

Lesson 3. Series: How to Determine the Value of Your Business

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Course Three: Reward is What You Get for Taking Risks.

As we said in lesson two “risk” is the nemesis that must be recognized in business. Every business has risk. So why invest money and time into a business that has risk. The answer is reward. As businesspeople we risk our money and our time to achieve a greater success. That reward is usually more money. Although there are some situations where the reward is a combination of money and intangibles. For our purposes we will stick with the tangible reward of money or wealth. Invest \$100,000 in something you expect to receive a return for your investment. As we discussed in the last session your expectation of return will have to do with the risk of your investment.

So if you invest your \$100,000 in a government insured certificate of deposit at a local bank you would expect your return or reward to be relatively small. That type of investment is going to be relatively liquid (you can get your money on fairly short notice) and low risk; thus a low return. However if you invested your money with your next door neighbor who has convinced you that he has discovered a new way of catching mice you would expect a much higher return on your investment. Higher risk equals higher return.

With investments this concept is fairly straightforward. As a passive investor you provide your capital and expect a certain return. Also as a passive investor you can compare competing investments based on perceptions of risks and potential returns. If two banks were offering \$100,000 thirty day CD” one at 4% and one at 5%; it would not be a difficult decision to select which one to invest your \$100,000. However if you were trying to decide between the bank CD and a much riskier stock investment there would be many other factors to consider. Those factors would relate to risk and reward associated with the competing investments.

A small business investment is a much more complicated situation. The complications are affected by two main points (i) a lack of liquidity and (ii) active participation by the investor.

When you make an investment you anticipate that you will receive a return (reward) for your investment plus you will receive your

investment back at some point in the future. As in our example if you invest \$100,000 in a bank CD you expect to receive interest and your \$100,000 back. Or if you invested in a public company you might expect to receive dividends but most assuredly you would expect to be able to sell your investment for more than you paid.

When you invest in a small business you will also expect to receive a return on a regular basis and to be able to sell your investment at some time. This is a key issue in placing a value on a small business. Can it be sold? The market for small closely-held businesses does exist but it is not organized nor is it a disciplined market. As a result predicting the sale of any individual small business can be very problematic.

At our consulting firm we spend a great deal of time advising clients about this area. When you go into a business have some idea how you will get out. In order to maximize your investment you must be able to exit from your business. If you plan this exit strategy going in you are in a much better position to achieve a successful exit than if you wait until you need to sell your business.

This lack of marketability will come into play in many valuations of small closely held businesses. Often a business valuator will discount (or decrease) the value of a business due to this lack of marketability. Obviously being able to sell your business is a key element in its value.

Another key element in most business valuations is the owner's involvement and his or her compensation. The owner (investor) not only invests money into the business but also time. The money investment can usually be tracked and documented. But often the time commitment is more difficult to measure. If an owner consistently works 70-hour weeks for half of a "normal" manager wages what is the investment of that owner. Plus what is the reward from that same business if the owner at the end of the year shows a \$100,000 profit?

As we will see in the next session recasting or restating financial information is an important part of determining the value of a small business. That is usually due to the type of situation we described above. And also the owner will often take out additional compensation in ways other than as a salary. The owner in the above example expenses several automobiles through the company and "writes-off" a business trip to Hawaii every year. This often

becomes the biggest challenge of the business valuator; what is the actual reward that this business is generating to the owner?

The actual reward might be calculated as follows:

Business Income	\$100,000
Less Adj to owners comp To equal normal salary	- 50,000
Cost to replace add'l Time by owner	- 20,000
Plus Owners "perks"	<u>+ 15,000</u>
Business Return	\$ 45,000

After restatement (recasting) the business is generating a return (pre-tax) of \$45,000 for the capital invested. We went from a \$100,000 return to a \$45,000 return by understanding what is a reward and what is an investment.

The owner of a small closely held business has many "opportunities" to affect the financial performance of his or her business. To understand value it is imperative that the financial data and operational data be examined to recognize adjustments that need to be made. Sometimes this is called "normalizing" earnings. To adjust the actual financial data to reflect the operation without the "unusual" items that might effect in particular period.

This is an area of much confusion and disagreement. Often a seller of a business will identify one-time operational issues that have had a negative impact on the business and want them adjusted back into the profit mix. A buyer will say that those so-called one-time expenditures are really just a normal cost of business and should be deducted to determine profits. This can create a wide difference of opinion as to what "normalized earnings" actually should be.

Adding to this confusion is the fact that many different types of earnings are often used as the basis for determining value. We will cover this aspect further in session five. Some valuation models will used pre-tax income, or after-tax income, or earnings before interest and taxes (EBIT) or earnings before interest, taxes, depreciation and amortization (EBITDA). These are all simply measures of reward to the owner of the business.

While reward may come in many ways in owning a small closely held business, our concern regarding valuations is to measure the intangible reward that results from the investment in that business.

Combining this reward determination with our assessment of risk will start to lay the foundation to determine value.

Worth mentioning at this point is a brief discussion of rules-of-thumb. We will discuss this subject in greater detail in a later session, but at this point I would like to look at this most simple of valuation models. A rule-of-thumb is a simple method that is industry specific that takes a relationship between value and some common aspect of the business. This is usually a percentage of annual revenues (or multiple of monthly or annual revenues), a multiple of earnings (or some form of earnings) or possibly a multiple of some measure of unit unique to that industry (a value times the number of gallons sold).

These rules-of-thumb are based on collective data from that industry. As such they can be very informative in that they are based on market information. The biggest weakness (and therefore concern) is that they are based on averages and do not address specific circumstances of individual businesses.

Underlining all rule-of-thumbs are basic assumptions about risk and reward. The formula may end up being simple such as one times annual revenues, but built into that simplistic is the basic concept of return on investment and alternative investment options.

Next: Course Four: Financial Statement Recasting