

## **Lesson 2. Series: How to Determine the Value of Your Business**

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### **Course Two: Risks Drives Everything.**

Risk is the nemesis that must be recognized in business. When you go into a new business you are risking your investment of time and money. How much risk? Everyone has probably had someone offer him or her an investment in some scheme that was “just to risky” to consider. How that determination was made, whether intuitive or analytical, is at the heart of measuring the value of a business.

As we said in the last session if we were assured a certain return in a business venture it would not be difficult to calculate the value of that business. You would only have to determine what an acceptable rate of return would be and do the math. So if a business would generate \$100,000 per year before taxes with NO RISK what would the value of that business be? Depending upon competing investment opportunities we might say that the value of that investment might be \$1,500,000. That would be a before tax return of about 7%. If there was NO RISK a before tax return of 7%, during certain times, might attract significant investment.

On the other hand there are no small privately held businesses that do not have risk. Matter of fact most of these business have very high risk. To demonstrate the impact of the risk factor lets take the same numbers as above and say the risk factor is 35%. We will discuss how we can estimate risk in a little bit. So at a risk factor of 35% the \$100,000 in income would be worth \$285,000. We went from a value of \$1,500,000 to a value of \$285,000 on the same income based on risk.

If you are a business owner this is a very powerful concept to understand. How risk is measured and hence how it effects the value of your business. Certain industries have perceptions of risk and as a result there is only so much a business owner can do to affect the value of his business in those industries. However even the highest risk industries will vary tremendously within the industry group. For example; restaurants. This is obviously a very high-risk business. Almost everyone knows someone, or a relative of someone, who has failed in the food service industry. The reasons are numerous and go beyond our scope here. But suffice it to say this is an industry that goes through boom and bust cycles during the best of times. Even when other industries are doing

exceptionally well there will be restaurants going out of business. It is just the nature of the beast that the failure rate in restaurants is high.

But within this high-risk business there are going to be restaurants that will rate at much higher risk than others. Now the obvious element is size. A large operation with significant capital invested is less risky than a small mom and pop, right? Well not inaccessibly. Size is a factor in success but usually measured by the number of units. If you have the resources to expand your restaurant from a single location than you improve your odds of overall success. This seems to be a factor due to circumstances that can hinder one location and cause it to decline in business even when the owners are doing everything right. Such as road construction, or some other act of god or government, that causes the business to fail. So you should never have one restaurant, you should always open 2 or 3 or 5? The answer is yes, if you want to lower risk.

If you do not have the capital to open 5 restaurants rather than one, how else could you lower risk. Good documentation is a good way to lower risk. The better your record keeping the more accurate your decisions about your business. Especially if you were trying to sell your business good records have a lot to do with being able to measure the risk of the business in the future. Besides record keeping would be good documentation on the day-to-day operation of the business. While no small business owner wants to spend time developing these operational type materials it will have a lot to do with the risk of the business failing. I think this is common sense. The better documentation you have the better your business is managed. The better it is managed the more profitable it will be. Therefore someone might measure the risk of the business maintaining a profitable operation into the future by looking at your operational documentation.

Another factor that drives risk in restaurants and most businesses is employees. While employees do not show up on a balance sheet as a business asset, they usually are the businesses biggest assets. Well trained and well paid employees will provide stability to a business that will decrease the risk associated with the business.

Understanding the concept of risk in establishing value for a business is to understand what is inherently risky about business. You will not find a business that does not have risk. Some businesses have less risk and as a result will be “worth” more in relationship to their income. A good example would be income

producing real estate. Because of the stability (and scarcity) of real estate and that usually the income is contractually based income producing real estate will have some of the lowest risk factors in business.

For example if we assumed two businesses producing \$100,000 per year benefit to their owners (lots of details here we are ignoring to make a point); one an apartment building and one a trendy new restaurant serving squid tacos. The apartment building might have a cap rate of 10% (we will discuss cap rates in a future session) that would give it a value of \$1,000,000. The restaurant might have a cap rate of 40% that would give it a value of \$250,000. Two business both generating \$100,000 to their owners one worth 25% of the other one. That is due to risk.

Actually we should say that is due to the perception of risk. No one can know the future for sure (first lesson); so values are driven by perceptions of the future. It is this fact that can cause such significant swings in value from one industry to another. An industry that is “perceived” to be strong in the future will have a higher current value based on actual performance than one that is perceived to be weak. As a result you can have some “old economy” type industries valued at rather low factors of their earnings and companies engaged in “new economy” speculation value at perceptions that don’t make much sense.

When someone is hired to value a privately held small business one of the key factors they need to determine will be a risk factor. This risk factor analysis becomes the capitalization rate and discount rate to determine value. One of the methods used is called a build up method. Which takes key elements of a business and assigns a rating or percentage based on the risk for that particular business. This model will begin with a risk-free rate (say 6%) and add additional percentage points based on the analysis by the valuator. An example might be:

Risk Free	6.0
Management	2.0
Industry	4.0
Key Employees	3.0
Marketing	1.0
Facilities	1.0
Record Keeping	<u>1.5</u>
	18.5

For this business the risk factor or capitalization rate might be 18.5%. Without knowing anything about the business we can see

that the valuator thought the industry had slightly higher risk, management was pretty good, maybe missing a key employee, but the business had good marketing, facilities and bookkeeping. Keep in mind that another evaluator might come up with an entirely different set of numbers. While there have been some tremendous improvements in the quality of business valuations there is still a great deal of judgment that enters into the decision.

While professional valuers would like to be able to eliminate “judgment” and replace it with scientific formulae, the real world deals with this judgment everyday. Much of the risk analysis that is done regarding a small business is intuitive. Someone trying to buy a small business will make these intuitive judgments in determining what they offer for the business. A good example is reflected in my experiences as a business broker. If a business had a well-kept building there was a perception that management was doing a good job. I was specifically told on a multiple million-dollar deal that one of the main reasons the buyer went forward with the deal was the housekeeping of the plant. What that buyer was doing was intuitively assigned a lower risk factor to that business because of the way they maintained their physical plant.

**Course Three: Reward is what you get for taking Risks.**