The Basics of Business Valuation

By Jason Early

President of Business Operations
BizEquity

BIZ|EQUITY®

The Basics of Business Valuation

By Jason Early
President of Business Operations
at BizEquity

In the 2012 shareholder meeting for Berkshire Hathaway, Warren Buffett said:

> *"If business schools could offer just one course, it would not be on stock trading, the efficient market hypothesis or modern portfolio theory. Rather, business schools should be encouraging students to learn the boring, but critically important, discipline of business valuation."*

Business owners who have expressed an interest in having their company valued have also implicitly recognized that there is value in understanding how to value their business. That said, it is essential for their advisors to have a good working knowledge of the components that make up their client's valuation report.

A business valuation report can provide business owners and their advisors with much more than just a "valuation number." For example, it can provide clients with important insights into different measures of business value as well as comparisons of the subject's key financial benchmarks with the industry cohort. In addition, business owners and their advisors can benefit from gaining an understanding of the mechanics of business valuation and using this knowledge to proactively manage or build value over the short and long term.

The report can also help with the variety of questions that client's typically have, including:

- What is my business worth today?
- How many different types of value are there and which are most important to me?
- What is the difference between an "asset sale" and a "stock sale"?
- What are the primary value drivers in general and how do they differ from the perspective of the income statement versus the balance sheet?
- How does my company compare to others in the same industry?
- Terms of key financial metrics involving liquidity, solvency, activity and profitability?

Why Are You Valuing The Business?

The reason for the valuation will impact the selection of the most pertinent value conclusion while shaping the discussion beyond valuation as data is entered and results obtained. After establishing the primary purpose for valuation, the importance of discovering a credible estimate of value can be seen in the following table

Purpose of the Valuation	Cost of an Improper Business Valuation
Buying/Selling the Business	Overpaying or leaving money on the table, and less than optimal "allocation of purchase price"
Divorce	Onerous settlement payments or other unfair outcome
Partner Buy-In	Improper/Ineffective post-transaction motivations
Partner Buy-Out	Over-leveraging firm to make required payments
Shareholder Dispute	Unfair outcomes and excessive legal fees
Key Man Insurance	Business Failure due to lack of capital in time of need
ESOP	Employee lawsuits or solvency problems due to over-valuation
Estate/Gift Taxation	Overpayment of federal taxes Potential fines plus interest in addition to tax liability
SBA Loans	Inability to garner funding Overpayment of purchase price/future insolvency

Defining Key Terms is Critical

The most common business valuation scenario can be boiled down to the following:

The determination of fair market value on a going concern basis in the 100% controlling interest in the firm's common stock or assets.

In short, what is the value of the entire company (assets or stock) "on the open market" to the typical or most likely buyer for the given business?

This scenario will apply, for example, if there are:

1) Plans to buy or sell a business
2) Reasons to obtain an SBA loan or seek out other financing
3) Requirements to file for estate/gift tax purposes.

Key Terms

Here are the basic terms (as defined in the International Glossary of Business Valuation Terms) you should know in order to understand and explain a business valuation report:

Going Concern - An ongoing operating business enterprise.

Fair Market Value - The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

Fair market value on a going concern basis for a 100% control interest is the most common scenario, but there are other "standards of value" besides fair market value such as:

Investment Value - Value to a specific/known buyer rather than hypothetical or most likely buyer. In consolidating industries, fair market value will approach investment value and account for the favorable synergistic impact of combining one or more companies. In this case, the normalized earnings are typically higher and the pertinent multiples will be higher.

Fair Value - As used in divorce cases, this is "value to the current owner" rather than to a hypothetical buyer. It also refers to an accounting concept which is roughly equivalent to fair market value.

Liquidation Value - Value based on the shutting down of the business with the sale of all assets and the repayment of all liabilities rather than as a going concern with perpetual life.

Premise of Value

There are also other "premise of value" options besides "on a going concern basis" such as:

- As a **collection of assets.** Not a going concern, but not out of business either.
- As a **planned liquidation.** Going out of business and selling all assets in a planned manner, e.g. a well-publicized auction.
- As a **forced liquidation.** Going out of business and selling all assets in a forced manner, e.g. a "fire sale."

Levels of Value

There are other "levels of value" besides a "100% controlling interest" such as:

- **On a minority (less than 51%),** non- controlling interest basis involves minority interest in ownership, e.g. 15% interest in the common stock and one other 85% shareholder.
- **On a minority (less than 51%),** quasi- controlling interest basis involves a minority interest with some degree of control, e.g. 33% interest with two other 33% shareholders or two 50% shareholders.

On a minority (less than 51%), controlling interest basis involves a minority interest with de facto control through Articles of Incorporation, Corporate By-Laws or other means.

To reiterate, the most common scenario will involve the need to value the entire company using the "fair market value" standard and "going concern" premise of value.

Sale of Assets Versus Sale of Stock/Equity

From the perspective of valuing a business for buying/selling/financing purposes, a key distinction arises between the assumed "purchase or sale of assets" and the assumed "purchase or sale of equity". Irrespective of the reason for the valuation, it is always possible to calculate and state the value conclusion in the form of either an asset deal or an equity deal.

The actual buying and selling of businesses can be accomplished through either the sale of assets or the sale of equity. Whether assets or equity are sold, the goal is typically to determine the fair market value on a going concern basis in a 100% controlling interest of the target.

Buyers and sellers must negotiate literally hundreds of "terms, conditions, contingencies, representations, warranties and indemnities" beyond the "price" itself. One of the most important areas of negotiation is the type of sale – asset or stock – and then specifically which assets and which liabilities are included.

Because the concept of fair market value normally entails or reflects all of these "typical" or normal terms and conditions associated with transactions either the "asset" or "stock" sale.

The majority of smaller, owner-operated businesses are sold on an "asset sale basis" while the majority of larger, middle-market companies are sold via the "stock sale" format. A variety of factors will determine the chosen mode of sale, with buyer and seller negotiating price and an array of other "terms and conditions" including the type of sale (asset or equity).

The crux of the distinction between the asset deal and stock deal pertains to the specific constellation of assets and liabilities which are included in the given transaction and reflected in each value conclusion. Business brokers hired to assist buyers and owners most commonly value businesses under the "asset sale" scenario through multiples of discretionary earnings while valuations for divorce or middle-market consolidation will be based primarily on the "stock sale" scenario.

Whereas the valuation of stock/equity involves the assessment of all of a company's assets and liabilities ("known and unknown" and "on or off the balance sheet"), the valuation of an "asset sale" revolves around those specific assets (and typically no liabilities) identified in the purchase contract.

For example, the "asset sale" format is generally contrasted with the "stock sale" as follows:

Asset Deal	Stock Deal
Only Inventory Fixed Intangible Assets	All assets (on and off-balance sheet)
No Liabilities	All liabilities (known and unknown)
Allocation of Purchase Price	No allocation (buyer inherits all account balances as they are for both book and tax purposes)
Ability to "step up" the basis of fixed assets	Inability to "step up" the basis of fixed assets (except via a Section 338 Transaction)
Avoidance of unknown liabilities	Greater exposure to unknown liabilities e.g. lawsuits, warranty, obligations, product returns, etc.
Limited tax maneuvers	Creative deal structures including the possibility of selling personal goodwill separately from corporate tax to minimize tax liability (in particular for C-Corporations), selling "stock for stock" in order to defer taxable gains, etc.
ESOP	Employee lawsuits or solvency problems due to over-valuation

In general, the goals of the buyer and seller are typically at odds with respect to the choice of deal structure (asset versus stock sale). Almost without exception, what is good for the buyer is bad for the seller (and vice-versa). The rationale for selecting one over the other is complex and worthy of legal and tax advice.

In some cases, licenses, contracts, or other key rights that belong to the corporation and cannot be easily transferred will dictate the use of a stock sale so that key rights remain with the new owner. For example, a corporation with a hard to obtain FDA license would likely be structured as a stock sale so that the FDA license is maintained by the corporation and transferred to the new owner(s).

A basic real-world valuation example involves the use of “discretionary earnings” to generate an estimate of “asset sale value” through either an income approach or market approach valuation method. This pivotal measure of earnings is widely used by business brokers, bankers, business appraisers and entrepreneurs to gauge the probable fair market value of controlling interests in private companies.

Example of Asset Sale Value Estimation Using Discretionary Earnings

By definition and assumption, a multiple of discretionary earnings results in the estimated value on an asset sale basis (not an equity value). By comparison, applying a capitalization rate against “net cash flows to equity” will produce an equity sale basis valuation result. As shown later, the “asset value” can be converted into an equity equivalent value through the application of certain steps.

Basic Valuation Example

Applying a multiple or cap rate to the firm’s discretionary earnings will produce an estimate of fair market value on a control basis that is consistent with the terms and conditions of the typical asset sale.

For example, applying a multiple of 3 to discretionary earnings of $600K generates an asset sale value in the amount of $600K.

Pertinent Risk-Adjusted Multiple	3.0 times
Average Discretionary Earnings	$600,000
Asset Deal Estimate of FMV	$1,800,000

This asset sale value of $1.8 million includes the firm's inventory (at cost), fixed assets (replacement value) and all intangible assets (goodwill, client base, covenant not to compete, etc.).

One of the pivotal tenets of business valuation is the so-called "size effect" or "size premium." Research has proven over and over again that higher earnings or cash flow levels will attract higher multiples of value. The business owner should be made aware of this "reality" based on its motivational properties.

The Role of the "Size Effect" on Business Valuation

The size effect can be a real motivator if properly understood. In short: "The greater the earnings or cash flow generated by a company, the higher the pertinent valuation multiple becomes." Another maxim in the business valuation field is that: "larger companies are less risky and their cash flows are therefore more valuable (less risk, higher value)."

From the perspective of the small business owner who is planning an exit strategy alongside of a strategic or business plan, this means that there are two routes towards enhancing company value from month to month and from year to year.

Two Routes Toward Enhanced Company Value	
Route One	Route Two
Increase the absolute amount of earnings or cash flow available to the owner. If earnings rise or double from $300K to $600K, the total value of the company will at least double: $300K times 2.5 = $750K $600K times 2.5 = $1.5M Increase in Value = $750K or 100%	Increase the pertinent valuation multiple. If earnings rise or double from $300K to $600K, the pertinent multiple will ALSO rise from say 2.5 times to 3.0 times: $300K times 2.5 = $750K $600K times 3.0 = $1.8M Increase in Value = $1.05M or 140% The overall impact of doubling earnings from $300K to $600K is an increase in value from around $750K to $1,800K with around $300K of this increase due solely to the "size effect."

The Big Picture

We now know that most valuations will require the estimation of fair market value on a going concern basis for a 100% control interest in either the "assets" or the "equity." In the bigger picture, however, there typically are four primary types of value which are calculated in valuation reports such as BizEquity's. We have discussed the "asset value" and "equity value" conclusions and we have touched upon "liquidation value" on a forced liquidation basis.

The term "enterprise value" is typically associated with middle market or high growth/startup appraisals which include some variation of discounted cash flow analysis or the guideline public company method. Similar to "asset sale value" to a certain extent, the firm's enterprise value is equal to the sum of its "equity value" plus "debt value", i.e. the overall enterprise (total assets) is capitalized with debt and equity. The use of a multiple of EBITDA in middle market transactions is assumed to generate an estimate of "enterprise value", whereby the firm's long-term debt must be subtracted to derive the "equity value."

More about Enterprise Value

In middle-market transactions, it is also helpful to distinguish between "equity value" and "enterprise value". Enterprise value is a reflection of the firm's value as a functioning entity and it is helpful in that it facilitates the comparison of companies with varying levels of debt.

This fair market value estimate is equal to the "total value of the firm" or the value of the firm's equity plus its long-term debt, i.e. it reflects the value of the entire capital structure (equity holders and debt holders) or "enterprise". M&A professionals routinely cite multiples of EBITDA as a gauge of enterprise value with equity value calculated after subtracting LT debt.

Consideration of enterprise value as well as equity value (market capitalization) can provide greater insight into probable long-term growth prospects.

It may be helpful to consider enterprise value as a "takeover price", i.e. an acquirer would have to take on the company's debt, but would retain its cash. In some variations, preferred stock, minority interest investments in the Subject Company and even capitalized lease obligations are included as debt. Cash is subtracted to reach Enterprise Value because (excess) cash is considered a non-operating asset AND it's already implicitly reflected within the equity value. In practice, it is "excess cash" which is normally subtracted (cash not needed to facilitate normal day to day operations). However, we are assuming that a company's cash balance (including cash equivalents such as marketable securities or short-term investments) equals excess cash.

Which Business Value is Most Important?

The answer to this question depends upon the purpose for the valuation engagement. If you're filing an estate/gift tax return, equity value is most important. If you're negotiating the P&S of a business via an asset sale, then asset value is most relevant. When evaluating middle-market companies for M&A purposes, equity and enterprise value will be important. If the business is rapidly deteriorating and the owners are considering contemplating a reorganization, then liquidation value may be most relevant.

BizEquity provides the technology and support to help advisors:

- Provide business owners with sound advice based on their business value.
- Zero in on prospects with our database of over 33 million pre-valued businesses.
- Define their ideal business owner target based on their firm's operating style.
- Market their services to business owners with off the shelf white-labeled marketing content and presentation materials.
- Engage a business owner and value their business in less than 20 minutes.
- Automatically benchmark the value and operational metrics of the business against their peers.