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What determines the value of my business?

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The value of a business can vary greatly depending on the specific assets or interest being appraised, the purpose of the valuation and the standard of value used in the Appraisal. Additionally, every business is dynamic and has its unique strengths and weaknesses, which will contribute to its value. We will examine these elements in more detail below.

What Assets or Interests are being appraised?

First, one must identify the Specific Assets (Asset Sale) being appraised or the Specific interest (stock sale) being appraised. The majority of sales of small closely held businesses are asset sales. Typically in a sale, a business owner would prefer to sell the stock in the company to minimize their tax liability. However, most buyers of small closely held businesses do not want to assume the contingent liabilities associated with stock ownership. Additionally, buyers want a stepped-up basis in the fixed assets so that they can depreciate the assets based on the current market value and shield income from federal income tax. All things being equal, a buyer would pay less for the stock of the company than they would for the assets of the company.

Standards of Value & Premise of Value

Business Appraisals are performed for a variety of business purposes including: Sale of the Business, Acquisition of a Business, Buy Sell Agreements, Estate & Gift Tax, Dissenting Shareholder Rights and Divorce. The Standard of Value used in the appraisal will vary depending on the purpose of the Appraisal. Some common Standards of Value include “Fair Market Value”, “Investment Value” and “Fair Value”.

Fair Market Value (“FMV”) is the most widely recognized and accepted standard of value and is relevant when appraising a business in contemplation of sale. The term "Fair Market Value" is defined by the American Society of Appraisers as “the amount at which property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts”. The FMV standard of value speaks to the market in general in an arms length transaction. This definition comports to that found in the tax code and in Revenue Ruling 59-60 and is used for estate and gift tax valuations. Revenue Ruling 59-60 cites eight factors influencing the value of a business:

1. The nature of the business and the history of the enterprise from its inception.
2. The economic outlook in general and the condition and outlook of the specific industry in particular.
3. The book value of the stock and the financial condition of the business.
4. The earnings capacity of the company.
5. The dividend paying capacity of the company.
6. Whether or not the enterprise has goodwill or other intangible business value.

7. Prior sales of stock and the size and block of stock to be valued.
8. The market price of stocks of corporations engaged in the same or similar line of business having their stocks actively traded in a free and open market, either on an exchange or over the counter.

Investment Value is the specific value of an investment to a particular investor based on individual investment requirements. For example, a specific investor may only be willing to pay 3.5X EBITDA for the assets of a business when the Fair Market Value of the business may be appraised at 4.0X EBITDA. Conversely, an investor may be willing to pay higher than Fair Market Value in an acquisition if they have identified certain synergies that will enhance their current operations.

Fair Value is a legally created standard of value that applies to certain specific transactions. In most states Fair Value is the statutory standard of value applicable in cases of dissenting stockholder's appraisal rights. In these states, if a corporation merges, sells out or takes certain other major actions, and an owner of a minority interest believes that they are being forced to take less than adequate consideration, they have the right to have the shares appraised and receive "Fair Value". Some states do not allow discounts for minority interests or lack of marketability when determining "Fair Value". The state of Delaware pioneered Fair Value issues and emphasizes value of a proportionate share without minority or marketability discounts. Conversely, minority and marketability discounts are typically taken when appraising a minority interest at "Fair Market Value".

The two primary Premises of Value used in the appraisal are Going Concern Value and Liquidation Value.

Going Concern Value is the value of a business that is expected to continue to operate in the future. The intangible elements of going concern value result from factors such as having a trained work force, a loyal customer base, an operational plant, and the necessary licenses systems and procedures in place.

Liquidation Value is the net amount that would be realized if operations ceased and the assets are sold piecemeal.

Normalization of Assets and Earnings

Before we can value a company the financial statements need to be normalized. "Normalization adjustments" are intended to adjust the company's Balance Sheets and Income Statements from a tax or accounting perspective to an economic basis.

To normalize the Balance Sheet, non-operating assets are typically removed from the assets to be transferred in a sale. The tangible assets must be converted from a book basis to their respective Fair Market Value. Fixed assets and other depreciable assets create a more complex task in trying to estimate Fair Market Value and may require the services of an Equipment Appraiser to determine the market value if they are significant to the transaction.

The normalization process of the Income Statement involves adjusting items that are not considered to be normal operating expenses (non recurring expenses). Additionally, adjustments are made for discretionary expenses such as Owner's perquisites and compensation, over or under payment of Rent and excess Family Salaries. The discretionary cash flow items are then added to the Earnings before tax, interest and depreciation to determine Seller's Discretionary cash flow.

Once the financial statements have been normalized, the appraiser uses the adjusted information as a basis for the valuation. This information can then be used to forecast the future operating results of the business as well as analyze the economic return of the owner.

Approaches to Value

The three recognized Approaches to Value are the Asset, Income and Market Approaches. Within each of these approaches are methodologies and procedures used to determine value. Below are some of the most recognized methods under the three approaches:

Asset-Based Approach:

Net Book Value is the company's book value of recorded assets less the recorded liabilities. This approach results in the book equity of the company on an accounting basis and is not related to economic value derived in the valuation process.

Adjusted Net Asset Method individually restates the assets and liabilities to current market values and then the adjusted net asset value is computed.

Income Approach:

Single Period Capitalization of Earnings Method is a process where the economic income for some single period is capitalized to estimate the present value of the company.

Discounted Cash Flow Method is a process of determining the present value of a series of specific income amounts that are estimated in future periods. It can be summed up as the present value of future returns discounted at an appropriate rate.

Excess Earnings Method is a hybrid of the asset and income approaches. The Excess Earnings Method involves valuing the company's tangible assets at Fair Market Value and adding an amount that represents the company's intangible value. The intangible value of the business is estimated by deducting a reasonable return on the company's tangible assets from the economic income of the company and capitalizing the "Excess Earnings".

Market Approach:

The Guideline Company Method involves comparing the subject company with its peers in a similar industry or SIC code. Based on the analysis, an appraiser will determine the appropriate multiples of Revenue, Seller Discretionary Cash Flow, EBIT or EBITDA to apply to the subject company.

Capitalization and Discount Rates in the Income Approach

Capitalization rates or Discount rates are determined by estimating the risk inherent to the subject company. The four components of a Capitalization Rate or Discount Rate are a Risk Free rate, Equity Risk Premium, Small Company Risk Premium and a Specific Company Risk Premium. The consistency or predictability of cash flows, asset base and industry each contribute to the risk profile.

The "Risk Free" rate, or safe rate, is a rate of return that an investor would receive when there is no risk of default. Typically the rate of return on U.S. Treasury Bonds is used as for a "Risk Free" rate.

The "Equity Risk Premium" represents the premium that common stockholders require in the public marketplace over investors in long-term government bonds.

The "Small Company Risk Premium" is the risk premium measured in the public marketplace for small publicly traded companies.

The "Specific Company Risk Premium" takes into consideration the analysis performed by the appraiser, including the operating performance, ratio analysis, industry risk, customer and supplier relationships, size of the company, management structure and other factors considered in assessing the risk related to the specific company.

Goodwill

The approaches and methods of determining value all lead toward determining the amount, if any, of goodwill in a business. Revenue Ruling 59-60 states that goodwill is based on earning capacity and rests upon the excess of net earnings above a fair return on the net tangible assets.

In the absence of earnings, the company's goodwill can be negative. The author has referred to this on occasion as "ill will". This occurs when the business is not generating an adequate return on its assets. As a result, the company's assets may be worth more in liquidation than they are on a going concern basis.

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Summary

As mentioned above, the ability to generate future cash flow or earnings is the most significant issue influencing value. Appraisers will assign an appropriate capitalization rate or multiple to a selected earnings stream to derive an overall value for a business. The capitalization rates or multiples will be derived based on alternative choices in the marketplace as well as what the market in general requires as a return on investment based on the inherent risks.

It is not uncommon for business owners to place a higher value on their business than anyone else. However, both buyers and sellers have to be realistic in their expectations.

Below is a hypothetical Asset valuation for two companies in different industries with the same revenue and cash flow. Numerous factors contribute to the final valuation:

	HVAC Service Company	Window Manufacturer
Assets:		
Current	$ 50,000	$ 450,000
Fixed	$ 300,000	$ 350,000
Total Assets	$ 350,000	$ 800,000
Revenues	$3,000,000	$3,000,000
EBIT	$ 300,000	$ 300,000
EBITDA	$ 350,000	$ 350,000
Indicated Value	$1,225,000	$1,450,000
Intangible Value	$ 875,000	$ 650,000
Revenue Multiple	.41X	.48X
EBIT Multiple	4.08X	4.83X
EBITDA Multiple	3.50X	4.15X
Capitalization Rate *	24.5%	20.7%

- Based on **E**arnings **B**efore **I**nterest and Income **T**ax. (EBITDA also includes depreciation and amortization)

Factors influencing value: The window manufacturer has a higher barrier to entry with an investment of $800,000 in assets. Additionally, these assets provide a lower level of risk in liquidation. Also, many commercial lenders look to the asset base to strengthen the deal. In many instances the ability to secure commercial financing coupled with seller financing are critical to closing the deal. While there may be a willing buyer and seller, the deal can not be closed until 100% of the purchase price is accounted for. Thus, sellers need to be flexible in providing financing to bridge the gap between the purchase price and the available down payment plus commercial finance debt.

Determining a business entity’s worth is a complicated process that involves a variety of analyses. Whether you are Selling, Buying or Planning for the future, it is important to engage a professional appraiser. McKinnon, Wootton Valuation Services LLC is a full service financial advisory firm valuing hundreds of closely held businesses annually.

Definitions:

Capitalization Rate- Any divisor (usually expressed as a percentage) that is used to convert income into value.

Discount Rate- A rate of return (cost of capital) used to convert a monetary sum, payable or receivable in the future, into its present value.

EBIT- Earnings before interest and income taxes.

EBITDA- Earnings before interest, income taxes, depreciation, and amortization.

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