

Know Your Value, Know Your Business

As a business owner, you want to be aware of the decisions and factors within your business that may positively or negatively influence its value, but sometimes these things are not so obvious.

There are many major factors that may influence the value of a business including but not limited to corporate goodwill, client diversity, competitive landscape, fixed assets, inventory, management structure, to name a few. As a business owner, some items can be addressed sooner rather than later to ensure that your company's value is maintained protected should you ever plan to sell or transition ownership.

Earnings and Cash Flow

Bottom line, the value of your business is defined to be the amount that someone would pay for it in the marketplace. Buyers are not purchasing what you have made in the past; rather, the buyer is looking to purchase a future income or cash flow stream that will provide a desired return on his or her investment. Therefore, earnings and cash flows become an important part of justifying a purchase price.

Positive Trending

Typically, the most recent three-to-five years of performance and two-to-three years of projections will be the periods analyzed to determine a company's value. Showing positive trends and growth in revenue, income from operations and cash flow will likely have a significant impact on value. When businesses suffer due to factors out of their control (industry dips, seasonal declines, recession, etc.) those can at times be accounted for as normal business, industry and economic fluctuations. However, if a business declines due to lack of performance on its own accord in comparison to similar companies in a similar industry, this may cause an impact in the company's fair market value and strategic value.

If your business is showing a steady decline, or even remaining flat, why would a buyer pay a premium? Many business owners, rightfully so, believe their company is worth much more than it is due to the time, sweat, and effort invested into their business. However, often this value is tied directly to themselves on a personal basis (being your own boss, providing a job you enjoy, unique benefits of ownership). Owners who can step away from the situation and evaluate their business from a buyer's perspective will appreciate the fact that positively trending cash flow and a positive outlook into the future may make the company much more attractive and valuable.

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Strength and Risk Factors

In a simple world where all external factors are equal, earnings/cash flow and a median valuation multiple would be the sole determinant of a company's worth. However, every company has unique upside and downside risks associated with its operations, and the company's future opportunities must be weighed against the perceived business and economic risks.

To determine a company's value, buyers must weigh the future opportunities against the perceived business and economic risk. Elements of the business that increase risk decrease the value of the business. Conversely, elements that decrease risk increase value. Examples of risk factors that may influence valuation include: industry life cycle; industry stability; customer base concentrations or dependencies; supplier dependencies; product or service differentiation; strength and size of market; management quality and depth; employee dependencies; impending regulation; new technology and many others. Although each of these risks is unique, they all have one common trait, an ability to either reassure or cast doubt on the predictability of future cash flow. As a result, the better a business can control, offset or properly present these potential risks, the more positive the impact on valuation.

Record Keeping

Maintaining clean financial books and records is essential. Keeping business and personal expenses separate is ideal, as many small business owners treat their company's cash flow like a personal checking account. Often, family expenses beyond owner compensation are being paid by the business such as meals, vacations, automobile, gas, insurance, phones, etc. While this approach definitely has some advantages for ongoing concerns, it can have detrimental effects when preparing a business to sell. Not only would these "owner benefits" have to be adjusted back into the company's earnings, they will also have to be explained to a potentially skeptical buyer. Keeping these types of expenses separate is of value when owners want to avoid buyer skepticism. Remember, when you are considering selling your business, each dollar of additional earnings or cash flow will return a "multiple" of that amount.

In addition, studies from major accounting firms over the years, and even from our own experiences, have indicated that companies with audited financials, or at least professionally managed books for small businesses, will consistently garner a higher purchase price than those not well kept. For most buyers, if it is not documented, it is not included as part of their valuation exercise.

Modernized Processes

Even in the most archaic of industries, advances in modern technology and automation require constant evolution from owners hoping to earn a premium for their company. Business owners that accept change and have adapted to more efficient and productive ways to operate their business will not only increase profits, but also build a business that can sustain additional growth with less operational costs required. Such changes can greatly impact your value as the future operational and profit prospects of your business will be tangible and already in place, rather than requiring an 'additional' investment by the buyer.

Key Man

If you wanted to, could you go on vacation for a month in Hawaii with the assurance that your business will operate smoothly without your presence? If not, you should strive for this goal. Although it is counter-intuitive for most entrepreneurs, it is essential to make your business less reliant on you. When a company is heavily reliant on an owner and his expertise, it is more susceptible to a lower valuation. This is certainly true for smaller companies where often times the owner is the whole business. In his or her absence, clients will leave and the company's ability to function is all but paralyzed. Owner's who can develop sound processes, responsible management, and a value chain to serve clients will be able to step away from working "in" the business and work "on" the business.

Typically, when a small business owner sells, the buyer will step in to run the company, as opposed to hiring a manager to run it for them. It is important that a current owner has laid the foundation for a completely new individual to seamlessly walk into the business and have the ability to successfully run it within three-to-six months time. Making it as easy on a buyer to take over management is key in maintain and creating value in your business.

Terms and Structure

Price and terms tend to have a negative correlation with each other. For example, an all cash transaction may yield a lower price when compared to a transaction that includes owner financing. The better the terms offered to a buyer, the higher the price that can be paid to the seller. This primarily relates to cash flow, the cost and availability of outside debt capital and the risk associated with completely "cashing out" the business owner at closing. The key is to identify the right combination of price and terms that creates a "win-win" for both buyer and seller.

Tax implications also play a major factor in structuring a transaction because it can greatly affect the cash flow of a company during the vital years after a change in ownership. Structuring the sale as an "asset" or a "stock" sale has conflicting benefits and consequences for the buyer and seller. In addition, if the seller is willing to finance a portion of the sale price or retain an ongoing investment in the stock of the company, it helps to reduce the buyer's uncertainty and have a positive impact on the value.

Conclusion

The value of a company is most likely a significant asset of the overall net worth of a business owner. Knowing the value of the company is an extremely important aspect for many facets of the overall planning of a business owner. The planning should be an ongoing process to be most helpful for a business owner to know the right time to transition ownership, whether changes are needed to enhance value or whether changes implemented are having a positive impact to the value.