Moore & Associates

Business Valuation Concepts

Overview

Business valuation is an important, yet complex, process that is frequently employed in a variety of business contexts. It is generally necessary to ascertain the value of a business when: selling to a third party, gifting interests to related parties, obtaining business financing, establishing a value for estate tax purposes, or establishing a value for purposes of a buy-sell agreement. Valuation is a specialty often practiced by certified specialists and experts familiar with valuation standards, concepts, industry metrics, financial principles, and additional relevant factors and variables.

Standards of Value

There are generally three standards a business valuation could be based upon: fair market value, fair value, and investment value. The purpose of the valuation determines the standard to be used.

- **Fair market value** is to be used in all instances where a business is valued for estate tax purposes. The value of the entity is based on a price that would be reached in a transaction between a hypothetical buyer and seller in an arm's-length transaction.
- **Fair value** arises in instances where shareholders seek a resolution for damages they incur from actions taken by the management of a company. When utilizing fair value, the value of a company is determined at a point in time immediately preceding the action that resulted in the erosion of the stock's value.
- **Investment value** is a value that is determined between specific parties subject to the transaction, rather than hypothetical parties. The analyst considers the proposed use of the business by the acquirers, their potential economic benefit stream, and their required rate of return in determining a value.

Approaches to Valuation

There are generally three approaches to business valuation: the book value, market, and income approaches. Each of these approaches has several methodologies that can be used to determine a value. The approach and methodology relied upon depends on the purpose and circumstances surrounding the valuation.

- The **asset approach** is the easiest to understand. Adjusted book value is used in cases where the fair value of assets is deemed representative of a company's value.
- With the **market approach**, a value is determined by using pricing multiples available from publicly traded companies, or recently published private transactions of companies which are similar in nature to the company being valued, to determine a value. Some of the more widely used multiples include Price to Earnings (P/E), Price to Sales (P/S), and Price to Market Value of Invested Capital (P/MVIC).
- The **income approach** derives a company's value either from capitalizing or discounting the projected economic benefit stream for that company. Generally, the capitalization of earnings method is used when a company's projected future earnings are expected to be stable. The process involves forecasting a plausible economic benefit stream of a company given the facts surrounding the valuation. The discounted cash flow method is used primarily when a justifiable forecast of a company's economic benefit stream is available to the analyst, and when the forecasted earnings entail an abnormal period of growth or decline over an identifiable period of time, which may be three to five years into the future.

Determining the Capitalization and Discount Rates

Understanding the Ibbotson Build-Up Method

- The cost of capital, also called the expected or required rate of return or the discount rate, can be viewed from three different perspectives. The first perspective is that the cost of capital is the required rate of return an investor would require from an investment in a company's equity and debt. The second perspective is that the cost of capital is the discount rate used to reach a present value of future cash flows. From a third perspective of a company, it is the return required to attract and retain capital in a competitive environment, where investors consider all possible best uses for their money.

  In determining the cost of capital using the Ibbotson build-up method, the return on an asset is estimated using an approach where a risk free rate and other risk premiums are added to determine an appropriate return based on a specific risk an investor assumes.
- Currently, historical returns for 30-year Treasury bonds are used to determine a riskless rate of return for an asset, e.g., 2.44% as of January 16, 2015.
- The equity risk premium is the additional return an investor would require to compensate for the additional risk associated with investing in equities as opposed to investing in riskless assets, e.g., 6.70%, the percent per annum arithmetic mean risk premium from 1926 to December 31, 2012, as provided by Ibbotson Associates.
- A small stock or size premium may be added to the cost of capital to account for the inherent risk associated with small company stocks, e.g., 9.74%, the percent per annum risk premium from 1926 to December 31, 2012, as provided by Ibbotson Associates.

- A company specific premium may be added to account for other risks specifically related to the company, such as management depth, importance of key personnel, stability of industry, diversification of product line, customer base, and suppliers, geographic location, stability of earnings, earnings margins and financial structure.
- A long-term sustainable growth often is also included in the computation of (subtracted from) the cost of capital for a business.

Discounts

There are several types of discounts that could be applied to a valuation of a business. Two discounts, discount for lack of control and discount for lack of marketability, are the most often applied discounts. The discount for lack of control takes into account the ability of a shareholder to dictate the uses of capital and economic benefit stream of the company. The less control a shareholder has over the sources and uses of capital the less attractive the investment becomes, which would warrant a larger discount on value. The discount for lack of marketability takes into account how active the market is for a business owner to sell his business interests. A business's size, its industry, its quality of accounting and internal controls, and other factors weigh in determining any discount for lack of marketability. The two discounts are not added together. First, any discount for lack of control is applied to the asset's value and then the discount for lack of marketability is applied to the adjusted value.

Positioning the Company for Sale

Maintaining Good Accounting Practices

A primary concern of potential acquirers is the quality of the financial statements of the target company. A company's financial statements tell its story to the reader. If the story is not to be believed, the risk to any potential acquirer may be too great to make an offer, or, if made, the offer may be less than otherwise would be made to take into account the perceived risk.

Maximize Goodwill

Goodwill is what drives a company's value above the fair market value of its assets. The fair market value of tangible assets provides a base by which a company may be valued. How those assets are utilized to generate cash flow accruing to the equity holders is what generates goodwill. Goodwill can be thought of as return in excess of the opportunity costs associated with the assets.

Ways to Increase Goodwill

- Over time, **good business practices** promote recurring business. Recurring business is what generates goodwill. Customers come to rely on the business to be fair in its dealings and its ability to provide a quality product or service. As your customers' comfort level in dealing with your business increases the perceived risk of doing business with your company lessens and the risk of switching to competitor increases, promoting the value of your company's name.
- There is a direct relationship between a company's value and the number of customers it serves. A **large customer base** diversifies the risk of losing business among many, lessening the risk of investing in the company. The loss of one customer among many customers will not have as drastic of an effect on the ongoing success of the company. As the customer list grows, the company has ever increasing control over pricing and margins, increasing the value of the company.

- Companies that are in a high growth phase have enormous cash flow requirements to support increasing working and fixed capital needs. A company can grow only as fast as its internal returns and its ability to borrow will allow. A balance needs to be struck between internal and external sources of financing. If a company does not borrow enough, it will not adequately seize its profit opportunities. If a company borrows too much, it risks not being able to meet its periodic debt service requirements. It is necessary to carefully monitor the company's liquidity ratios (Current and Quick Ratios, Accounts Receivable Turnover, Inventory Turnover, etc.), its leverage ratios (Debt to Equity, Debt to Assets), its coverage ratios (Times Interest Earned), and its operating ratios (Fixed Asset Turnover) to assure its ongoing success.
- Secure a **stable and motivated management team and skilled technicians** with the company. Having a stable management team and skilled technicians that will remain with the company when sold can ensure the buyer that the business will continue as usual, customer relationships will be maintained, the reputation of the company will remain intact, the rank and file employees will remain in place, vendors and lenders will feel secure, the company will continue to grow and the projected future cash flows are attainable. When the timing is right, consider identifying key employees and implementing a retention plan to assure they remain with the company.

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