

Lesson 1. Series: How to Determine the Value of Your Business

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Intro: This series addresses the often-asked question of how to determine the value of a privately held small business. The problem is that there is usually a lack of good data to use as a comparison. Unlike the real estate market where there are many transactions and most often those transactions are public in some nature, a small business sell is less common and usually the information from that transaction is not available to outside parties. So how do you determine the value of a small closely held business? This series will address some of the factors that determine value and some of the techniques used by people who do valuations. This series will not tell you the value of your business. After we have covered all aspects of determining value you may feel that you are better qualified to understand what drives value and maybe even knowledgeable enough to estimate the value of your business. That would be well and good. But this course is not about becoming a business valuator nor is it about teaching the business owner to determine the value of his business. It is about you learning how it is done.

What we will cover:

1. Course One: The basics. What determines value? How public companies can sometimes seem to be valued without regard to the company's financial condition. What you will need to know about a small privately held company to determine value.
2. Course Two: Risk drives everything. Understanding and trying to measure risk determines value. How to measure risk. What are some of the characteristics of high risk and low risk? Why are some industries considered low risk and others high risk.
3. Course Three: Reward is what you get for taking risks. What type of reward enters into measuring value? How is reward different than owner's compensation? How to adjust the reward analysis for owners comp. What are considered "normal" rewards for relative risks?
4. Course Four: Financial statement recasting. What does it mean? Why are statements restated? How can one owner be different in his analysis as opposed to another? What are usually considered add backs?
5. Course Five: Methods of income and benefit used in analysis. What is owner's discretionary income? How is this used to determine value in small businesses? What are

earnings before interest and taxes (EBIT) and earnings before interest, taxes, depreciation and amortization? Other types of income/earnings used in analysis.

6. Course Six: Valuing Intangibles. What are intangibles? Why is it important to place a value on intangibles? What aspects of a business increase/decrease the value of intangibles.
7. Course Seven: Methods used to arrive at value. Capitalization of earnings. Discounting future benefits.
8. Course Eight: Capitalization rates and discount rate. How they are calculated and what they mean to the value of a business.
9. Course Nine: Sample valuations. Will show the same company with the same set of facts value in different ways with remarkably different results.
10. Course Ten: Conclusions.

Our objective is to provide you with sufficient understanding to know what contributes to value in your business and what doesn't. This course is not all-inclusive and only attempts at a core understanding of the subject matter. Enjoy!

Course One

The value of any business is actually a very simple concept. But while simple in theory it is often difficult to actually determine. Value is based on the ability of a business to generate a stream of funds into the future. Or in other words how profitable will this business be in the years ahead.

If you could predict with complete accuracy the future profits (or cash flow) of a business you could easily determine its value. By knowing the future income stream, the value would be based on the investors (buyers) desired return as compared to other investment alternatives. So if a business could generate \$100,000 per year return to its owner without the owners active involvement and with some reasonable assurance that this would occur every year; the buyer might say the business was worth \$1,250,000 which would be a 8% return on his investment. Simple.

Now the problem; nobody knows the future. And with businesses you better believe you do not know the future. You could have a company with a consistent track record of increased profits for the last twenty years, and in the twenty-first year lose money! The reasons could be management, your product is suddenly obsolete,

the global economy, the national economy, the local economy, the weather, the stars; you name it and it can effect business.

So if determining the value of a business is based on predicting the future, you probably should go see a physic rather than a business consultant, right? Well maybe! The answer you get could be as useful. However there are ways of determining a Agood guess \cong at the future performance of a business; the past. Keeping in mind the example above of the company with a consistent twenty-year profitable track record and then losing in the twenty-first; nevertheless, in most cases the past is a very good indicator of the future. A company that has been in business twenty years is going to be a lot easier to forecast into the future than one that has been in business only a few years.

The quality and quantity of historical information enters into an analysis that determines the “risk” associated with the future of a business. The elements that determines risk are as numerous as the elements that effect a business performance; the global to local economies, competition, management stability, management skills, capital requirements, cost of capital, product/service stability, customer demographics, suppliers stability, location of the business and on and on.

Therefore in the simplest of terms a business is worth its ability to generate future profits (or cash flow) modified by a risk factor, which incorporates all elements of risk associated with predicting and producing those future profits. Easy to say, hard to calculate.

Shannon P. Pratt, a widely recognized valuation authority, describes this theory and its complications more elegantly:

A generally accepted theoretical structure underlies the process of valuing a business interest. In theory, the value of an interest in a business depends on the future benefits that will accrue to it, with the value of the future benefits discounted back to a present value at some appropriate discount (capitalization) rate. Thus, the theoretically correct approach is to project the future benefits (usually earnings, cash flow, or dividends) and discount the projected stream back to a present value.

However, while there is general acceptance of a theoretical framework for business valuation, translating it into practice in an uncertain world poses one of the most

complex challenges of economic and financial theory and practice.¹

Some of this may sound like gobbledygook, but if you are a seller or a buyer of a business it is important to understand the concepts of value. The value of your business may be determined by an industry specific rule-of-thumb or many other methods that attempt to simplify the basics described above into something that is easier to calculate and understand. But, it will be based on the basic principle of future benefits modified by a risk factor. Understanding this puts you in a better position to make a deal that works for you.

As we have recently seen in some of the more bizarre examples with .com public companies, value is based on a perception of the future. While the more dramatic examples of this tend to occur in publicly traded companies where individual investors may not be risking a large portion of their personal wealth, this is still a valid concept with privately held businesses. A business is worth what a “buyer/investor” perceives as future reward associated with the business. A business that has a unique concept or product will have a much higher “perceived” value to investor/buyers than a ho-hum business model.

The challenge to the valuator is to be able to understand and translate “sizzle” into value without overstating the future potential of an unproven business. The easiest business to value is one with a proven, stable track record; the hardest is one with great (but unproven) potential.

Our Next Course: Risk drives everything.

About the author. Ted Clifton is a principle in Clifton Carrillo Business Consultants, LLC, a Denver consulting firm, he is a CPA with 34 years business experience, 9 years as a business broker and consultant in New Mexico. He has done hundreds of business valuations for small and medium size privately held businesses.

¹Shannon P. Pratt, VALUING A BUSINESS, The Analysis and Appraisal of Closely Held Companies, Second Edition (Dow Jones-Irwin, 1981 and 1989), p. 35.