

## Do You Value Your Business?

By: Paul Mangum

Well, of course you do. The better question is probably, “What is the value of your business? If you are the owner or part owner of a business it is likely you have thought about that at some point in your tenure as an owner. You may be thinking about selling your interest or perhaps you are doing some estate planning. Maybe it’s for bank or insurance purposes or perhaps you are admitting a new partner or getting a divorce. There are countless reasons why someone may want or need to know the value of their ownership interest in a business.

Where do you start? Many people start by looking around at the building and equipment and furniture and think they are what is valuable in their business. Surely the assets, the “stuff”, the things you can see and touch, are what’s valuable. Yes, they certainly are valuable but they may not be the items that determine the value of your business interest. In fact, in your particular case, they may not even be particularly relevant. How can that be? I’ll get to that in a moment – but the point I want to make at the start is that the balance sheet of a business does not necessarily determine the value of a business to its owners.

The most common standard of value in business valuation is “Fair Market Value”. The Internal Revenue Service, in the oft quoted Revenue Ruling 59-60, defined fair market value as “the price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts”. The Service further instructs that “all available financial data, as well as all relevant factors” should be considered, including nature and history of the business, the outlook for the economy and the specific industry, the earning capacity and financial condition of the business, the dividend paying capacity of the business, the presence of goodwill or other intangibles, previous sales of interest in the company and the market prices of public stocks in similar businesses.

There are several methods business appraisers use to value business interest. Each of these has variations and not every one is appropriate for the circumstances at hand. The three main methods are the Market Approach, the Asset Approach and the Income Approach. The application of each of these approaches usually starts with a value of the entire business which is then reduced to the level of the interest being valued if such interest is less than 100%. Further adjustment may be required depending on the characteristics of the interests.

The Market Approach analyzes sales of public companies in the same or similar industry under the theory that the public prices those shares by factoring into account the particulars of the industry and its prospects for the future, as well as expectations for the economy in general. It’s a conceptually appealing approach and commonly used. However, it is often difficult to find publicly traded companies that truly provide a meaningful comparison. Frequently, they are many times the size of our subject company, have multiple lines of business, deep management, sophisticated and complicated capital structures and international exposure. Even when a comparable company is found the appraiser must often make adjustments to accommodate for the increased risk evident in the subject company for items such as regional concentration, over reliance on just a few customers, lack of depth or experience in management, etc.

The Market Approach also encompasses previous sales of interest in the subject company. This is a very powerful indication of fair market value if the sales were at arms length. However, the appraiser must be careful to determine whether the fundamentals of the company's business have changed since the previous sale.

The Asset Approach determines fair market value by assuming that the company's assets are what give it value. It may be thought of as the "liquidation value" of the company. The starting point is to determine the current value of all the company's assets and liabilities. This approach is used mainly when the underlying assets are very valuable compared to the income they are producing, such as in a real estate holding company, or where the interest being valued is large enough to compel the liquidation of the company. It is not appropriate when valuing a minority interest in a company or with a service company or other company where it is apparent that the company is most valuable as an operating entity.

The Income Approach approaches fair market value by assuming that the value of the company is indicated by some measure of the historical or future earnings or cash flow of the business. For instance, if recent earnings are considered indicative of future earning capacity, then a weighted average of such years' earnings might be derived. This average would be "capitalized" at an appropriate rate to indicate the company's value. This is basically a variation of familiar "P/E" or Price/Earnings ratio commonly discussed in public stock market analysis. This method is most appropriate when valuing an operating business or when the interest being valued is a minority interest and the owner's value is determined basically by the ability of the company to make distributions or pay dividends.

As noted above, it may be necessary to adjust the value determined by one of these methods to reflect its characteristics. For instance, it would not usually be appropriate to value a 25% ownership interest in a business simply by dividing the value of 100% of the company by 4. This reflects the reality that a 25% owner lacks the ability to control the company. Such owner cannot compel liquidation, dividend payments, direct management, etc. Therefore a Discount for Minority Interest might be appropriate. Also, the shares of a closely held business cannot be easily and quickly sold on an established market such as the New York Stock Exchange. If an entity value is determined by using data from publicly traded securities, a discount to compensate for the time and costs of selling the interest or Discount for Lack of Marketability might be in order. On the other hand, if the interest is a majority or controlling interest, a premium for the benefits such interest confers might be considered.

The variations of these approaches are endless and each company is unique. An appraiser must understand not only the business and its industry but have a complete understanding of the type of interest the owner has. If you find yourself thinking about the value of your business, remember - it's about more than the "bricks and mortar".