from our friends, the IRS. Revenue Ruling 59-60 is a set of guidelines for IRS use in determining the value of closely-held stock in gift and estate cases. The ruling outlines several factors for consideration:

- ♦ *The history and nature of the business.*
- ♦ *The economics of the industry.*
- ♦ *Book value and financial condition of the business.*
- ♦ *Earnings and dividend paying capacities of the business.*
- ♦ *Goodwill and other intangibles.*
- ♦ *Sales of stock and size of block to be valued.*
- ♦ *Market price of actively traded stocks of public companies engaged in the same or a similar business.*

The ruling discusses the significance of earnings and assets, but it does not prescribe any hard and fast formulas. It advises, "**A sound valuation will be based upon all relevant facts . . . common sense, informed judgment, and reasonableness.**" Now *that's* a big help, isn't it! The worksheets at the end of this section present some commonly accepted methods for determining the value of a closely-held business.

Actually, business valuation has its foundation in the capitalistic principle that investors invest in businesses for one reason: to generate wealth, usually measured in terms of profit. Furthermore, expectations of profit vary based on the degree of investment risk -- the higher the risk, the higher the expected profit demanded. In the next articles we'll take a look at some various methods for determining the answer to that key question: "What's my business worth?"

Valuing Your Closely - Held Business: Which Road to Take

Approaches to Calculating Value

The two basic methods for valuing a closely-held business are the *ASSET APPROACH* and the *EARNINGS APPROACH* (although capitalization of income and discounted cash flow can be seen as separate valuation tools, both require an earnings analysis of the business; therefore, for our purpose here, we are calling both an "earnings approach"). Both asset and earnings approaches use the financial statements of the business -- the balance sheet and the income statement -- as the bases for valuation.

The Asset Approach

The asset approach focuses on the balance sheet. There are four specific asset-based methods to arrive at a value for a business:

Book Value

Book value (also called net worth or owner's equity) is the total assets minus the total liabilities. In other words, what the business owns, minus what it owes to its creditors. Simple right?

Usually, book value represents the value of the assets **only** where most of the assets are liquid (easily convertible to cash) and closely reflect their current market value. If this is not the case, we need to adjust the book value to come closer to "fair market value."

Adjusted Book Value

Differences between book values and market values usually arise in "Property and Equipment" and "Intangibles and Goodwill." The IRS requires plant and equipment ("fixed assets") to be carried on the books at original cost and depreciated over allowable recovery periods -- which, as a rule, is shorter than the assets' actual productive lives. This difference results in a rapid "write-off" of assets.

Frequently, investments in equipment are virtually eliminated from the balance sheet, although the assets themselves are still utilized in operations. (The same is true of buildings and improvements, which are likely to *appreciate* rather than *depreciate* in value.) Because of these accounting practices, depreciated book values generally understate the true value of fixed assets.

Intangible assets and goodwill appear on the balance sheet only if they have a cost basis. (That is, they appear recorded at a value equal to what it cost to acquire them. If nothing was paid to acquire them, they don't show up.) But these assets can, of course, play a vital role in the enterprise.

Intangibles may include specific assets (such as patents, copyrights, trademarks, client lists, and trade contracts) or to such attributes as a good reputation or a strong market position. Whether these assets are tangible or intangible, they need to be "written up" (or down) to their real economic or market value in order to calculate the asset-based value of the business -- adjusted assets minus adjusted liabilities.

Liquidation Value

This method of valuation does not consider the business as an on-going company. It assumes that the business will cease operating, sell its assets and pay its liabilities. Any leftover cash would go to the owners. This calculation is only meaningful in establishing an absolute bottom price below which an owner would be better off to liquidate the company than to sell.

The liquidation value takes into account the fact that the assets -- inventory, property, and equipment -- would not bring in as much if they were sold "under pressure" as they would if the company were to continue in business. Some general rules of thumb for liquidation values are:

- ♦ 80% of all accounts receivable less than 90 days old.
- ♦ 50% of all inventory.
- ♦ 40% of the current market value of equipment.
- ♦ 25% of the current market value of buildings.
- ♦ 40% of the current market value of land.
- ♦ 0% for leasehold improvements.

Reproduction Value

This value is the current market cost of reproducing the fixed assets of the business (property, fixtures, leasehold improvements, equipment). Like liquidation value, reproduction value represents a benchmark -- the value which a hypothetical buyer would not exceed unless the *earnings* of the business so dictated.

So these are the generally used methods to determine the *value of a business* based on the *value of its assets*. But what about that item noted in the last section -- *earnings*? Well, earnings -- and their influence on value -- will be our next topic.

Key Factors for Consideration: The Relationship Between Earnings and Value

What's your business worth? We just looked at some ways to determine value based on the assets of a business. That is, value determined by what the business owns. A strong argument can be made that a business is worth not what it owns, but rather what it earns. In other words, if you sold your business, you'd really be paid for the company's ability to make money.

The Earnings Approach

The earnings approach focuses on the income statement. The real value of any business -- when approached on a return-on-investment basis -- is in its earning power: the ability to make money. The earnings approach is founded on the theory that a business should yield a *fair return* on the owner's capital invested in the business.

For valuation purposes, both "earnings" and "fair return" need to be defined. For tax reasons, business owners usually want to increase their salaries (a tax deduction for the corporation) in order to minimize taxable income. In addition, owners usually want to credit the company with as many discretionary "customer entertainment" or "business promotion" expenses as possible.

Strategies such as these will help hold down the company's before tax income; therefore, "earnings" must be restated to reflect the actual return to the owner -- the return on investment (needless to say, the IRS will be happy to help you restate your earnings if they think any of these "discretionary" expenses are not legitimate).

What Are Earnings?

For closely-held businesses, "earnings" are commonly defined as a combination of:

- (1) The accounting net profit.
- plus** (2) Excess owner's salary -- the amount an owner-manager pays himself/herself above the amount a hired general manager would be paid for the same job (for *small* businesses -- "small" defined as businesses having less than \$500,000 in annual sales -- the entire owner's salary is generally added back to the accounting net profit to compute adjusted earnings).
- plus** (3) Depreciation/amortization expense (non-cash expense items).
- plus** (4) Discretionary expense items.
- plus (or minus)** (5) Extraordinary one-time expenses (income).

There are several ways to forecast earnings, all based on the premise that if past or current earnings indicate future earnings, then they can be used to value the business (stated another way, the value of the company is based on what it will earn in the future, not on what it produced in the past; but the past provides the basic data on which to base future projections). Past earnings can be used in three different forms to calculate value:

- ♦ Average earnings (for 3 to 5 years)
- ♦ Weighted average earnings (for 3 to 5 years)
- ♦ Current (or most recent) earnings.

The basis for selection would be which form most accurately reflects the earnings which we expect the company to produce in the future.

Rate - of - Return / Capitalization Rate

The earnings available to the owner of a business represent a return on the funds that have been invested in the business -- in simplest terms, the initial *capital stock* plus *retained earnings*. If a buyer were to invest \$100,000 in a business and wanted a 20% return on investment, the business would need to produce \$20,000 per year in earnings.

$$\mathbf{\$100,000 \times 20\% = \$20,000}$$

On the other hand, if a business produced \$20,000 in earnings per year and a prospective buyer required a 20% return on investment, he or she would, in theory, invest \$100,000 in the business. What we are really doing is answering the question: \$20,000 is 20% of what?

$$\mathbf{\$20,000 / 20\% = \$100,000}$$

Stated another way, the value of a business that produces \$20,000 in earnings per year is \$100,000 -- for a buyer that requires a 20% return on investment.) In this example, the "20%" is the "capitalization rate" and it is equivalent to the required return on investment on earnings. Capitalization rates are used to determine the value of a business, based on earnings.

Risk and Return

As noted earlier, the higher the risk in an investment, the higher the required return will be. A buyer would require a higher rate of return on investment from a business which was perceived to be higher in risk. The capitalization rates for "risky" businesses are, therefore, higher than those for less risky companies. The following provides commonly used capitalization rates associated with risk categories:

CLASS 1 Large sized-business (over \$10 million sales), sound financial condition, stable earnings, experienced and capable management team with good depth.

Capitalization rate: 10% - 15%

CLASS 2 Medium- to large-sized business (\$2 million to \$10 million sales), well-established company, good top management.

Capitalization rate: 15% - 20%

CLASS 3 Small- to medium-sized business (\$500,000 to \$2 million sales), possible fast growth situation but limited available capital, less stable earnings pattern, management usually lacking experience and depth.

Capitalization rate: 20% - 30%

CLASS 4 Small-sized retail or service business (restaurants, garages, marinas, etc.), some capital required, limited growth potential, highly competitive environment, possibly experienced management but little depth.

Capitalization rate: 30% - 50%

CLASS 5 Personal service business (manufacturing rep., bookkeeping service, personnel agency), very little capital required, highly dependent upon the skills of the owner or manager.

Capitalization rate: 40% - 100%

(Value sometimes based upon one year's gross revenue.)

CLASS 6 Professional practice, highly technical, totally dependent upon specialized knowledge of participants, may have heavy capital requirements.

Value usually based upon value of assets.

Calculation

The formula for determining the value of a closely-held business, based on earnings is:

$$\text{Value} = \frac{\text{Earnings (average, weighted, or current)}}{\text{Capitalization Rate (Risk Rate)}}$$

In other words, the key for value is:

$$\text{Value} = \frac{\text{Which earnings}}{\text{What risk factor}}$$

The Capitalization Rate is the inverse of a multiple of earnings: A "cap rate" of 20% equals "multiple" of 5. Using the previous example:

	Earnings	\$ 20,000
<i>times</i>	Multiple	× <u>5</u>
<i>equals</i>	Value	\$ 100,000

Discounted Future Earnings and Comparable Public Companies

If the future earnings of a business are *not* expected to look like those of the past (for example, if they are expected to increase 10% for 5 years and then level off), then discounting these future earnings to find their **present value** is a valid method of valuation. In actual buy-sell transactions, this method is frequently rejected because of its subjectivity; in the sale of small businesses, it is virtually unused.

Comparison with publicly-traded companies to arrive at a guideline for a price-earnings multiple is another method which exists, but is rarely used with most closely-held business. The reason it is frequently rejected is the vast difference between the control, scope, management, and tax ramifications of having an individual majority-owner in a closely-held business.

Combined with the asset-based methods that we discussed last time, these are generally the methods used to determine the **value** of an independent business. As you've probably noted, these methods can (and usually do) produce a widely varying **range of values**.

The question then arises, "How do we get to *THE* value that fairly represents the business?" The answer is that it's a matter of **informed** judgment. As we noted earlier, in an actual buy-sell transaction, the price will be based on the value that the buyer and seller have **perceived**, plus their negotiating skills, and the **pressure** on each side to buy or sell.

When no actual transaction will take place, the "informed judgment" must take into account all factors (asset values and earning values) and arrive at a "concluded value" -- one which reflects economic reality and represents the value of the assets **and** earnings as part of an ongoing business entity.

Business Valuation Worksheet

BOOK VALUE

Total Assets..... _____
minus Total Liabilities..... - _____
equals Book Value (also called Net Worth or Owner's Equity) = _____

ADJUSTED BOOK VALUE

Fixed Asset Fair Market Value _____
minus Fixed Asset Book Value - _____
equals Appraisal Surplus = _____
plus Book Value + _____
equals Adjusted Book Value = _____

LIQUIDATION VALUE

Book Value (or Adjusted Book Value) _____
minus Liquidation Costs/Discounts - _____
equals Liquidation Value..... = _____

REPLACEMENT VALUE

Estimated Cost of Reproducing Assets..... _____

CAPITALIZATION OF EARNINGS

Step 1: Restate Earnings

	(Least Recent)		(Most Recent)
	<u>C</u>	<u>B</u>	<u>A</u>
For the year:	_____	_____	_____
Net Profit	_____	_____	_____
+ "Excess" Owner's Salary	_____	_____	_____
+ Owner's Discretionary Expenses	_____	_____	_____
+ Depreciation Adjustment	_____	_____	_____
+ / - One-time expenses (income)	_____	_____	_____
TOTAL	_____	_____	_____

Step 2: Calculate Current and Average Earnings

Current Earnings	=	A	_____
Average Earnings	=	$\frac{A + B + C}{3}$	_____
Weighted Average Earnings	=	$\frac{3A + 2B + C}{6}$	_____

Step 3: Select Capitalization Rate

Step 4: Divide Earnings by Capitalization Rate

$$\frac{\text{Current Earnings}}{\text{Capitalization Rate}} = \left(\frac{\text{_____}}{\text{_____}} \right) \text{_____}$$

$$\frac{\text{Average Earnings}}{\text{Capitalization Rate}} = \left(\frac{\text{_____}}{\text{_____}} \right) \text{_____}$$

$$\frac{\text{Weighted Average Earnings}}{\text{Capitalization Rate}} = \left(\frac{\text{_____}}{\text{_____}} \right) \text{_____}$$

PRESENT VALUE OF FUTURE EARNINGS

- Step 1: Project growth in earnings for each year until they are expected to level.
- Step 2: Select present value factors for the appropriate capitalization rate.
- Step 3: Multiply each year's earnings by the corresponding present value factor.
- Step 4: Add the present values.

<u>Year</u>	<u>Earnings</u>		Present Value Factor at ____%		<u>Present Value</u>
_____	_____	×	_____	=	_____
_____	_____	×	_____	=	_____
_____	_____	×	_____	=	_____
_____	_____	×	_____	=	_____
_____	_____	×	_____	=	_____
				Valuation =	_____

NOTE: The year in which sales level off is valued by dividing the earnings by the capitalization rate, then multiplying that amount by the present value factor for that year.

Present Value of \$1

<u>Years Hence</u>	<i>Capitalization Rate</i>										
	<u>1%</u>	<u>5%</u>	<u>10%</u>	<u>15%</u>	<u>20%</u>	<u>25%</u>	<u>30%</u>	<u>35%</u>	<u>40%</u>	<u>45%</u>	<u>50%</u>
1	.990	.952	.909	.870	.833	.800	.769	.741	.714	.690	.667
2	.980	.907	.826	.756	.694	.640	.592	.549	.510	.476	.444
3	.971	.864	.751	.658	.579	.512	.455	.406	.364	.328	.296
4	.961	.823	.683	.572	.482	.410	.350	.301	.260	.226	.198
5	.951	.784	.621	.497	.402	.328	.269	.223	.186	.158	.132