



Business Valuation White Paper

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When business owners first meet with an exit planning advisor, they are often surprised that one of the advisor's first recommendations is to obtain a certified valuation of the company. Owners usually react in one of the following ways: "Now? I'm not planning to leave for years!" or "I know what this company is worth. I built it!"

Before you jump to any of these conclusions, understand that using the services of an experienced business appraiser to value your company as you transfer it to successors may help you avoid an unpleasant encounter with the IRS and help you to reap all of the value of your life's work. It also is important to realize that obtaining a value helps to dispel many of the common misconceptions that owners have about the value of their businesses and what the values mean to their overall exit plan. For instance, if an owner feels that his or her business is really worth, say, \$5,000,000 according to a rule of thumb or based upon what a similar business sold for, that owner may be reluctant to move forward with Exit Planning because he or she wants or needs twice that amount to feel financially secure. Likewise, an

owner may believe the business to be worth \$10,000,000, an amount sufficient to meet his or her financial security goal, and therefore believes no additional planning is needed. However, the owner may later discover when the business goes to market that it is only worth half that amount. At this point, it is too late, or the owner may be too burned out to spend the time, effort and money necessary to grow business value.

Even so, you may still question the importance of valuations in the Exit Planning Process. You may see the process and cost of a valuation as simply another barrier to your ultimate destination of leaving your company. So, is a valuation really necessary? And if so, how much will it cost and who should conduct the valuation?

The answers to these questions will be answered as we look at six reasons why smart owners secure independent business valuations.

Reason One

Exit Planning is a seven-step process that is completely focused on each owner's unique

objectives. A major objective shared by many owners is to receive full, fair value for their ownership interest. When discussing the value of their lives' work, most owners are not comfortable with rules of thumb, informal or casual estimates because rules of thumb rarely take into account variations in revenue, cash flow, location, reputation, proprietary technology, contingent liabilities and other factors that may have a significant effect on the value of a particular business. How do you determine the full, fair value of a business unless an experienced, trained business valuation specialist values it?

Ask yourself this question: If you sold your business to a sophisticated outside buyer, would that buyer acquire the business without first determining its worth? Of course not—nor should you sell or transfer your business to anyone without *first* determining its worth.

Reason Two

When thinking about your business exit, one of the first questions you must answer is, "How much will you need from the sale of your company to maintain the lifestyle you want for yourself (and your family) in retirement?" The companion question should be, "Is the business worth enough (on an after-tax basis) to support those needs? You must know this answer before you can successfully proceed down any exit path.

Let's look at this simple example. Suppose a business owner is prepared to leave his/her business, subject to being financially secure and

independent. In most cases, the source of the financial security is predominantly from the conversion of business value to cash (with taxes being paid). Knowing the business value well in advance of the ownership transfer is imperative. Again, if the owner believes the value to be higher or lower than it really is, this causes the owner to take the wrong set of actions or inactions.

If the value is higher than believed, the owner can leave sooner rather than later. If the value is lower, there is work to do that the owner may have thought unnecessary. So, how can you develop an exit strategy based on obtaining financial security without starting with a reliable valuation?

Reason Three

It surprises many owners to learn that business value is relative, not fixed. It can vary based on the reason for transferring ownership and on the conditions under which a transfer is made. For example, an appropriate business value for a third-party sale may be significantly higher than that established for a transfer of the same business to key employees over time, or a gift of the business to children. Business valuation experts understand this, "rules of thumb" don't.

The classic example we've seen many times is the owner using a valuation guesstimate based on sales of comparable businesses to third parties—and applying that value to a proposed sale to the company's key employees—who have no money. The result, in the unlikely event

that the sale goes forward, is frustration and failure as the cash flow of the business cannot, after taxes, support the higher valuation using a third-party sale value approach. The solution is to have the business valued both from a full fair value perspective—perhaps a third-party sale scenario—and from a transfer to insiders approach, with the difference in value being paid to the owner via other and more tax effective methods.

Value is not only relative, it fluctuates. In co-owned companies, unless the value established for the buy-sell agreement is updated periodically, one owner may receive too much or too little (upon death, disability or departure), while the other pays too much or too little. Using outdated valuations often results in litigation (and subsequent loss of business value) as the remaining owner goes to court.

Likewise, if you are contemplating a sale to a third party, the business value is dependent not only on the intrinsic value of the business, but on the “external” condition of the mergers and acquisitions market for that type of business in that particular geographic area as of now—not six months or two years ago. The mergers and acquisitions cycle is continually changing based on a variety of external factors, such as the cost of financing, the state of the stock market and the availability of capital, all of which dictate not only the EBITDA (Earnings Before Interest, Tax, Depreciation and Amortization) multiple, but the terms of a possible third-party deal. This also effects how much of the deal price is to be paid

in cash, in the form of a seller carry back note, or represented in an earn-out.

Reason Four

An important part of The Exit Planning Process™ (Step Three) is growing the value of the business. Whether you are contemplating a transfer to insiders or a sale to outsiders, it is important to motivate and keep management/key employees. Incentive programs that both motivate and “handcuff” employees to a company are typically based on formulas. The most successful of these incentive programs (whether cash- or stock-based) use formulas that link the size of a bonus to growth in business value. Participating employees are justifiably interested in knowing how the business value was established, how it is measured and whether the value is fair to them. Relying on an outside appraiser is often the best way to dispel management/key employee concerns.

Reason Five

If you are considering a transfer to key employees, do you believe that your employees will accept an unsupported valuation? Bear in mind, they likely have little sense for what the business value is, or how it should be determined. Even though you may (for tax and other reasons) decide to sell the business at a low value, employees may not consider the value to be low. It is best to anticipate these concerns and to obtain an independent valuation at the outset of the planning process.

The fair market value will likely be the value that you want and are willing to sell the business for. The valuation establishes that the fair market value is the appropriate value as well. Yet, as the following explains, this is not the value at which the employees will buy much of the ownership. A common technique is to allow the buying employees to purchase an initial amount of ownership, valued using a minority discount. This not only makes the purchase feasible, but the employees realize they are getting a “deal” when they contrast their per-share purchase cost with the fair market value determined not your accountant, but by an independent, certified valuation expert.

Reason Six

In a transfer to key employees, a common transfer technique (designed to reduce both owner’s and buyer’s tax liabilities) is to initially transfer a minority interest at a discounted value. Using a “rule of thumb” valuation to support a minority discount simply will not fly when the IRS asks you to justify the discount. You must depend on the valuation of an independent valuation specialist who is able and willing, to defend the valuation before the IRS.

Since a valuation is necessary to implementing a successful Exit Plan, why not obtain it earlier in the process so that it can be used as a basis for all planning – establishing value and related incentive planning to the acquiring key employees, using it as the basis for gift planning if a transfer is to children, using it to reaffirm the expected sale price if you choose a third-party

sale exit path, or determining how much value needs to increase to reach your Exit Objectives? After all, in the words of Yogi Berra, “You’ve got to be very careful if you don’t know where you’re going, because you might not get there.” Yogi Berra wasn’t an Exit Planning specialist, but he was on to something. You simply can’t be efficient and effective in growing value, if you don’t know the start and end valuation points.

How much does a valuation cost? How about a lawyer’s answer – “it depends?” Valuation costs range from zero to \$25,000 for a fairly straightforward company. Valuation services are available online and from non-certified advisors. Valuations are often performed by transaction intermediaries or CPAs who may or may not have formal training and certification. These valuations are often performed for little or no cost. These valuations are often useful—especially if you are contemplating a third-party sale. Using an investment banker or business broker provides you with a picture of what is happening today in your merger and acquisition market segment.

Many business valuation specialists will provide an “estimate of value” or a “calculation of value” that falls short of being an opinion of value, but can be effectively used for planning purposes. When an ownership transfer is imminent, that “calculation of value” can be fleshed out to create a valuation opinion. For a “normal” business with \$10 million or so in revenue, a valuation typically costs \$5,000 to \$15,000 and a “calculation of value” costs 60 to 75 percent of

that amount. When the value calculation is upgraded, an additional 25 percent or so is charged. Thus, valuation calculations might typically cost about \$5,000 if the valuation cost is about \$7,500 to \$8,500. Having said this, the complexity of valuations varies tremendously based on the companies being valued – the cost of valuations varies significantly between different regions of the country, as well as among the many valuation firms or individuals in your community. It is important to interview local appraisers during the early stages of the Exit Planning process. The bottom line is this: valuations are not costly – a business worth even \$1 million can easily afford a valuation.

If the cost of a valuation seems unnecessary, compare it to the cost of underestimating the company's value (thus leaving money on the table), or of defending a rule of thumb value before the IRS – unprotected by a proper valuation. The uncertainty of value undermines the entire purpose of performing effective planning – if you don't know what you have, how are you going to get more? Plus, the money you

saved by foregoing a valuation will make a nice down payment on your legal fees.

Who should you use? The short answer is a credentialed valuation expert. Do not use anyone else (with the possible exception of valuing a very small business that has no proprietary technology, such as a small retail store, franchise restaurant or service business with only a few employees). Common certification designations are CVA (Certified Valuation Analyst), ASA (American Society of Appraisers), ABV (Accredited in Business Valuation) and CBA (Certified Business Appraiser).

CONCLUSION

The transfer of your ownership interest is the final act in your business career. Doesn't it make sense to be certain that everything has been done to maximize the value of your life work?