BUSINESS VALUATION

FOR BUSINESS OWNERS

VALUATION REFERENCE GUIDE

VALUATION GUIDE

Business Valuation for Business Owners
What is Business Valuation?

BASICS. OVERVIEW

Valuation Purpose, Standard of Value, Premise of Value, etc.

VALUATION TOOLKIT

Valuation Approaches, Methodologies and Risk Considerations

BUSINESS VALUATION

FOR BUSINESS OWNERS

If you are a business owner chances are, you come across scenarios where business valuation is required. What is "valuation?" In general terms, valuation is a process of appraisal to arrive at the opinion of value, which determines the economic value (i.e. worth) of something, whether it is a company in its entirety, or a company unit.

There are many reasons why a certified (formal) appraisal might be required, for example: for gift and estate tax planning purposes, buying or selling a business, partner(s) buy-ins and buyouts, buy-sell agreements, M&As, marital dissolution, financing, shareholder oppression, and economic damages, just to list a few instances.

As illustrated above, each valuation engagement is driven by a specific purpose. In turn, the purpose of the valuation influences the Standard of Value, Premise of Value and methodologies used to complete the assignment.

WHY YOU MAY NEED VALUATION SERVICES?

GIFT & ESTATE TAX PLANNING & REPORTING

Tax-related valuations accomplish two main objectives: (1) maximize wealth transferred and (2) minimize taxes, by allowing a valuation professional to apply certain valuation discounts (adjustments), such as a Discount for Lack of Control (DLOC) and a Discount for Lack of Marketability (DLOM).

TRANSACTION

Whether considering buying or selling a business, partner buy-in or buyout, valuation analysis will facilitate the process and provide objective and independent opinion about the fair market value of the business.

MATRIMONIAL DISSOLUTION

In some cases, business interest is one of the main assets in a marital estate. Typically, the business is not divided between the spouses and therefore it is crucial to determine what constitutes separate vs marital property when estimating the company's value and personal vs enterprise goodwill.

ECONOMIC DAMAGES

Many court cases involve calculating economic damages. Some cases relate to sought out compensation for patent infringements, eminent domain, contract breaches, lost profits, or lost business value. In each case, determining what the economic benefits (e.g., profits, cash flows, earnings, etc.) would have been had the wrongful act not occurred and placing the injured party in a position it would have occupied had the incident not occurred.

VALUATION BASICS

OVERVIEW

Business valuations are sought to be part art, and part science. However, the overall field is guided by specific set of rules, such as state statutes, the IRS regulations, SBA standard operating procedures (SOPs), the Department of Labor as well the professional organizations such as the Appraisal Foundation (USPAP), the American Institute of Certified Public Accountants (AICPA) and the National Association of Certified Valuators and Analysts (NACVA). As previously mentioned, valuation analysis is driven first and foremost by its purpose, which in turn influences the Standard of Value, Premise of Value, approaches and methodologies used to value the subject company. Both the Standard of Value and the Premise of Value must be defined in each valuation engagement.

FAIR MARKET VALUE

The definition of Fair Market Value is relied upon as the primary legal authority and is binding when it comes to courts, government and individuals. Revenue Ruling 59-60 defines fair market value as:

"*The amount at which the property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy, and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.*"

The underlying assumptions include three main points: (1) transaction is in cash or cash equivalents, (2) there is exposure for sale in the open market, and (3) neither party is under compulsion.

PREMISE OF VALUE

The Premise of Value refers to the concept of highest and best use of the asset. For most operating businesses, the Premise of Value is going concern, meaning, the company is expected to operate in perpetuity. Alternatively, the Premise of Value can be a forced or an orderly liquidation, or treating the subject business as an assembled group of assets (meaning, the assets are worth more, when separated from the overall business operations).

"I AM NOT NAIVE ENOUGH TO SETTLE FOR ANYTHING LESS THAN A REASONABLE VALUATION OF MY WORTH" ~ ROY KEANE

VALUATION APPROACHES

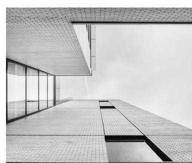
Income Approach

The value of any business or an investment is predicated upon its future earning potential. Therefore, the value of the business under the Income Approach is calculated as the present value of future expected cash flows. When an investor purchases a company, they are buying into the business' future earnings and cash flows. Given the concept of time value of money (e.g., $1 today is worth less than $1 tomorrow), the company's future expected cash flows are discounted back to present value, given the company's appropriate, market-driven discount rate.

Market Approach

Under the Market Approach, a comparison is made between the subject company and its financial characteristics such as sales, EBITDA (earnings before interest, taxes, depreciation and amortization), pre-tax profit, etc. and the guideline companies or transactions within the same industry. When market transactions are observed, certain market-based multiples can be derived, such as the Price-to-Sales multiple (Price/Sales) or the Price-to-EBITDA multiple (Price/EBITDA), etc., and applied to the financial metrics of the subject company to arrive at the market indication of value.

Asset Approach



The Asset Approach relies on the appraisal of various assets and liabilities held by the company, using the company's balance sheet as of the valuation date. All assets and liabilities are adjusted to their fair market value (for example, real property is appraised via a real estate appraisal as of the valuation date vs using its book value). Subsequently, the company's liabilities are subtracted to arrive at the fair market value using the adjusted net asset value method. The Asset Approach provides a "floor" indication of value as the entity tends not to be worth less than the net underlying assets of the subject business.

VALUATION TOOLKIT

APPROACHES AND METHODOLOGIES

There are three main approaches to valuation: the Income Approach, the Market Approach and the Asset Approach. Each approach has several methodologies which can be used to arrive at the opinion of value. For example, two prominent methods under the Income Approach are the Capitalization of Earnings Method and the Discounted Cash Flow Method (DCF). Under the Market Approach, two common methods are the Guideline Public Company Method (GPCM) and the Guideline Merged and Acquired Company Method (GMAC). Typically, when valuing an operating business, it is recommended to use at least a couple of approaches (e.g., the Income Approach and the Market Approach) because each approach provides additional information about the value as well as the opportunity to corroborate the indication of value. A valuation professional can rely on several methodologies to arrive at the indication of value either for the subject company in its entirety or a portion of the company for either tax purposes, transaction purposes, marital dissolution, and so on.

An Asset Approach is used to value holding companies or asset-heavy companies. Since these types of businesses primarily are not income-generating, the company's value is mainly based on the value of the underlying assets held by the company. Therefore, in such cases, one of the best approaches to use is the Asset Approach.

When evaluating company operations as part of the economic damages analysis, similar methodologies apply. For example, lost profits are calculated either via the before-and-after method, under the Income Approach or the yardstick method, under the Market Approach or a hybrid of both methodologies.

CONSIDER:

Risk & Discount Rates

Required Rate of Return and Cost of Capital

The concepts of risk and return are prominent not only in the world of finance but also in everyday decision-making. Valuation is no different. When valuing a business or any economic benefit stream (i.e. cash flows), one must account for what a knowledgeable investor will require as a return on their investment, given the level of risk associated with the subject investment. When analyzing risk and return, the terminology may reference and use the following terms: discount rate, cost of capital or a required rate of return. All previously-mentioned terms refer to the same concept that each investment (whether it is a company or a stock) bear a certain level of risk and require an appropriate level of return.

A discount rate describes the process of discounting a stream of future cash flows or a lump sum to present value based on the concepts of time value of money ($1 today is worth less than $1 tomorrow because an investor, at least hypothetically, can invest $0.97 today for example, and earn $0.03 interest and have $1 tomorrow).

The same concept is called the cost of capital when thinking in terms of borrowing - what is a cost of debt (e.g., interest rate on a loan/ debt financing) and/ or cost of equity (ownership investment).

A prospective investor, before making an investment in a company or an asset will want analyze how risky the company's operations are. Furthermore, he or she will examine what are the projected cash flows and how much he or she will need to earn in order to generate an adequate return on their investment? This return on investment should be commensurate with the riskiness of the subject investment.

This rate (i.e., cost of capital or a discount rate) is derived based on market evidence. The cost of equity components include the following: a risk-free rate (e.g., government bonds), equity risk premium (return on a portfolio of stocks above the risk-free rate), industry risk premia (beta risk), small-size premium, and a company-specific risk premium. The cost of debt is typically benchmarked to corporate bond yields, and is tax-adjusted.

"Accounting numbers are the beginning, not the end of business valuation" ~ Warren Buffet

Normalization Adjustments

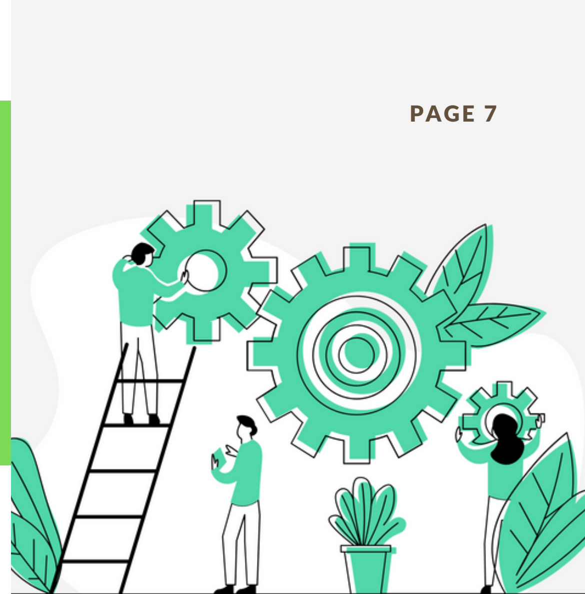
NORMALIZATION ADJUSTMENTS

Closely-held businesses and their owners tend to include a number of expenses in the company's financial statements that do not pertain to core business operations. Normalization, also referred to as the economic adjustments, typically relate to excluding or removing personal expenses, discretionary, non-operating, or one-time/ non-recurring expenses from the company's financial statements.

In many circumstances, when valuing a closely-held business, before the appropriate valuation approaches can be applied, normalization adjustments must be made to analyze and present the subject company's historical financial statements on a normalized and current economic basis. These adjustments can include owners' compensation, travel, meals and entertainment, rent, one-time lawsuit and so on.

AVC

Economic and Industry Analysis



ECONOMIC AND INDUSTRY ANALYSIS

Businesses do not operate in a vacuum. In addition to analyzing the company's internal operations and future potential, external factors such as the overall economic environment and the industry in which the subject company operates must be evaluated.

"The basic facts are straightforward but the interpretations vary" ~ Bittlingmayer and Hazlett

When analyzing the economic environment, it is helpful to review the health of the economy in general, for example in terms of the GDP growth, Consumer Confidence and Sentiment, unemployment rates, demand for various goods and services, stock market activity and what effects they may have on the subject company's operations on the current and forward-looking basis.

When evaluating the subject industry, regulatory requirements, the level of competition, barriers to entry, projected growth rates, demand for products and services, propensity of R&D and technology efforts, operations of related industries (supplier relationships), etc. can all have significant impact on how well the company will perform in the future. Evaluating how well the company is performing in comparison to its peers (including quantitative ratio analysis) is essential and is required per the IRS Ruling 59-60, which outlines eight (8) factors to consider, at a minimum, when valuing closely-held businesses.

Therefore, after performing the economic and industry assessment, a thorough valuation analysis will capture and discuss any additional risk factors and their effects on the subject company.

The Art & Science of Business Valuation

VALUATION IS A PROPHESY INTO THE FUTURE

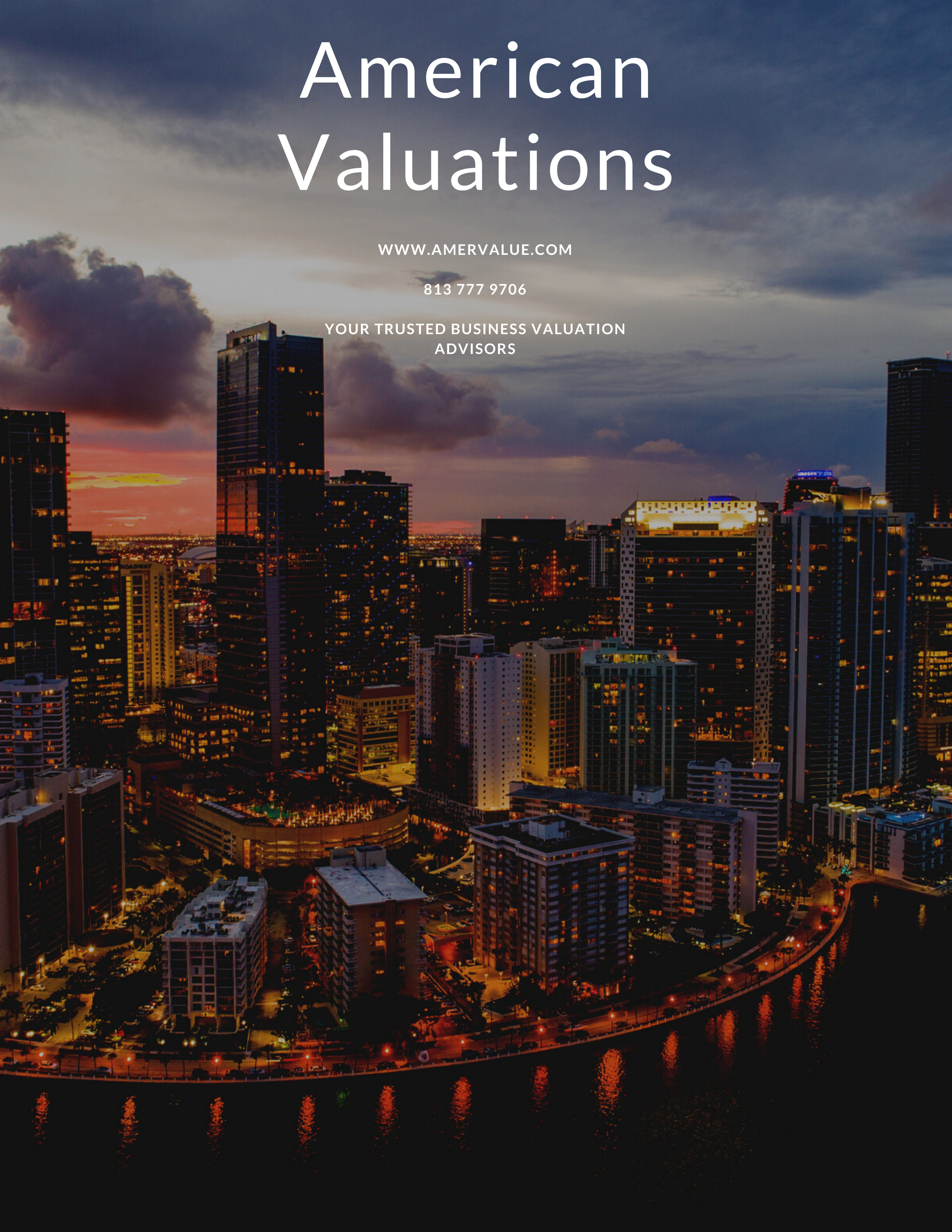
As the need for valuation services grows, it is more important than ever to stay abreast and to be familiar with concepts, regulatory updates and methodologies used to arrive at an indication of value.

A number of organizations, government and commercial, establish guidelines to follow during valuation assignments. Nonetheless, a number of factors that permeate each valuation analysis are judgement-based; hence, the "art form of valuation." Intuitive and well-informed judgement of the valuation professional are great tools, which help advisors and their clients to analyze and create a logical interpretation between the qualitative or "soft" information and quantitative data. What is important to remember is the need for reasonable explanation, and supportable basis for any assumptions used and relied upon throughout the valuation engagement.

When analyzing the subject company, in addition to financial information, ensure that adequate considerations are given to the company's qualitative analysis, which includes but not limited to the following:

- strength, weaknesses, opportunities and threats (SWOT analysis);
- Michael Porters' five forces are addressed (power of supplies, power of customers, competitive rivalry, barriers to entry and the power of substitute products or services);
- how are the company's physical facilities are (e.g., any wear and tear requiring updates or limited capacity of example)?
- is there a key person or personnel risk?

Each business is unique. True justice, as it relates to the company value, can only be established when reputable, reasonable and relevant forces are considered and included in the carefully-prepared and thorough analysis.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