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What is Your Business Really Worth?

By Shaun McGehee

There are several paths a business owner can take when it comes to transitioning ownership. For example, an owner may sell to a strategic buyer (competitor), to a financial buyer (private equity firm or employee stock ownership plan) or to the company's management team (management buyout). The owner may also decide that a full or partial sale is several years in the future, but is interested in exploring gift and estate tax planning strategies or buying out another owner.

Whether a business owner is selling all or a portion of the company or engaging in a transaction that requires a valuation, knowing what the company is worth is critical. Obtaining a business valuation, or appraisal of the company's worth, will give the owner a competitive edge. This is because valuation is the heart of business transactions and corporate decisions. By going through the valuation process, an owner will come to understand the drivers that positively and negatively impact value. Armed with a valuation, an owner can make intelligent business decisions.

Key Value Drivers

Business owners should know the value of their business and what factors drive value. Most business owners understand that private businesses are typically priced as a multiple of earnings before interest, taxes, depreciation and amortization ("EBITDA"). EBITDA serves as a proxy for cash flow, the lifeblood of any business. Companies with higher growth potential and greater free cash flow (discretionary cash flow available to owners) typically command higher multiples of EBITDA.

Generally, multiples increase as the company's size increases. In other words, a company with $20 million in revenue and $2 million in EBITDA will likely be valued at a greater multiple than a company with $10 million in revenue and $1 million in EBITDA.

In addition to a company's size, there are internal and external factors that affect value. External drivers include market conditions such as the range of multiples that publicly-traded companies in the same or similar line of business command. Lending conditions, industry specific factors and government regulation are also examples of external market conditions that may positively or negatively impact value. A business owner typically has little to no control over the market conditions that affect value, but does have control over the internal value drivers.

Internal value drivers include the company's margins, management team depth and experience, customer concentration, business plans and growth strategies. Generally, companies with experienced and deep management teams and solid growth command higher valuations.

The aforementioned key value drivers are a few of the factors that impact valuations. It has often been said that valuation is an art and a science, and business owners should, at the very least, have a basic understanding of the theory and application of business valuation.

The Valuation Process

The first step in the valuation process is scoping the engagement. This critical first step outlines various administrative issues such as identifying the goals and objectives of the business owner, the valuation process and the standard of value to be employed in the valuation. Business owners should recognize that like beauty, value is in the eye of the beholder. That is, the same business interest may have a materially different value depending on the standard of value assumed in the valuation. Just a few of the various standards of value are listed below:

- Fair Market Value
- Fair Value
- Investment Value
- Use Value
- Book Value

The most common standards of value are fair market, fair value and investment value. The standard of value applied in the valuation is specific to the goals and objectives of the business owner and should be discussed at the outset of the engagement process, prior to conducting any valuation analysis. In certain circumstances such as selling to an ESOP or for gift and estate tax reporting, the standard of value is mandated by law. In those instances, if the business owner desires to sell shares to the ESOP or gift shares to family members, trusts or to charity, the appropriate standard of value is fair market value, which is the price between a willing buyer and seller, with each having reasonable knowledge of all relevant facts and neither under compulsion to buy or sell.

Once the valuation assignment is scoped out, the valuator will begin the second step which is the collection of data. During this phase, the valuator will conduct initial due diligence which includes, among other things, the collection of financial data, background and history of the enterprise, budgets, customer lists, business plans, and other important documents.

Step three is a continuation of the second step, with the difference being that step three is far more detailed as the valuator actively engages in detailed discussions with the business owner and dives deep into the inner workings of the business. This step usually includes an on-site due diligence meeting with the business owner and/or key members of the management team.

After the valuation analyst conducts in-depth due diligence, he or she begins step four, building the valuation models. In conducting the valuation portion of the analysis and developing the concluded work product, the valuation analyst typically considers various valuation approaches deemed to be appropriate in estimating the value of the company. The generally accepted approaches and methods may include:

- Income Approach – Discounted Cash Flow Method – Analyzes the company's forecasted cash flow stream, estimates its future economic returns and "converts" those returns into a value estimate.

- **Market Approach – Guideline Publicly Traded Company Method –** The guideline publicly traded company method looks to the market pricing multiples of comparable companies in the industry that are adjusted against the earnings of the subject company.

Step five in the valuation process entails reviewing preliminary schedules with the business owner. Depending on the valuation assignment and the terms and conditions outlined in the engagement letter, the preliminary schedules may or may not communicate all of the assumptions and value conclusions. This may be to protect independence, but in all cases this serves as a quality-control measure.

Step six is when the valuation analyst formally prepares the report and ultimate deliverables to the client. Step seven is the formal presentation to the client, which typically includes an oral presentation of the report and detailed explanation of the conclusions reached.

Parting Thoughts

It is never too early to start planning the transition of a business. Ideally, business owners should discuss their goals and options with their financial advisors years before any ownership transition transaction. There are usually complex issues to address, such as tax implications, management succession and owner's legacy. Business owners should understand the key value drivers and engage in active discussions with their financial advisors to implement a strategy to meet their goals.

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