The BizEquity® System and Accuracy

By Scott Gabehart

Chief Valuation Officer, BizEquity

(BA, MIM, CBA, CVA, BCA, CBVS)

BIZ EQUITY®

The BizEquity System and Accuracy

By Scott Gabehart
Chief Valuation Officer (BA, MIM, CBA, CVA, BCA, CBVS)

Introduction

BizEquity has created an operating system and cloud-based platform for doing business valuations on private companies and has filed over 61 patents and inventions with a total of 7 granted patents currently. The platform was created with over $15 million dollars; 600,000 man hours of development effort, and over 10 years of development. It streams data from multiple data source comparable and performance sources and uses this data to hit against it's patented business valuation algorithm.

The BizEquity Algorithm is based upon professional business valuation standards and revolves around both a Discounted Cash Flow (DCF) and Sellers Discretionary Earnings (SDE) methodology. It is unique in this hybrid approach and its proportion-based utilization of DCF if the company valued is a growth company and/or in select industries and SDE/Adjusted EBITDA if operated as a more traditional tax efficient business.

All multiples, discount rates and cap rates are industry-specific, size adjusted and reflective of myriad company-specific factors including growth, profitability, asset intensity and key risk factors such as customer concentration, degree of repeat clientele, importance of owner to day to day operations, and much more.

Our system will produce valuation estimates which are generally within (+/ -)10% - 15% of the mean value expected if one were to hire 5 professional appraisers to value the same company with identical facts. Valuation is both an art and a science, with literally dozens of underlying assumptions needed to reach a conclusion of value. Any given assumption can impact "value" materially, up or down. In reality, the best way to view business value is in the form of a range, i.e. between X and Y. Because certain valuation purposes require a "point estimate", they must often be relied upon.

System and Accuracy

To date, BizEquity has valued over 30 million businesses world-wide. The system is constantly benchmarked against subscriber or user transactions; realtime data availability of comparables; and best practices we employ from business valuation expert and "guru" Scott Gabehart. Scott is a best selling business valuation author, professor of business valuation at the MBA level, and offline practitioner with around 25 years of experience in brokering and valuing companies across the country.

In the U.S., the system was benchmarked by Heffler Advisors certified valuations that were delivered from 2001-2014. Applying general economic GDP growth figures and market comparable changes, the system performed extremely well. On average our system was within a median value of 2.7% for any Enterprise Valuation; 4.45% of Equity Valuations; and within 4.34% of Asset based valuations; and within 1.8% of liquidation values where available.
This was against a sample size of 3,400 total companies valued by certified business valuations which ranged from $4,500.00 to $15,000.00.

There is literally no such thing as "the value" of any company.

Fair market value (which we calculate) is different from "investment value" (value to a specific buyer with synergies) or "fair value" (shareholder oppression suits). In addition, performing valuations for divorce can be dramatically different than performing a valuation for a business sale or acquisition or for shareholder oppression, ESOP's, etc.

BizEquity has acquired market transaction multiples from virtually every major database in the world, with each database providing useful data for a given purpose, e.g. financial benchmarking or transaction multiples and for a given segment of the market for business control, e.g. one database for main street businesses, one for middle market companies, one for dental/medical practices, one for asset sale versus stock sale valuations, many for the US and others for other countries, etc.

We valued around 100 dental practices for BofA and came, on average, within around 8% of the historically negotiated deal values (fair market values). The Mutual of Omaha team apparently came even closer than this in their testing (around 4.5% for equity values).

KPMG, the Wall Street Journal and the American Banker's Association (ABA) would not be using and promoting our tool if it were not reasonably accurate in the same sense that an offline appraiser's estimate is hopefully "reasonably accurate".

System and Accuracy

The ultimate proof of our system's appeal, accuracy and reliability is our near 90% customer retention ratio.

Why Do BizEquity Value Estimates Differ from Offline Estimates?

It is not uncommon to face a situation wherein the BizEquity estimate is materially different from that of a Certified Business Appraiser estimate. Not to worry though- even when clients believe there is a major discrepancy, it is typically due to one or more different assumptions made in the formal appraisal which differ from the standard BizEquity case.

In responding to the issue as to why a BizEquity online estimate can differ from a formal offline appraisal report estimate, there are both generic explanations and discussions (see below) AND a specific, fact by fact comparison associated with the actual data used by another appraiser.

Generic Explanation

There are MANY reasons for a disparity between the BizEquity estimate(s) and those produced offline by a formal business appraisal. As mentioned, there is a typical "plus or minus 10% to 15%" range among professional appraisers using identical facts. As an example, a mean value of say $1 million could easily be valued between $800K and $1.2m by a group of appraisers.

None of the reports would necessarily be "wrong" or inaccurate - just based on different assumptions and interpretation of key facts and trends and tendencies, etc. Add to this the other factors and a range of $1.8m to $2.5m is legitimately explainable without concluding that the $1.8m estimate was somehow "low" or "wrong" or not useful. The appraiser (offline and online) relies on "generally accepted business valuation principles and procedures" or GABVPP to reach the conclusion of value.

Importantly, the end result is an opinion that is based on facts and grounded in this "generally accepted" framework.

Through the appraiser's individual (advisor's or business owner's) experience, training, integrity and reliance on GABVPP, they are able to project the activities of buyers and sellers in the marketplace into an estimation of value. There are literally dozens of reasons why the value estimates will differ, and much can be learned by understanding them. It is not uncommon for a variance of even 10% to 25% (or more in tax court, shareholder dispute and divorce settings) to exist even with the same fact pattern. Reasonable people will disagree as to what the proper estimate of business value is - they may be close, but they will be different. As such, a business valuation may be considered an investigation into the law of probabilities with respect to business value. The value conclusion or opinion cannot be guaranteed and it cannot be proven in any precise way. It can, however, be substantiated and supported whereby the final opinion is the result of a thorough analysis of a large amount of data.

A valuation opinion is not an "absolute" finding; rather it forms a basis for negotiation between opposing parties and their respective interests. This opinion or conclusion may be a "point estimate of value" but is more accurately described as a "range of value." Attempts have been made to turn this process into more of a science, but subjectivity always takes center stage. **Valuation is and will always be one part science and one part art.**

When teaching students of business valuation, I often make the point that business valuation in a vacuum is meaningless.

Valuation Efforts and Techniques Take on Meaning Only in the Real World.

You can look at the process of developing the subject company's multiple via the norm as part of a battle with an opponent. You want to build the strongest case you can in support of your conclusion. If you feel the business is above average, state your case clearly and forcefully. Whether dealing with a buyer or seller or with a judge in divorce court, one must defend one's valuation results with confidence and measured zeal. Why is this business above or below average? List your reasons and be prepared to defend them by imagining a cross-examination.

The following pages present examples of how and why value estimates differ from offline to online and from one appraiser to the next.

Case One:

Factors Affecting Value Estimate Differential
One real world valuation case where the online versus offline value estimates were FAR APART (a perfect storm) led to the discovery of numerous differing assumptions which were responsible for the differential:

1) Valuation effective date (January versus October)
2) Reliance on year-end versus interim financial statements
3) Use of financial statements versus tax returns
4) Comparison of asset sale value to equity value (apples and oranges)
4) Data entry errors involving non-cash charges and owner compensation
5) Use of different NAICS code
6) Extremely high amount of recent fixed asset purchases (between January and October)
7) Changes in business cycle
8) Seasonal factors

System and Accuracy

This was an example of a "perfect storm" of factors which contributed to the large differential, ranging from incorrect data entry to extremely high fixed asset value to the presence of a cyclical industry to a lack of quality market comp data to differences between tax versus GAAP accounting to valuation for estate tax purposes and more! The following five factors provide support for the evolution of value between the BizEquity Report and the Offline Appraisal Report.

1) Data Error Entry into BizEquity's System

Income Statement Errors

Officer Compensation should include one owner only (not three!)
Difference of around $200K

Non-cash charges should include depreciation only
Should have been $2,923K, not $3,471K
Difference of $548K

Total difference of around $748K in total discretionary earnings

Based on multiple of say 5X, this would decrease value by around $3.75m

Because earnings are lower, multiple would be somewhat lower as well

Final difference is around $4 million lower value

Balance Sheet Errors

Entered total liabilities of only $4,669K
Total actual liabilities were $9,484K

Final difference of $4,815K or nearly $5 million lower

Between income statement ($4 million) and balance sheet ($5 million), the cumulative difference is already at around $9 million

2) Lack of Comp Depth for Logging and Use of Blended SIC/NAICS Code

Logging: from middle market multiple of 5.81 to 3.99
Local Ground Transportation: middle market multiple of 4.44 versus 5.81

If most current and blended multiples were used, average multiple would have been at least .5 lower, e.g. 4.5 instead of 5

Final difference would be around $1.5m lower

Based on 1) and 2), estimate is now around $10.5m lower

3) Extremely High Fixed Asset Values Due to Recent Purchases

Nearly $11m in outlays during three years leading to valuation date (our algorithm increases value too much in this rare circumstance)

However, large debt balance is neutralizer in terms of equity value

This unique fixed asset adjustment is responsible for roughly another difference of $1m in value

Based on 1), 2) and 3), estimate is now $11.5m lower

4) Cyclical Business and Specific Events Taking Place in December of 2016

Cyclical business requires consideration of long run averages as well as recent results (reduces earnings figure used to derive value estimate)

Bad weather prevented shipping of logs and recognition of revenue (representative of unique risks in logging industry, reduces pertinent multiple).

Reduces earnings figures and multiples marginally

Based on 1), 2), 3) and 4), cumulative estimate is around $12m lower

5) Appraisal for Estate/Gift Tax Purposes

Generally based on lowest possible value considered reasonable and in conformity with Revenue Ruling 59-60, IRS expectations and fair market value.

Conclusion

Total overall impact is around $12m, thereby clarifying the difference between the BizEquity Report estimate of $16.6m and the offline report of around $5.2m.

NAICS Code for Other Industry Sector

484	Truck Transportation
4841	General Freight Trucking
484110	General Freight Trucking, Local
48412	General Freight Trucking, Long-Distance

Case Two:

The source of the differential was the “full appraisal’s” assumption to exclude cash and any of the actual excess net working capital in general.

For example, their multiple of SDE generates a control value of around $2,970K (versus our estimate in the form of the asset sale value equal to $2,968K!!). From there, they reach an equity value by only adding back $777K (titled “All Other Assets” on their page 20) versus the full and appropriate addback of all cash ($1.5m), A/R ($800K) and other liquid financial assets ($0) which totaled around $2.3m. Adding the $2.3m to their asset sale value of $2,970K delivers an equity value of around $5.3m (versus our estimate of around $5.2m).

So in fact, our results are almost identical to theirs. The difference lies in assumptions they made to exclude cash and any excess net working capital.

As per their report: We do not add back cash as the seller retains the cash in this transaction. We calculate reported working capital (excluding seller-retained cash) on that date as $776,032. All is held as receivables. This provides potential excess working capital of $400,000, rounded. In a sales transaction, smooth transitions rarely occur. We set aside this excess working capital as a reserve for these contingencies.

Bottom line? Almost identical underlying results!

Case Three:

In addition to the depreciation expense (very small effect), there are two factors which drove the differential:

1) Use of different NAICS code

2) Use of third year with lower discretionary earnings in Mutual of Omaha version

The main cause of the differential is the NAICS code. Can you send me the web address for the company? There are several Bruce Company construction companies across the US.

Concluding Remarks

As noted, there are an unlimited number of reasons why valuation results differ from one case to the next. Our reliance on generally accepted business valuation principles and procedures allows us to ensure a reasonable and reliable estimate of fair market value and years of fine-tuning and perfecting have culminated in a one-of-a-kind valuation system for use by financial advisors and business owners of all types and sizes.