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Executive Performance on Demand

How To Value A Private Business

A Guide For Small and Medium Business Owners

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SMALL AND MEDIUM PRIVATE BUSINESS VALUATION

The purpose of this document is to provide the reader with an overview of some of the motivations and approaches used to support buyers/sellers in determining the valuation of a private business. Regardless of motivation and approach employed - or the perceived value by the buyers or sellers of a firm - the price is only certain when both parties agree and the transaction is executed.

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INTRODUCTION

For publicly traded companies the stock market provides liquidity and sets the pricing of those firms' shares trading in that stock's "marketplace" – the "stock exchange". The exchange serves as the marketplace that brings buyers and sellers together where the fundamental supply and demand mechanism augmented with the perceived risk and reward (or required return) of equities determines prices. This liquidity facilitates a readily understandable "market" price for publicly traded companies. However, there is significantly less liquidity in the sale of private businesses and therefore significantly more challenges in determining valuations or "price".

There are many approaches used to value a private business entity. Some approaches focus on asset values including book value and market value. Other approaches focus on historical earnings and future earnings and apply a multiple to those earnings to value the business. Another approach is to consider the historical sale price of similar transactions for like firms or businesses - it is in these instances that "market" value of an entity may be better understood. However, given the "illiquidity" characteristic of private firm transactions one can readily argue that the true market price of the entity under consideration is only known at that time when the buyer and seller come to agreement on price and the transaction is made.

When valuing a business, the purpose or aim of the valuation will impact the choice of approach. Consider the example of a lender such as a financial institution evaluating debt financing for a private firm. Here the lender is interested in determining the value of assets that may be secured as collateral for the debt. The more liquid the asset the more desirable to the lender; Accounts Receivable assets are likely far more attractive than inventory (of course these Receivables must be relevant – not attributed to "deadbeat" customers) and real estate is typically more desirable than manufacturing equipment. The attractiveness of these two examples is contingent on the lender's ability to promptly extract discernible value from these assets in the event of the borrower's default.

Consider the motivations of a seller in the approach of determining the "price" of a private business versus the motivations of a buyer (or perhaps lender). The approach used by these parties will likely differ as each focus on their individual specific value perspectives. Table 1, summarizes many of the motivations and value sought from both the buyer's and the seller's perspective. Understanding these motivations enables both parties to better understand the relevant value of the entity under consideration.

TABLE 1: BUYER/SELLER MOTIVATIONS

BUSINESS VALUE PERSPECTIVES	
Buyers Motivation	**Sellers Motivation**
Access to demand (new markets) • New or enhanced products/services • New or enhanced customers • New or enhanced geographic reach Access to supply/materials Access to intellectual property Access to service/production capacities Access to talent Integration (Vertical/Lateral) Growth Strategy Portfolio Strategy	Lifestyle • Retirement • Succession planning Divesture (Partial/Complete) Reorganization Harvesting Value (Partial/Complete)

APPROACHES TO VALUATION

A business or enterprise may be valued in several ways including:

- Asset valuation
  - Book value
  - Market value
- Historical Earnings
  - Multiples and drivers
- Discounted Cash Flow Analysis
  - Future earnings
  - Growth, Risk

ASSET VALUATION

This approach surrounds the purchase/sale of assets (tangible and intangible) within the firm. Some buyers prefer to purchase assets instead of the company or firm as a whole as they may be in need of only components of a firm and/or wish to avoid uncertainty related to any liabilities associated with the firm. These liabilities include activities that may not be readily reported or determinable such as future legal claims from customers, suppliers, employees or other stakeholders related to prior actions (or inactions) of the firm.

BOOK VALUE

The “book” value of assets is reported on the Balance Sheet of the financial statements. The “book” value is essentially the historical cost of the asset less any depreciation allocated against that asset. The relevance of “book” value for the purpose of valuation is tenuous in most cases. Consider the “book” value of capital equipment such as an assembly line or service vehicles or computer technologies. The cost of replacing these assets will often be significantly different than the “Book” value however the price one could command for these used assets may be something different again. Consider land assets, these are recorded on the Balance Sheet at historical cost and not depreciated (nor appreciated) in accordance with Generally Accepted Accounting Standards.

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MARKET VALUE

The “Market” value of assets is determined by the price a buyer is willing to pay for the asset and is indifferent to “Book” value. Using the example of a land asset purchased twenty years ago; this land would have a book value at historic cost but may have appreciated significantly over two decades or perhaps depreciated for a number of reasons such as environmental contamination. Even more liquid assets such as receivables or inventory may have a lower “Market” value in relation to their “Book” value as risk of non-payment or obsolescence will reduce their value. Market value may be estimated (by the price paid for similar assets in recent transactions under similar circumstances) and is only certain once a buyer has executed the purchase transaction.

HISTORICAL EARNINGS

Some business valuations use historical earnings as the underlying guide or driver of determining the price of a firm. This approach typically uses a “multiple” of historical financial performance and may include a measure of Revenue, Profit and/or “Free-Cash Flow” from operations. This is typically used for its ease of understanding such as “...the business is worth four times its net profit...” or “...a similar firm just sold for five times its bottom line (net profit) ...” Although these measurements do provide an ease in understanding the historical earnings of a firm, they are precisely that – historical – and therefore do not necessarily predict the future. Consider a firm that manufactures and/or services cash registers, public telephone booths or road maps; clearly new technologies such as computer terminals, mobile telephones and portable GPS devices are a significant threat to future earnings. Another firm may be strategically positioned through geographic advantages, new product/service offerings or improved long-term customer/vendor agreements. It is not difficult to see that historical performance in any of these examples (and countless other cases) does not, alone, reflect future performance and therefore would not make a relevant stand-alone measurement when valuing a firm or enterprise.

DISCOUNTED CASH FLOW

This approach is more complicated or involved compared to the above-described approaches to business valuation. Predicated on this method on considering the firm as an apparatus or system comprising of components, processes, activities, subsystems, inputs, and outcomes. The outcomes are the predicted or forecasted operating cash flows derived from the apparatus and these cash flows are subsequently discounted based on the risks associated with the realization of these forecasted cash flows.

The process involves:

- Identifying and separating any redundant assets
- Calculating the current cash flows or more accurately the "Free Cash Flows" (FCF's) from the firm
- Calculating all future FCF's contingent on
    - Growth assumptions
    - Investment in Assets (including replacement and Working Capital)
    - Synergies (this is more relevant from the buyer's perspective)
- Discounting all future FCF's to determine their present value contingent on
    - Time value of money
    - Market/business risks
    - Cost of capital
    - Opportunity costs

It is important to clarify that the valuation calculated by the seller may be significantly different than the valuation calculated by the buyer as each party will likely identify different FCF's and discount rates that vary in accordance with each party's perception of risk and cost of capital.

TABLE 2: SUMMARY OF VALUATION APPROACHES

BUSINESS VALUATION APPROACHES		
Approach	**Advantages**	**Disadvantages**
Asset valuation • Book value • Market value	•Simplistic measurable •Good for redundant assets or non-going concern	• Often too simplistic • Fails to assess any cash flow or dividend reward the assets may deliver
Historical earnings multiplier	•Better reflects rewards of the firm •Relevant for finite/predictable financial performance	•Does not consider: •Future growth •Synergies •Risk & capital cost
Discounted cash flow analysis	•Most sophisticated approach •Reflects growth synergies risk & capital cost	•Complicated approach •Requires forecasting & assumptions about future performance

SUMMARY OF APPROACHES

The key is to apply the right approach to relevant situation. For example, if a firm is no longer a “going concern” then the asset valuation for the purpose of sale is perhaps the most relevant approach. If a firm has a finite life with stable and predictable cashflows, then perhaps the historical earnings approach may be considered. However, with a sophisticated understanding of the Free Cash Flows, the relevant risks and the cost of capital the Discounted Cash Flow approach can be utilized by both buyers and sellers to best reflect the valuation of a firm from their diverse perspectives.

“BUY” OR “BUILD” DECISION

It is important to note that in most cases the buyer has the option to “Buy” or “Build” the required business sought to fulfill the motivation and should be expected to “Buy” only when the cost to “Buy” is less than the cost to “Build”. Time is a cost unto itself and if the cost to “Build” is less than the cost to “Buy”, but the time required to build creates costs or foregoes opportunity, then the buyer needs to understand this cost and make the relevant decision. With Table 1 as a guide, it is easy to see that in some instances the cost in time to build certain competencies may be very high. Consider a manufacturing firm that has won a lucrative contract to produce goods but doesn’t currently have capacity to meet the contract performance requirements. Without immediate capacity that manufacturing firm may lose the contract, be forced to accept performance penalties, or perhaps outsource the activity to a competitor and lose future opportunity. Time is also a significant expense when seeking proprietary knowledge of technology. The time required to imitate these types of assets can be significant if not impossible.

THE SELLER’S CONUNDRUM

Often the seller(s) of a private firm derives more value than just the cash flows from the annual net profits or retained earnings. Private companies may be managed by owners and family and friends of owners. The skill set of owners/managers is by its very nature not relevant in the start-up and/or running of their own firms. However, this skill set may not be a good fit in the role of a non-owner manager or employee. Many owner / managers recognize that they do not desire to be employees or would not be a good fit for many firms as the intrinsic rewards of leading and controlling an enterprise as well as the lifestyle ownership provides is seldom realisable as an employee.

These non-tangible rewards combined with the tangible perquisites that ownership provides (in addition to setting one’s own salary) must be understood when determining the total value a business provides an owner/manager. These rewards will, for all intents and purposes, be foregone in the event of the sale of the business.

STRUCTURE OF THE DEAL

Usually there is uncertainty from the perspective of the buyer as to the veracity of the information provided by the seller. The uncertainty surrounds undisclosed formal / informal / imminent liabilities (such as legal claims against the firm from customers, suppliers, and employees), likelihood of business demand meeting expectations (such as termination or non-renewal of long-term customer agreements), key managers leaving the firm in play to work for competitors (or establish a new firm). This uncertainty may be managed within the structure and covenants of the deal. Depending on the buyers' needs and capabilities the offer may include:

- Partial payment (20-50%) of the agreed upon price initially with subsequent performance levels or goals required for future payments
- Requirement of the selling owner(s)/principal(s) to remain with the firm for a specified period (1 to 3 or more years)
- Reduced or increased payment for diminished or improved performance targets

Naturally the seller is not obligated to accept these conditions however he/she should not be surprised in the event of an offer in this structure. It's important for sellers to understand that these types of deals will serve to reduce the uncertainty and inherent risk from the perspective of the buyer and this reduced risk will ordinarily increase the price. Further, the seller needs to consider the personal or corporate tax implications of any deal to fully understand the value created. Regardless, it is the acumen and skill of the buyers and sellers that will ensure the best outcome for both parties is negotiated.

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Terry has 30 years' experience managing multi-unit, transnational industrial service businesses and is dedicated to an unrelenting pursuit of continuous improvement and innovation. With sophisticated strategic planning skills, intellectual curiosity and determined attention to detail, Terry has developed a deep understanding of process challenges and controls.

A hands-on manager, Terry identifies and implements process management systems that empower employees and lead to enterprise success. Terry's strengths best serve those companies seeking improved organizational management and control and/or pursuing capacity improvement processes and systems.

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