

Business Valuation Misconceptions

Conventional wisdom would seem to indicate that someone who has worked years to build a business should have a good idea of what their company is worth. Unfortunately, few do, as most entrepreneurs have honed great expertise in managing the trees of the forest in building their life's work and have had little time to take a step back and concentrate on the forest as a whole.

There are many important reasons that business owners should know the value of their businesses long before they decide to sell or transition ownership. By understanding the basics, you should be able to successfully plan the financial future for you and your family by understanding the value of your most important asset—your business.

Timing: Waiting too long to start the process

More often than not, private business owners wait to start the valuation process when their business is ready to be sold or when a lender requires a valuation as part of its due diligence process. Although the business sales and lending processes generally require that valuations be completed, if these events represent the first time an owner has a valuation completed, you can be sure critical business and estate planning issues have not been addressed. If the business is to have a life beyond that of its current owners, effective planning for ownership transition requires a regular valuation of the business.

In addition, a business owner can greatly enhance the value of their business with proper preparation well in advance of the sale date.

Industry Multiples: Rule of Thumb

Many times, business owners in well established industries rely on a standard multiple, or “rule of thumb”, that dictates that businesses in their industry always sell for two times annual revenue (the revenue multiple); so they naturally ask why they should pay someone to value their business? These rules of thumb are used by business brokers, the individuals who often facilitate small private business transactions, and represent median multiple values. In reality, the multiples cover a wide range of value and the median value is just a convenient midpoint and does not represent the revenue multiple for any actual transaction. Unless your firm is truly a median firm, then using the industry rule of thumb for this purpose is clearly wrong. You've put a lot of hard work into making your business be the best that it can be, why accept only a mid-point valuation?

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For example, according to the Business Reference Guide, a well-known compilation of industry rules of thumb, general insurance agencies typically sell for 1.50 to 1.75 times revenue. If you were valuing your firm for sale using this rule of thumb and your annual revenue was \$250,000, then you would have placed the value of your business somewhere between \$375,000 and \$437,500. Turning to a well-respected source for business transaction data, Pratt's Stats, revenue multiples for general insurance agencies over the past five years seemed to support the rule of thumb, with median transaction multiple of 1.70. However, of the 25 reported transactions in the past five years, the range of multiples went from a low of 0.29 to a high of 2.51, which would value your business as low as \$75,000 or as high as \$625,000, or somewhere in between. Where your firm lies within this range is obviously of the utmost importance and can only be determined by a valuation approach that incorporates academically validated methods with industry-specific valuation factors.

Timing: Valuation date

Often times, an owner concentrating on running his business will be surprised when he finds out that a local competitor sold his business six months ago for a tidy sum. Suddenly, you start thinking that if your competitor got three times revenue six months ago, then your business is worth at least this much and maybe it's time to check out.

Unfortunately, maybe it is, and maybe it isn't. What happened six months ago is not really relevant to what something is worth today. What your business is worth today depends on three factors: 1) how much cash it generates today; 2) expected growth in cash in the foreseeable future; and 3) the return buyers require on their investment in your business. First of all, unless your firm's cash flows and growth prospects are very similar to the competitor, the revenue multiple used for that transaction is irrelevant to valuing your firm (which is also another reason to take rules of thumb with a grain of salt). Moreover, without getting into the nuances of finance, even if the competitor was equivalent to your company in every respect and both firms were sold today, one factor, such as if interest rates were higher today than six months ago, the firms would likely sell for less than three times revenue. Conversely, if rates were lower today than six months ago, the firms may be worth more than three times revenue. In short, businesses by their very nature are dynamic, not static, and given this their values can easily change over time as economic and industry conditions change.

Lack of Earnings: Low profits does not automatically mean low value

Often times, a business owner believes that if their business loses money, it is not worth much. However, appearances can often be misleading as most private businesses appear to lose money. Last year, a client was considering buying a business in a neighboring state to expand their territory. The asking price was approximately \$3.0 million, and, according to the firm's tax return, it hardly made a profit. Our client wondered how they could justify such a high asking price.

Like many privately-held businesses of this type, this business was generating a great deal of cash, but this cash was camouflaged as legitimate business expenses. One expense category really stood out, payments to directors and officers. This payment included the owner's wage of \$125,000 per year and a bonus of \$900,000 that the owner paid himself and family members at the end of year. The \$125,000 wage is what the business would have to pay a manager to do the same job as the owner. This was a real expense. However, the \$900,000, represents what we call a discretionary expense of cash that otherwise would be a return to capital. It is real cash the business generated and is not a necessary business expense, it can be utilized to increase the value of the business.

Unlike public companies, the separation between ownership and management does not really exist in a private firm. Thus owners have some discretion over how they categorize cash flow generated by the business. Quantifying the type and size of these discretionary expenses is often a critical determinant of the firm's value. As such, owners should keep a tab on what these discretionary expenses may be so that, when they are ready to sell the business, they can document these facts to the buyer (which is also another reason to start thinking about valuation of your business well before it is time to sell). By doing so, the seller increases the buyer's confidence that the business does legitimately generate the cash the seller claims and, accordingly, increases the buyer's willingness to pay the asking price for the business.

Absolute Value: There is only one answer

Business owners who are used to looking up the value of their publicly-traded stock portfolio on their smart phones often view our valuation process similarly, sort of like a "black box," where you can just dump some data in and generate a credible valuation result. While our training and experience greatly improves our accuracy and reliability, our valuation methods and approaches do not produce an absolute value. The truth is, if you were to have five business appraisers value the same business, all five will come up with a different value. That is because each analyst may use different methods, approaches, discount rates, risk levels, and other variables to estimating the value. However, if the valuator uses sound valuation methodology and approaches and has adequate experience, then you can assume the business valuation will be reasonable.